91st Congress } COMMITTEE PRINT
1st Session }

TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED WEDNESDAY, OCTOBER 8, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: Foundations; General)

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
33-758 O WASHINGTON : 1969

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

CLINTON P. ANDERSON, New Mexico
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
FRED R. HARRIS, Oklahoma
HARRY F. BYRD, Jr., Virginia

JOHN J. WILLIAMS, Delaware
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming

TOM VAIL, *Chief Counsel*
EVELYN R. THOMPSON, *Assistant Chief Clerk*

CONTENTS

PART A—WITNESSES

Foundations

	Page
Honorable Ben B. Blackburn, United States Representative, State of Georgia	1
Mrs. Bruce B. Benson, President, League of Women Voters of the United States	18
Paul Anthony, Executive Director, Southern Regional Council	28
Laurence Speiser, Esq., Director, Washington Office, American Civil Liberties Union	61
Reed Larson, Executive Vice President, National Right to Work Committee	78
Richard E. Thigpen, on behalf of The Duke Endowment	93
Honorable Justice Arthur J. Goldberg, on behalf of the Denver Post and the Denver Post Employees Stock Trust	100
Dr. Kenneth B. Clark, President, Metropolitan Applied Research Center, Inc	145
John M. Stalnaker, President Emeritus, National Merit Scholarship Corporation of Evanston, Illinois	155
Roger A. Clark, Counsel, Morris and Gwendolyn Cafritz Foundation	177
Lyman C. Conger, Chairman of the Board, Kohler Co., Kohler, Wisconsin	203
Albert E. Arent, on behalf of the Phoebe Waterman Foundation, Inc., Philadelphia, Pennsylvania	235
Isaac N. P. Stokes, Chairman of the Board and General Counsel of Phelps-Stokes Fund	245
William H. Baldwin, President and Trustee, Kresge Foundation	261
Sydney Howe, President, The Conservation Foundation	275

PART B—ADDITIONAL STATEMENTS

Foundations

Mills E. Godwin, Jr., of Virginia, Retiring Chairman, and Governor Buford Ellington, of Tennessee, Incoming Chairman of the Board, Southern Regional Education Board	288
Dr. Jonas Salk, Director, the Salk Institute for Biological Studies, San Diego, California	297
Dr. Malcolm Moos, President, University of Minnesota	318
James Day, President, National Educational Television and Radio Center	325
Dr. Charles L. McClaskey, President, National Association of Foundations, Inc	363
Robert B. Nelson, Esq., on behalf of the Weatherhead Foundation and The National City Bank of Cleveland, as Trustee Under the Will of Albert J. Weatherhead, Jr	375
C. Maxwell Stanley, Muscatine, Iowa	381
Milton E. Meyer, Jr., Hindry & Meyer	385
Joseph G. Engel, President, N. R. Leavitt Foundation	389
Paul R. Haas, Chairman, Board of Trustees, The Moody Foundation	411
Julius A. Rippel, President, Fannie E. Rippel Foundation	415
New York State Bar Association, Tax Section, Prepared by Special Committee on Exempt Organizations	425
Landrum Bolling, President, Earlham College, Richmond, Indiana	443
Richard F. Barrett, on behalf of The Stackpole-Hall Foundation, St. Mary's Pennsylvania	451
Mr. J. Roscoe Miller, Chancellor and President, Northwestern University	519

IV

General

	Page
Walter P. Reuther, President, United Automobile, Aerospace, and Agricultural Implement Workers of America (UAW)	459
Otto H. Loser, City Comptroller, Chicago, Illinois	483
American Industrial Clay Co., of Sandersville, Engelhard Minerals & Chemicals Corp., Freeport Kaolin Division of Freeport Sulfur Company, Georgia Kaolin Company, J. M. Huber Corp., and Thoele Kaolin Co	491
Henry C. Van Rensselaer, Vice President and Director, Bow Valley Industries, Ltd	501
Jaye F. Dyer, Executive Vice President, Apache Corp	509
New York State Bar Association, Tax Section, Prepared by Committee on Employee Benefits	535
Louis O. Kelso and Norman G. Kurland, Institute for the Study of Economic Systems	589
Kenneth M. Plaisted, General Counsel, National Board of Fur Farm Organizations, Inc	707

STATEMENT OF THE HONORABLE BEN B. BLACKBURN - October 8, 1969

MR. CHAIRMAN:

I appreciate your affording me the opportunity to appear before your Committee. We are all aware of the need for tax reform and the elimination of the abuses now occurring under the present Internal Revenue Code.

I would like to discuss the tax abuses of organizations enjoying special tax-exempt status under existing provisions of law. Many of these organizations engage in political activities which by reason of tax privileges are being subsidized by the Federal Treasury. My purpose in being here today is to call the Congress' attention to some examples of political activities which I personally, and many others, consider to be improper activities by groups enjoying special tax privileges and to suggest possible ways of preventing future abuses.

Tax-exempt organizations are classified under Section 501(c) of the Internal Revenue Code of 1954. Under this section, 17 types of organizations are excluded from taxation. I would like to discuss those found under Section 501(c)(3) and Section 501(c)(5).

The organizations operating under the provisions of Section 501(c)(3) of the Internal Revenue Code exist for purposes of charity, scientific research, religious functions, public safety, promotion of literary or educational endeavors or the prevention of cruelty to children or animals. The Internal Revenue Code further provides that no

substantial part of the activity of any such organization (generally referred to as a "foundation") is to carry on propaganda or otherwise attempt to influence legislation. The Internal Revenue Code further prohibits participation in political campaigns.

In my opinion some organizations have flagrantly violated this section of the Code. The violations have been tolerated due to ambiguity in construing the phrase, "substantial part." It has been commonly held by I.R.S. and other authorities in this field that 10% or more of the funds of any organization would be considered a "substantial part." 10% of the Ford Foundation's assets as of 1968 would be approximately $3,060,436, whereas 10% of some small church group could amount to less than $500.

Tax-exemption is a privilege! There are many different spokesmen for groups presenting their views on legislation before both houses of Congress. Most of these spokesmen do not enjoy tax-exempt status. The government should not subsidize one group's political activities, by allowing any tax-exempt organization to engage in lobbying activity.

As an example of this misuse of privilege, I would like to invite the attention of the Committee to a group which was recently formed to actively lobby against the ABM proposal. This tax-exempt organization is supported primarily by contributions from religious organizations. Its headuqarters is in space granted to it in the Methodist Building at 100 Maryland Avenue, N.E. This group has

lobbied against the proposed ABM system. A few days ago a representative from this group came to my office and presented my staff with further information concerning its opposition to the 1968 Military Authorization Bill. Attached as Exhibit A is a copy of the material which I received, along with a list of the organizations which provide it with financial support. Over 50% of the groups listed are church-affiliated and therefore exempt under Section 501(c)(3) as religious organizations. The business of the nation's defense can in no logical way be related to religious under takings.

I would also like to invite to your attention the National Students Association (NSA). I have closely reviewed the tax returns of this group. That group is clearly and heavily engaging in political activity. In fact, political activity has become such a large part of the group's activity that a subsidary organization, the National Students Institute has been formed to conduct the non-political activities the NSA was previously performing. It appears that the National Students Institute, which is now a tax-exempt organization, will serve the function of raising funds through through soliciting tax-deductible contributions and then contributing these funds to the National Students Association. The national convention of the National Students Association has advocated the abolishment of the House Un-American Activities Committee (now the House Committee on Internal Security), the

repeal of the McCarren Act, passage of Civil Rights legislation, the admission of Red China to the United Nations and various "Vietnam Summer Activities." Attached as Exhibit B is documentation of these activities. Furthermore, I was distressed to learn that the new National Students Institute, as incorporated under laws of the District of Columbia, has a Board of Directors identical to that of the now tax-paying NSA. Its bylaws are very similar and it utilizes the same facilities as the NSA. The NSA has not filed tax returns for the past two years, and no explanation is forthcoming from the IRS.

The 1965 and 1966 returns of this organization list its specific grants and their purposes. Present reporting laws are wholly inadequate for any person to know whether or not the National Students Association is engaged in legal activities under its tax-exempt classification. The NSA granted in 1966 to the Southern Student Union Relations $36,317.18, the Fast for Freedom Fund $20,365.39, the Student Stress $890.52, and Southern Literacy Project $363.75. These are just a few of the specific grants listed by this organization which dispensed a total of $551,397 in 1966. The Library of Congress has advised me that it is impossible to discover the purposes or functions of the recipient organizations. A close examination of the tax returns does not provide sufficient information. For the Committee's information, attached as Exhibit C are copies of the NSA's tax return for 1965 and 1966. —

Briefly, one more group I would like to bring to your attention is the National Education Associaton (NEA). This group, which is organized for the promotion of education has endorsed numerous political position including Home Rule for the District of Columbia and fair housing legislation. I do not feel that this activity is related to the promotion of education.

I know that the members have followed the revelations of various activities of his committee of tax-exempt foundations. In the hearings on Tax Reform before the House Ways and Means Committee, Representative John Rooney of New York presented a clear picture of misuse of tax-exempt funds. In Representative Rooney's race in the Democratic primary, he was opposed by one Frederick Richmond. Mr. Richmond is head of the Richmond Foundation. During the election, Mr. Richmond's foundation gave numerous grants to different ethnic groups within the Congressional District. The campaign staff of Mr. Richmond was also the staff of the Foundation. In Mr. Rooney's statement he revealed that some of the expenses of the campaign were paid out of the Foundation funds under the title of such things as printing expenses and stationary accounts. Finally, Mr. Richmond encouraged his contributors give directly to the Foundation, thus making their contributions deductible on their income tax returns. I would advise members of the Committee to read Mr. Rooney's testimony since it gives one of the best examples of political

activities by tax-exempt groups.

In July of 1967, the Ford Foundation made a grant of $175,000 to the CORE Special Purpose Fund of New York to be used for: (1) a youth training institute; (2) an adult training institute;and (3) a voter registration drive. This grant was supplemented in 1968 with another $300,000. These funds were actually used in voter registration dirves in Cleveland, Ohio. Many political analysts believe that because of the registration activity by CORE through the financing of the Ford Foundation, Carl B. Stokes was elected Mayor of Cleveland, Ohio in 1967. By such activity the Ford Foundation through its economic power, augumented by special tax privileges is having a decisive political power which is resulting in the election of political candidates. No more effective political influence can be found!

I have stated many times that in the political arena all combatants should operate under the same set of rules. I know that every member of the Committee would object strongly to having a tax-exempt group pour funds into his opponent's campaign. Under the Tax Reform Act recently passed by the House, foundations are precluded from engaging in voter registration drives except when the foundation supports voter registration drives in five states. Thus, the Ford Foundation, for example, can avoid the effect of the legislation by supporting five different voter

registration drives in five different states.

No discussion of political activities by tax-exempt groups would be complete without some attention to labor organizations as classified under Section 501(c)(5). From mutual experience in politics, I think we would all agree that money is the mother's milk of a political campaign. To the degree that one candidate receives direct or indirect financial or material support for his campaign from a source that enjoys financial subsidy through a special tax privilege, to that degree the equality of rules between two political candidates is greatly upset. Labor unions do not deny the use of union dues for political activities, When a member of a union pays his dues, he is paying for political action. The organization insists that their political activities are carried by a separate organization known as the Committee on Political Education (COPE). However, as it was reported during the last election, the full staff of the national office of the AFL-CIO was brought to work for COPE and on the local level union officials were employing their union staff to engage in campaigning for favored candidates. Numerous cases have come before the Federal Judiciary in which union members have objected to political use of dues for political activity. For the information of the Committee the cases are as follows: United States v. Anchorage Federal Labor Council 193 F. Supp. 504 (1961); United States v. Planters Local #481 et al 172 F. sd 854 (1949); United States v. International Union United Automobile, Aircraft and Agricultural

Implement Workers of America 352 U.S. 567 (1957); and United States v. CIO 335 U.S. 106 (1947).

There is a contention that political funds are contributed voluntarily. To work on an American flag ship, a seaman must be a member of the International Seafarers Union. Members of this union have been compelled at times to "contribute" (or as the union leaders would say, have voluntarily given) 1/3 of their income to political activities. I think it is insulting the intelligence of Congress to argue that these funds are granted voluntarily. Not even politicians devote 1/3 of their income to political campaigns.

The Internal Revenue Code provides that all 17 types of organizations classified under Section 501(c) cannot engage in support or opposition to any political candidate. However, for some strange reason, the IRS has consistently ignored the mandate of the law. Attached as Exhibit B are copies of letters sent by the Internal Revenue Service to one Mr. Reed E. Larson and one Mr. F. R. Dickerson attempting to explain why only labor unions are exempt.

The Federal Corrupt Practices Act provides that neither corporations, or trade organizations,or labor unions are allowed to contribute funds to the support or opposition of any political candidate or party. It seem that the IRS is not

aware of the Corrupt Practices Act which is enforced by the Justice Department. In Baltimore, a Grand Jury hearing is now being conducted concerning campaign contributions by the Seafarers International Union to various candidates for Senatorial seats. I think it would be appropriate for the Congress to demand that the IRS investigate the tax-exempt status of the Seafarers Union.

During the course of my testimony today, I have cited several problems which exist under the present IRS Code. When the members of the Committee examine the tax returns of tax-exempt organizations, you will see that it is virtually impossible to determine how these funds are bineg used. I propose that the Committee require a full explanation of the purpose of each grant, contribution, or gift made by a tax-exempt organization along with the identities of the chief officers and executive directors of recipient organizations, The law should provide criminal sanctions should such officers or executive directors use funds for purposes other than those permitted by law. Only by providing full disclosure from tax-exempt organization can we possibly curb the misuse of funds.

Earlier this year, when I appeared before the House Ways and Means Committee on this matter, I outlined for them the legislation which I was introducing. My ideas are contained in H.R. 7432. Essentially this bill is divided into two sections. The first section pertains to organizations classified under Section 501(c)(3).

I will not take credit for the ideas found in this section since they were originally proposed by the Subcommittee on Tax-Exempt Organizations of the American Bar Association. The Subcommittee recommended that all organizations classified under this section shall have the right to defend themselves whenever their tax-exempt status is threatened. Furthermore, they should be permitted to appear before Congressional Committees and submit reports to them concerning matters of direct interest to the organization. By direct interest I specifically mean the purpose for which the organization was granted exemption.

The second purpose of my bill is to prevent any tax-exempt organization from directly or indirectly contributing any material support for the promotion or opposition to any candidate or any political party. I would sincerely urge the Committee to give consideration to my proposal. A copy of my bill, H.R. 7432 is attached as Exhibit F. Finally, I would request that the Committee review the House language with regard to voter registration drives conducted by tax-exempt foundations. In my opinion, the present language is inadequate.

Finally, if meaningful control over the use of special tax-exempt funds is to be achieved more complete reporting laws are essential. Criminal sanctions are a necessary adjunct to such control where abuse of funds for non-permissible purposes is discovered.

Mr. Chairman, I believe that you and the members of your Committee are anxious to provide the American people with needed tax reform. I appreciate your affording me the time to make this brief contribution.

League of Women Voters of the U.S.
1730 M Street, N.W.
Washington, D.C. 20036

October 8, 1969

BEFORE THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

Statement of Mrs. Bruce B. Benson, President
League of Women Voters of the United States
Concerning H.R. 13270

<u>SUMMARY OF PRINCIPAL POINTS</u>

H.R. 13270 raises serious problems for organizations like the League of Women Voters Education Fund and the Overseas Education Fund of the League of Women Voters, which are independently engaged in nonpartisan educational work but which receive a significant part of their financial support from private foundations.

I. Under proposed section 4942, contributions to non-operating private foundations are excluded from the definition of "qualified distributions" and therefore will not help a donor foundation avoid the tax on undistributed income. Unless it is absolutely clear that the Education Fund and the Overseas Education Fund are <u>not</u> non-operating private foundations, we have reason to fear that private foundations will withhold their contributions to these Funds -- contributions which are vital to the continuation of their work in teaching the responsibilities of citizenship. The line between private foundations as defined in proposed section 509 and publicly-supported charities is a shadowy one and it will be difficult to predict from year to year whether the Education Fund and the Overseas Education Fund will qualify as publicly-supported organizations. It appears unlikely, moreover, that the precise requirements for qualifying as an "operating foundation" can be met.

We suggest (1) that an effort be made to define the category of private foundation more narrowly and (2) that the effective date of the new legislation

33-758 O - 69 -- No. 19 -- 2

be deferred until some time after the Treasury Department has promulgated its final regulations thereunder. In addition we support the very helpful proposal made by the Treasury Department in its Technical Memorandum of September 30, 1969, that distributions to private foundations be considered "qualified" if the recipient organization applies the contributions directly to charitable activities within one year of receipt.

II. We are also greatly disturbed over the provisions of proposed section 4945 which impose a 100 percent tax on private foundations and a 50 percent tax on foundation managers for any amounts expended --

"(1) to carry out propaganda, or otherwise attempt to influence legislation,"

or "(2) to influence the outcome of any public election (including voter registration drives carried on by or for such foundation)".

With respect to the first of these provisions only, an exception is made if the activity is limited to "making available the results of nonpartisan analysis or research". However, any organization operating in the area of citizen education and dealing with subjects of civic concern runs the risk that those who deem themselves adversely affected by the organization's activities, no matter how nonpartisan or objective, will accuse the organization of attempting to influence legislation and demand that the punitive taxes of section 4945 be imposed. Furthermore, there is the risk that such subjects may become issues in an election, in which case the exception for nonpartisan analysis or research is not even applicable. These risks are intrinsic to educational work in the field of government and politics. Organizations like the Education Fund, never certain whether in any particular year they will be held public or private, can continue to function only at great peril. Reasonable protection is given to foundation managers by imposing the penalty only if they make the expenditure "knowing that it is a taxable expenditure". The same good-faith defense should be available to the foundation itself.

League of Women Voters of the U.S.
1730 M Street, N.W.
Washington, D.C. 20036

October 8, 1969

BEFORE THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

Statement of Mrs. Bruce B. Benson, President
League of Women Voters of the United States
Concerning H.R. 13270

I am Mrs. Bruce B. Benson of Amherst, Massachusetts, President of the League of Women Voters of the United States. I am appearing in behalf of the League and our two affiliated organizations, the Overseas Education Fund and the Education Fund. The League, which will be 50 years old next year, is an organization of nearly 160,000 members in 1285 local Leagues in the 50 states, the Virgin Islands, the Commonwealth of Puerto Rico, and the District of Columbia. During its history, the League throughout the country has been actively involved in working to increase citizen participation in government at all levels. Through election Voters Service the League encourages people to register and to vote and helps them to vote as informed citizens by providing objective non-partisan information about candidates and pro and con information on issues. Our Voters Service work is not limited to election time. Throughout the year, the League works to involve people in learning about and participating in government and politics at all levels.

Overseas Education Fund

In 1947 the League of Women Voters of the United States established a non-profit, educational affiliate now known as the Overseas Education Fund of the League of Women Voters. This was in response to requests coming to the League from individuals and organizations of other countries for assistance in developing responsible citizenship and effective civic organizations. It is the goal of the Overseas Education Fund to encourage and assist the development of citizen

initiative, participation, and action in other countries within the framework of their own culture and to help voluntary groups work together to identify realistically their needs and evolve ways of meeting them. The methods employed by the Overseas Education Fund include briefing and scheduling travel of nationals of other countries who are in the United States and interested in aspects of United States government; conducting annual seminars for women community leaders from Latin America to observe citizenship and volunteer activity in the United States; and administering a four-month Institute presently based at Boston University for foreign women leaders which focuses on organization techniques and citizen involvement in community programs and includes field work in Boston and surrounding communities. Field representatives provide technical assistance and consultative services in organization techniques to groups in other countries upon request. The program is carried out through carefully coordinated efforts of volunteers and professional staff.

Education Fund

In 1957 the League established the Education Fund to promote and carry out nonpartisan citizenship education within the United States. The work of the Education Fund falls into two categories: communicating to other organizations and individuals the experiences and techniques in citizen education that the League of Women Voters has developed over the years and, where these established techniques lack effectiveness, to carry out experimental projects resulting, hopefully, in adaptations that will be more effective. Specifically under these two categories the Education Fund has made surveys of local and state government structure for distribution in local communities, has disseminated information on selected issues of the day, and has helped teach citizen groups methods of stimulating the registration and involvement of voters. The Education Fund has no membership of its own. It depends upon the grass-roots support of League members in the 1285 local Leagues from coast to coast and of citizens who are not League members to carry out its activities.

Effects of H.R. 13270, the Tax Reform Act of 1969

The League understands the concern of Congress regarding the misuses of funds by some foundations and is sympathetic with the problems of writing legislation which will prohibit "self-dealing" and at the same time permit private resources to be used to encourage informed citizen participation in government. It appears to us, however, that the proposed legislation on private foundations goes far beyond what is necessary to remedy any known abuses. To avoid duplicating the testimony of others, I shall address myself only to the provisions which raise serious problems for the League of Women Voters Education Fund and the Overseas Education Fund.

Difficulty of Distinguishing Between Private Foundation and Public Charity

The League of Women Voters is a social welfare organization exempt under section 501(c)(4) of the Internal Revenue Code. The Education Fund and the Overseas Education Fund are exempt under section 501(c)(3) and contributions to them are tax deductible. We believe that both of these Funds are publicly-supported charities, but the line between private foundations as defined in proposed section 509 and public charities appears to be a shadowy one. Under the mechanical test set forth in section 1.170-2(b)(5) of the Income Tax Regulations, defining a "publicly supported" organization under current law, an organization may be public one year and private the next. Because of the rule excluding from the category of public support that portion of large contributions which exceeds 1 percent of the organization's total support for a prescribed period, it is possible for one unusually large contribution to change the status of the organization overnight from public to private. This same situation would exist under the provisions of H.R. 13270.

Both the Education Fund and the Overseas Education Fund depend heavily for their support upon contributions from private foundations. Under proposed

section 4942, contributions to nonoperating private foundations are excluded from the definition of "qualified distributions" and therefore will not help a donor foundation avoid the tax on undistributed income. Unless it is absolutely clear that the Education Fund and the Overseas Education Fund are not nonoperating private foundations, we have reason to fear that private foundations will withhold their contributions to these Funds -- contributions which are vital to the continuation of their work in teaching the responsibilities of citizenship.

Inability to Qualify as Operating Foundation

The definition of an "operating foundation" in the proposed section 4942(j)(3) appears to exclude the Education Fund and the Overseas Education Fund for a variety of reasons. For example, if the present 50th Anniversary Campaign for $11 million to expand our work over a ten-year period is successful, both the Education Fund and the Overseas Education Fund will have substantial endowment and reserve funds and could not meet the requirement of subparagraph (b)(i) that substantially more than half of their assets be devoted directly to the active conduct of their educational programs. Their income from Government grants might also prevent them from meeting the alternative test of subparagraph (B)(ii). The Education Fund, but not the Overseas Education Fund, might also fail under subparagraph (A) if its grants to the League of Women Voters for specific educational projects were not construed as direct expenditures for the active conduct of its program.

Accordingly, unless a narrower and more practical definition of private foundation can be devised, organizations like the Education Fund and the Overseas Education Fund stand in constant jeopardy and the significant public service which they render to this nation may be severely curtailed. At the very least an opportunity should be provided for organizations to clarify their status before the new strictures on private foundations are made effective. Perhaps the effective date could be deferred until some time after the Treasury Department has promulgated its final regulations under the new statute. In

addition we support the very helpful proposal made by the Treasury Department in its Technical Memorandum of September 30, 1969, that distributions to private foundations be considered "qualified" if the recipient organization applies the contributions directly to charitable activities within one year of receipt.

Exposure to Drastic Penalties

We are also greatly disturbed over the provisions of proposed section 4945 which impose a 100 percent tax on private foundations and a 50 percent tax on foundation managers for any amounts expended

"(1) to carry out propaganda, or otherwise attempt to influence legislation,"

or

"(2) to influence the outcome of any public election (including voter registration drives carried on by or for such foundation)."

With respect to the first of these provisions, attempting to influence legislation, an exception is made if the activity is limited to "making available the results of nonpartisan analysis or research." Any organization operating in the area of citizen education and dealing with subjects of civic concern runs the risk that those to whom the results of its analysis and research are displeasing will attack the nonpartisan character of the work or charge that the organization has gone beyond merely making the results available. The risk is intrinsic to educational work in the field of government and politics. Present law respects honest and fair educational efforts and provides a safety valve for error or misunderstanding through the "substantiality rule." No such safety valve exists in the proposed legislation, and organizations like the Education Fund, never certain whether in any particular year they will be held public or private, can continue to function only at great peril.

Let me cite an example. With funds provided by the Department of Interior and various foundations and with the assistance of hundreds of volunteer workers from the League of Women Voters, the Education Fund studied the problem of pollution of our waterways, held seminars, and produced a book and a number of

brochures designed to increase public understanding of this dangerous problem. Undoubtedly there are and there will be proposals before the federal and state legislatures attempting to solve the problem of water pollution, with sharp differences of opinion as to the need for the restrictions and expenditures involved. Under such circumstances, when unrelated persons may attempt to make partisan use of the Fund's studies, it may be difficult for the Fund to defend the nonpartisan character of its analysis and research.

With respect to the second provision previously quoted, relating to the influencing of elections, it is also conceivable that anti-pollution legislation may become an issue in some election battle. At this point expenditures made for an objective study may be attacked as amounts paid to influence the outcome of a public election, in violation of section 4945(b)(2), as to which, it should be noted, no exception is provided for "making available the results of nonpartisan analysis and research."

In view of such possibilities, should the Education Fund be subject to the risk of a 100 percent penalty tax and its officers, directors, trustees and key employees be subject to the risk of a 50 percent penalty tax? The 50 percent penalty on foundation managers is imposed only if they make the expenditure "knowing that it is a taxable expenditure." At the very least, should not the same good-faith defense be available to the Fund itself?

Inadequacy of Special Provision for Nonpartisan Activities

Both the Treasury and the Ways and Means Committee have recognized the value of the nonpartisan work done by the League of Women Voters Education Fund in connection with voter education and registration and have tried to make it clear through a Treasury press release of May 9, 1969, and through a statement on page 34 of the Committee Report that the proposed legislation was not intended to inhibit such activities by the Fund. Unfortunately, if the Education Fund is determined to be a private foundation, the statute as drafted may not provide the intended relief. Among other things, the proposed section 4945(d), excluding from

taxable expenditures "nonpartisan activities carried on by certain organizations," which was drafted with the Education Fund in mind, requires that substantially all of the income be expended directly for the active conduct of the Fund's program* -- a requirement which may be difficult to meet if, as part of its program, the Education Fund continues to make grants to the League of Women Voters for its traditional nonpartisan voter education programs, such as its panel discussions between candidates, its factual presentation of their stated positions on the issues, and its voter registration drives. In any event, section 4945(d) deals only with the prohibition in section 4945(b)(2) on influencing public elections and leaves the Education Fund fully exposed on the proscription of section 4945(b)(1) against attempting to influence legislation, with the hazardous consequences previously mentioned.

Conclusion

The League of Women Voters and its affiliated organizations have a long and honorable record of constructive nonpartisan service to this nation. Unless the new legislation makes it absolutely clear that organizations like the Education Fund and the Overseas Education Fund are not to be treated as private foundations, enormous damage will be done. Furthermore, with respect to all organizations doing honest work in the area of political education, whether they are private foundations or public charities, a decent respect for human frailty requires either that the substantiality test be restored with respect to influencing legislation or that the penalty tax be limited to willful and premeditated attempts to influence legislation or the outcome of an election.

We believe that even more intensified efforts are needed in our society to involve more citizens at all levels of government; that a responsible democracy depends on citizens learning the importance and the responsibility of voting and

*Paragraph (3) of Section 4945(d). Paragraph (2), which requires that the principal activity be "nonpartisan political activity in 5 or more States," may also be troublesome for semantic reasons -- the Education Fund is engaged principally in nonpartisan educational work, which may or may not be embraced within the term "political activity."

of participating in the democratic process. Private philanthropy plays a significant role in supporting the educational work needed to achieve the goal of an informed and active electorate. H.R. 13270 appears to go further than necessary to correct the abuses which have been revealed in the operation of private charitable foundations. We hope this Committee will make the proper changes.

Respectfully submitted,

Mrs. Bruce B. Benson,
President, League of Women Voters
of the United States

A STATEMENT BY THE SOUTHERN REGIONAL COUNCIL TO THE UNITED STATES SENATE COMMITTEE ON FINANCE RE. HR 13270

(A SUMMARY OF CONTENTS)

I. INTRODUCTION

(A) Agreement with Proper Restrictions on Tax-exempt Funds

(B) Agreement with Correction of Abuses

II. CONCERN WITH 7½% TAX ON FOUNDATION INCOME

III. CONCERN WITH AFFECT OF "ANY ATTEMPT TO INFLUENCE LEGISLATION THROUGH AN ATTEMPT TO AFFECT THE OPINIONS OF THE GENERAL PUBLIC OR ANY SEGMENT THEREOF."

(A) Ruling on Supreme Court of Georgia on this Point as Regards the Southern Regional Council

IV. CONCERN WITH THE LIMITATION OF NO MORE THAN 25% SUPPORT FROM ONE FOUNDATION

V. CONCERN WITH THE AFFECT OF GRANTEES FROM FOUNDATION EXPENDITURE RESPONSIBILITY

(A) Inability Under the Bill for Small Foundations to Provide Support

(B) Disastrous Results of Excessive Supervision of Grantees from Large Foundations

CONCLUSION

A STATEMENT BY THE SOUTHERN REGIONAL COUNCIL TO THE UNITED STATES SENATE COMMITTEE ON FINANCE RE. HR 13270

-o-

Mr. Chairman, Members of the Committee:

Thank you for this opportunity to be heard. As Executive Director, I represent the Southern Regional Council an organization formed in 1944 for the purpose of contributing generally to the development of the region and more specifically to race relations within the region and the nation. Our five incorporators were Bishop Arthur Moore of Georgia; the late Dr. Howard Odum of the University of North Carolina; the late Dr. Rufus E. Clement, president of Atlanta University; the late Dr. Charles Johnson, president of Fisk University; and the late Mr. Ralph McGill, publisher of the Atlanta *Constitution*. The Council consists of one hundred distinguished Southerners, black and white, Protestant, Catholic and Jew. There is maintained in Atlanta an office and a staff of approximately forty persons. As indicative of our interests we have on that staff, or use as consultants, specialists in urban planning, manpower resources, health and nutrition, community organization, and related areas. We emphasize in our work research and publication on those matters which we feel most pertinent to the region. We also sponsor special projects such as the Voter Education Project, which has been the subject of some interest to the Congress in the formation of this bill.

Our concern about HR 13270 arises from our belief that the bill before you jeopardizes a valuable and unique operation by which our society is served. That operation is the partnership which has been created between private tax-exempt foundations and private tax-exempt agencies. We are confident this partnership has been to the public good. And, it is important that a significant part of the needs and the stimulation of the private sector are served by private funds, under private control, apart from the undue involvement of government.

Before we cite those particulars of the bill which most concern us, we should like to make two general observations:

(1) For twenty-five years the Southern Regional Council has recognized that we enjoyed the benefit of tax-exempt funds in proper exchange for certain restrictions on the use of those funds. For instance, our implementation of the requirement that no substantial portion of our efforts be partisan has been to attempt to see that no portion of our activity is political. We have attempted to operate within the spirit of the law as

well as the letter of the law. We are confident this is true of many other agencies. We do not appear before you to request that the existing regulations and laws which have created this method of operation and our reasoning be altered.

(2) It may be that the present tax laws have allowed individuals and groups to abuse those laws by creating so-called "foundations" for personal gain rather than to serve the public interest. We believe the Congress is justified in seeking to stop those abuses. Our concern is that honorably conceived and legally operated foundations -- and those whom they support -- not be punished and unduly restricted because of activities of others.

Our particular concerns with HR 13270 are as follows:

(1) Sec. 306 - Tax on Private Foundation Investment Income.

While the precedent may be ominous, the proposed 7½% tax probably would neither significantly alter foundation operations nor add substantially

to the public treasury. The true effect would be to reduce by 7½% those funds available to the private agencies. These private tax-exempt groups are, therefore, those really being taxed. This must be recognized by those who believe that there are limitations on the capability of the public sector and that there is, therefore, an important role for private agencies.

(2) Sec. 4945(c)(1) - Taxes on Taxable Expenditures.

It is extremely important to note that this section of the bill removes from the current Internal Revenue Service regulations the requirements that no substantial part of a tax-exempt organization's resources be used in partisan political activity or in support of a candidate for office. Rather, there is substituted excessive stipulations to preclude any political activity.

We have been told this has been done because some tax-exempt agencies have abused the present regulations by engaging in substantial

partisan political activity. These abuses may have occurred. But, if they have it has not been because of the inadequacy of current laws and regulations, but rather because of the failure of adequate enforcement of those laws and regulations.

* * *

While we subscribe completely to the concept that tax-exempt funds should not be used for partisan purposes, we are gravely concerned, for instance, by the wording in the proposed legislation, "any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof,..."

Literally interpreted, we believe this provision would prevent responsible agencies now engaged in serious research and publishing from making any meaningful comments on the society in which we operate. We assume, for instance, that at best the Council could publish statistics on migration from the region, but not offer opinions on the causes or impact of that migration. We assume that, at best, we could publish a medical report on hunger and malnutrition, but not offer remedial proposals. We assume we could

33-758 O - 69 -- No. 10 -- 3

publish statistics on black-white registration, but not offer any analysis of processes which affected that registration. We would not expect, and do not request, that we be allowed to propose specific legislation nor to support or oppose legislation being considered. However, under the provisions of this bill we assume that regardless of the effort and integrity we invest in forming them, we could not share our opinions with "the general public or any segment thereof."

It is in the public interest that agencies such as the Southern Regional Council be allowed not only to collect information but analyze and comment on that information. Our publications have been used extensively by the media, by scholars and others, and they have figured in the deliberations of the Congress. This contribution to public consideration and to public debate is, we believe, not only valuable, but non-partisan.

We have been upheld by the courts of Georgia in that opinion. In 1963 the Georgia Department of Labor informed the Council that we had been held taxable by virtue of their interpretation that we had a point of view, shared it with the public, and, thereby, engaged in "propaganda" and influenced legislation.

In Court, the State readily accepted the fact that the Council did not lobby, did not support or oppose any specific legislation, nor any candidate for public office. Rather, the State introduced as evidence a collection of Council publications and rested its case on the statement of the executive director that these publications were circulated to the general public.

The Superior Court found in favor of the Council and that decision was appealed to the Supreme Court of the State of Georgia. That Court unanimously upheld the decision of the lower court. We would like to quote the following statement from the Court's decision, Williamson vs SRC, Inc., 223 Ga. 179:

> "If the word 'propaganda' is given the broad meaning that it is any dissemination of ideas, then no religious or educational institution could qualify under Code Anno. 54-657(h)(7)(H), since a substantial part of the activities of such institutions is the dissemination of ideas and beliefs. Under the constitutionally protected right of freedom of speech, an organization cannot be penalized for disseminating ideas and beliefs which are not opposed to our system of

government, even though such ideas may not meet with the approval of all of the people in the area in which they are advanced."

* * *

We submit that the process of public dialogue and the dissemination of ideas is essential in a democracy. We submit, further, that such dialogue should be especially encouraged, not prohibited, by organizations that have established themselves in that society.

(3) Sec. 4945(d)

We are grateful that the report of the Ways and Means Committee of the House of Representatives specifically recognized the Council as an agency which could -- subject to the information they had available -- engage in programs in support of voter registration.

Within this section of the bill, however, and perhaps more importantly elsewhere in the bill, there are requirements that certain programs can receive no more than 25% of their support from any one source. There are

implications to this stiuplation which may not be readily apparent.

The most important of these are:

(a) There are still relatively few foundations which are willing to support programs of social reform. These foundations and the programs they have supported should be commended, not discouraged, for venturing substantially into new areas since frequently these programs -- like the Council's Voter Education Project which could not have come into existence under this provision -- have made an important contribution to the public welfare.

(b) Occasionally an unusually imaginative foundation has had the courage and foresight to support exclusively, or almost exclusively, a new group which has promise and a sound idea. We know of a number of now establish-ed agencies -- many of which now enjoy the financial support of federal, state, or local governments -- which would not be

in existence had one foundation been limited to providing no more than 25% of a beginning budget.

Subject to other proper considerations, there is no more rationale to restricting a foundation to a maximum of 25% support for a deserving effort than restricting an agency of the federal government to the same limitation on any publicly funded program.

(4) Sec. 4945(f) - Expenditure Responsibility

This section would require that foundations be "fully responsible" for the use of grants made. While the three requirements under this section would, on the surface, seem to be reasonable, there are serious consequences to these requirements if they are literally enforced. We believe the enforcement of the three requirements of this section of the bill would be severely damaging to foundations and cause recipients to loose a substantial degree of their independence and autonomy. It would also probably mean that the smaller foundations would have to cease giving to those affected by this provision, since they

have neither the staff nor the resources to meet these requirements.

Please do not misunderstand us. We are for the full and complete reporting on the use of tax-exempt funds. During the 25 years of our existence the great majority of our support has come from foundations. During the current year the Council will receive support from at least fourteen foundations totalling more than a million dollars. During all this time and dealing with foundations, large and small, we have never known an instance where a foundation staff did not satisfy itself beforehand as to the pertinence of our request and our competence to administer any funds granted. Nor, have we known of an instance where this process was not further reviewed by the foundation board. Further, we always at least annually issue a full audit of our expenditures and a complete report on our activities for the foundations and other interested parties.

However, the current situation is that the Internal Revenue Service is charged with determining whether or not an agency is tax-exempt and this serves as a guide to foundations. Earlier, we made a request to tho IRS regarding our own process of granting funds to other agencies and in a letter dated March 22, 1960 the IRS stated:

(1) "If you make a distribution of your funds to an organization which presently has exemption as a charitable or educational organization described in Section 501(c)(3) of the Code, there is no further obligation on your part to satisfy yourself as to the use of the funds distributed.

(2) "Contributions made by you to organizations, which have not established an exempt status for Federal income tax purposes, will not jeopardize your exempt status if the contributions are made and used only for one or more of the exempt purposes specified in Section 501(c)(3) of the Code. In such an event you should use reasonable care in ascertaining that the contributions will be used only for an exempt purpose and you will be able to substantiate that fact if called upon to do so by the Internal Revenue Service."

We submit this is a workable and efficient method. The burden of requiring foundations to be "fully responsible," as interpreted in the bill, would be harmful to all concerned.

Small foundations, with small staff, do not now generally give to non-tax-exempt agencies because they do not have the resources for the necessary supervision, and few large foundations make such grants because the requirements are too burdensome. Under this bill, small foundations would likely have to treat currently exempt organizations as they have non-tax-exempt ones in the past; simply removing them from their list of potential recipients of funds.

Equally disastrous, from the standpoint of all concerned, large foundations would probably have to be so vigorous in complying with these provisions, including their own on-the-spot staff supervision and auditing of their funds being spent, that they would in effect become the supervising grantee as well as the grantor. It is not an exaggeration to state that under these conditions, the independent tax-exempt agency staffs become employees of the donating foundations and the boards of those tax-exempt agencies become bystanders. We urge you to give the most serious consideration to the implications of this situation.

In conclusion, we believe it most important to stress that this bill, as it relates to foundations and those whom foundations support, is widely regarded to be punitive against those agencies and those foundations dealing with social reform, poverty, and minority affairs.

There are those agencies, of which the Southern Regional Council is one, that have attempted not only to contribute to the general welfare but to bring into reality the potential and the promise of this nation for all of our people. In a sense, it could be said we occupy the middle ground; recognizing need, tragedy and aspirations on the one hand, and holding on the other hand a deep faith in the ability of this society and this government to be the means by which wrongs can be corrected and the wholesome society created.

In this critical time of crisis, polarization and misunderstanding we urge you, do not cripple -- as this bill would -- those agencies which, with increasing difficulty, are attempting to occupy that middle ground where the faith remains that the capabilities and intent of our government and our society can be equal to our promises.

Paul Anthony
Executive Director
Southern Regional Council

September 11, 1969

ATTACHMENTS:

1. Members of the Council
2. A Statement of Purpose
3. A Statement on the Voter Education Project

THE SOUTHERN REGIONAL COUNCIL, INC.
5 Forsyth Street, N. W.
Atlanta, Georgia 30303

January 1969

OFFICERS*

PRESIDENT

John H. Wheeler

VICE-PRESIDENTS

Paul R. Christopher
Lucius H. Pitts
C. G. Gomillion
Josephine Wilkins

THE EXECUTIVE COMMITTEE

Raymond M. Wheeler, Chairman

Samuel DuBois Cook
Frank Smith
James McBride Dabbs
McNeill Smith
Julius L. Chambers
H. Franklin Williams
Vivian W. Henderson
Marion A. Wright

LEGAL COUNSEL

Joseph F. Haas

EXECUTIVE DIRECTOR

Paul Anthony

*Addresses of officers are given in the attached list of Members of the Council. All organizations and positions are shown for identification purposes only.

Members of the Council

CLASS of 1969

Mr. J. Bill Becker
President
Arkansas AFL-CIO
1408 Rebsamen Park Road
Little Rock, Arkansas (72202)

Mrs. Joe R. Brewer
Box 314, Route 1
Scott, Arkansas (72142)

The Reverend Caxton Doggett
Hyde Park Methodist Church
Platt at Cedar & Magnolia
Tampa, Florida (33606)

Dr. Luther H. Foster
President
Tuskegee Institute
Tuskegee Institute, Alabama (36088)

Dr. C. G. Gomillion
308 Bibb Street
Tuskegee Institute, Alabama (36088)

Dr. John A. Griffin
Executive Director
Southern Education Foundation
811 Cypress Street, N. E.
Atlanta, Georgia (30309)

Mr. Joseph F. Haas
Attorney
2709 First National Bank Building
Atlanta, Georgia (30303)

Mrs. Grace T. Hamilton
582 University Place, N. W.
Atlanta, Georgia (30314)

Miss Ruth L. Harvey
Attorney
453 South Main Street
Danville, Virginia (24541)

Mr. Donald L. Hollowell
Regional Director
Equal Employment Commission
1776 Peachtree Street, N. W.
Atlanta, Georgia (30309)

Dr. Guy B. Johnson
Professor of Sociology
University of North Carolina
Chapel Hill, North Carolina (27514)

Miss Barbara Jordan
Attorney
5303 Lyons Avenue
Houston, Texas (77020)

Mr. William H. Maness
Attorney
603 Florida Theatre Building
Jacksonville, Florida (32202)

Mrs. Vivian Carter Mason
2630 Chesterfield Boulevard
Norfolk, Virginia (23504)

The Reverend M. D. McCollom
District Superintendent
The Methodist Church
209 Bowling Avenue
Columbia, South Carolina (29203)

Mr. Benjamin Muse
Heron House
Reston, Virginia (22070)

Class of 1969 (continued)

Mr. John P. Nelson
Attorney
1100 Medallion Tower
344 Camp Street
New Orleans, Louisiana (70130)

Dr. Lucius H. Pitts
President
Miles College
Birmingham, Alabama (35208)

Dr. Hollis F. Price
President
LeMoyne College
Memphis, Tennessee (38126)

Mrs. Tom Ragland
3821 Abbott Martin Road
Nashville, Tennessee (37215)

Mr. Claude Ramsay
President
Mississippi AFL-CIO
133 South Lamar Street
Jackson, Mississippi (39201)

Mr. David H. Scull
President
Turnpike Press
P. O. Box 170
Annandale, Virginia (22003)

The Reverend Kelly M. Smith
First Baptist Church
319 Eighth Avenue, North
Nashville, Tennessee (37203)

Mr. McNeill Smith
Attorney
700 Jefferson Standard Building
Greensboro, North Carolina
(27402)

CLASS OF 1970

Mr. Bradford D. Ansley, Jr.
Businessman
7501 Midnight Pass Road
Sarasota, Florida (33581)

Mr. Julius L. Chambers
Attorney
216 West 10th Street
Charlotte, North Carolina (28202)

Mr. Edward E. Elson
President
Atlanta News Agency
3875 Green Industrial Way
Chamblee, Georgia (30005)

Dr. Edward E. Haddock, M.D.
1133 West Franklin Street
Richmond, Virginia (23220)

Dr. Robert J. Harris
Dean
Division of Arts and Sciences
University of Virginia
Charlottesville, Virginia (22903)

Mrs. Martin L. Harvey
Businesswoman
145 N. Farish Street
Jackson, Mississippi (39202)

Dr. Vivian W. Henderson
President
Clark College
Atlanta, Georgia (30314)

Mr. Harry Huge
Attorney
Alexandria, Virginia
(1823 Jefferson Place, N.W.
Washington, D. C. - 20036)

Class of 1970 (continued)

Mr. Henry Marsh
Attorney
3211 "Q" Street
Richmond, Virginia (23223)

Mr. L. D. Milton
President
Citizens Trust Company
212 Auburn Avenue, N. E.
Atlanta, Georgia (30303)

Dr. Samuel Nabrit
Executive Director
The Southern Fellowships Fund
795 Peachtree Street, N. E.
Atlanta, Georgia (30308)

Mr. J. Allen Parker
President
Alabama Exchange Bank
Tuskegee, Alabama (36083)

Mr. J. Rupert Picott
Executive Secretary
Virginia Teachers Association
316 Clay Street
Richmond, Virginia (23219)

Dr. Jewel Prestage
Chairman, Department of
Political Science
Southern University
Baton Rouge, Louisiana (70813)

Rabbi Jacob Rothschild
The Temple
1589 Peachtree Street, N. E.
Atlanta, Georgia (30309)

The Rt. Rev. Msgr. Alexander
O. Sigur
P. O. Box 2250
Lafayette, Louisiana (70501)

Dr. Vascoe A. Smith, D.D.S.
505 Vance Avenue
Memphis, Tennessee (38126)

Mr. Walter Sharp
Route 2, Beech Creek Road
Brentwood, Tennessee (37027)

Mr. James Stokely
Author and Poet
405 Clifton Heights
Newport, Tennessee (37821)

Dr. William H. Townsend
Optometrist
1304 Wright Avenue
Professional Services Building
Little Rock, Arkansas (72206)

Mr. Nat Welch
Executive Director
Community Relations Commission
1203 City Hall
Atlanta, Georgia (30303)

Mr. Avon Williams
Attorney
McClellan-Looby Building
327 Charlotte Avenue
Nashville, Tennessee (37201)

Dr. T. Franklin Williams, M.D.
405 Whitehead Circle
Chapel Hill, North Carolina (27514)

CLASS OF 1971

Mrs. Lawrence Coe
Member, School Board
262 Stonewall Street
Memphis, Tennessee (38111)

Class of 1971 (continued)

Dr. Samuel DuBois Cook
Professor of Political Science
Duke University
Durham, North Carolina (27706)

Dr. Ralph Mason Dreger
Professor of Psychology
Louisiana State University
Baton Rouge, Louisiana (70906)

Mr. Martin L. Harvey
Dean of Student Affairs
Southern University
Southern Branch Post Office
Baton Rouge, Louisiana (70813)

Mrs. Julien J. Hohenberg
91 Morningside Park
Memphis, Tennessee (38104)

Mrs. Helen Howard
Director
Vine City Foundation, Inc.
558 Magnolia Street,N. W.
Atlanta, Georgia (30314)

Mr. Paul Johnston
Attorney
1142 Brown-Marx Building
Birmingham, Alabama (35203)

Mr. Sylvan Meyer
Editor
The Daily Times
Gainesville, Georgia (30501)

Mr. George Owens
President
Tougaloo College
Tougaloo, Mississippi (39174)

Mr. Robert J. Palmer
Businessman
304 South Main Street
Sumter, South Carolina (29150)

Mrs. Mary Sand
1447 Granada Street
New Orleans, Louisiana (70122)

Mrs. Jane Schutt
955 Pecan Boulevard
Jackson, Mississippi (39209)

Mr. John Siegenthaler
Editor
The Nashville Tennessean
1100 Broadway
Nashville, Tennessee (37203)

Mrs. Alice N. Spearman
3401 Brookwood Court
Columbia, South Carolina (29204)

Mr. Lee B. Thomas, Jr.
President
Vermont American Corporation
500 East Main Street
Louisville, Kentucky (40202)

Mr. John W. Walker
Attorney
1304-B Wright Avenue
Little Rock, Arkansas (72206)

Mr. John H. Wheeler
President
Mechanics and Farmers Bank
Box 1932
Durham, North Carolina (27702)

Dr. Raymond M. Wheeler, M.D.
3724 Warrington Drive
Charlotte, North Carolina (28211)

Dr. Bell I. Wiley
Professor of History
Emory University
Atlanta, Georgia (30322)

Class of 1971 (contined)

Miss Josephine Wilkins
Sheraton-Biltmore Hotel
817 West Peachtree Street, N.E.
Atlanta, Georgia (30383)

Dr. H. Franklin Williams
Professor of History
University of Miami
Coral Gables, Florida (33146)

Mr. Paul D. Williams
Publisher
3320 Gloucester Road
Richmond, Virginia (23227)

Mr. Marion A. Wright
Attorney
Top Knot
Linville Falls, North Carolina
(28647)

Mr. Jack Young
Attorney
213 Redmond Building, Suite 207
115½ N. Farish Street
Jackson, Mississippi (39201)

Mr. James E. Youngdahl
Attorney
711 West Third Street
Little Rock, Arkansas (72201)

CLASS OF 1972

Mr. Fred D. Alexander
Realtor
2140 Senior Drive
Charlotte, North Carolina (28208)

The Reverend Hubert Beckwith
Congregational Christian Church
of Fairfax County
P. O. Box 288
Annandale, Virginia (22003)

Dr. A. D. Beittel
American Friends Service Committee
P. O. Box 4325, Fondren Station
Jackson, Mississippi (39216)

The Honorable Julian Bond
State Legislator
162 Eurahlee Street, S. W.
Atlanta, Georgia (30314)

Mr. H. A. Hank Brown
President, AFL-CIO, Texas
Box MM - Capitol Station
Austin, Texas (78711)

Mr. Irving E. Carlyle
Attorney
P. O. Box 84
Winston-Salem, North Carolina (27102)

Mrs. John Cashin
416 Owens Drive, S. E.
Huntsville, Alabama (35801)

Mr. Paul R. Christopher
Regional Director, AFL-CIO
216 Flatiron Building
Knoxville, Tennessee (37917

The Reverend Walter B. Clancy
Director
Catholic Social Services
Diocese of Little Rock
2415 North Tyler
Little Rock, Arkansas (72207)

The Reverend Philip Cousin
St. Joseph's A.M.E. Church
Markham Educational Building
804 Fayetteville Street
Durham, North Carolina (27701)

Mr. James McBride Dabbs
Planter, Author
Rip Raps Plantation
Mayesville, South Carolina (29104)

33-758 O - 69 -- No. 19 -- 4

Class of 1972 (continued)

Mr. Neil O. Davis
Editor-Publisher
The Auburn Bulletin
Auburn, Alabama (36830)

Dr. Albert W. Dent
President
Dillard University
New Orleans, Louisiana (70122)

Mr. Nils Douglas
Attorney
1110 Medallion Tower
344 Camp Street
New Orleans, Louisiana (70130)

The Reverend Duncan M. Gray, Jr.
St. Paul's Episcopal Church
1116-23rd Avenue
Meridian, Mississippi (39301)

Dr. Charles M. Grigg
Director
Institute for Social Research
Florida State University
Tallahassee, Florida (32306)

The Honorable Brooks Hays
Attorney
Little Rock, Arkansas
(314-2nd Street, S. E.
Washington, D. C. - 20003)

Dr. Aaron E. Henry
Pharmacist
213 Fourth Street
Clarksdale, Mississippi (38614)

Mr. George Lewis, II
President
The Lewis State Bank
Tallahassee, Florida (32301)

Dr. Herman H. Long
President
Talladega College
Talladega, Alabama (35160)

The Reverend Powers McLeod
District Superintendent
The Methodist Church
2252 Allendale Road
Montgomery, Alabama (36111)

Mrs. Helen Mervis
1422 Valence Street
New Orleans, Louisiana (70115)

Mr. Daniel Pollitt
Professor of Law
University of North Carolina
Chapel Hill, North Carolina
(27514)

Mr. Frank Smith
Director
Tennessee Valley Authority
405 New Sprankle Building
Knoxville, Tennessee (37902)

Dr. C. H. Thomas, Jr.
Professor of Political Science
South Carolina State College
Orangeburg, South Carolina (29115)

LIFE FELLOWS

Mrs. Jessie Daniel Ames, '62
The Wren's Nest
P. O. Box 626
Tryon, North Carolina (28782)

Mr. Hodding Carter, '64
Publisher
Delta-Democrat Times
Greenville, Mississippi (38701)

Mr. Herbert M. Davidson, '68
Editor-Publisher
Daytona Beach News-Journal
Daytona Beach, Florida (32014)

Life Fellows (continued)

The Reverend Theodore R. Gibson, '66
Christ Episcopal Church
P. O. Box 6
Cocoanut Grove Station
Miami, Florida (33130)

Dr. Frank P. Graham, '67
Chapel Hill, North Carolina
(Room 951, United Nations
New York, New York - 10017)

Mr. Paul E. Green, '65
Author, Playwright
University of North Carolina
Chapel Hill, North Carolina
(27514)

Dr. Gordon B. Hancock, '62
Educator & Newspaper Columnist
P. O. Box 6056
Richmond, Virginia (23222)

The Rev. Edward A. McDowell, '62
270-D Peachtree Hills Avenue, NE
Atlanta, Georgia (30305)

~~Mr. Ralph McGill, '64~~ Deceased
~~Publisher~~
~~The Atlanta Constitution~~
~~Atlanta, Georgia (30302)~~

Rabbi Charles Mantinband, '68
Temple Emanuel
Box 1502
Longview, Texas (75601)

Colonel Francis P. Miller, '66
Charlottesville, Virginia
(2810 "P" Street, N. W.
Washington, D. C. - 20007

Dr. Riley B. Montgomery, '66
President Emeritus
Lexington Theological Seminary
Lexington, Kentucky (40508)

Dr. C. H. Parrish, '68
Department of Sociology
University of Louisville
Louisville, Kentucky (40208)

Mrs. J. N. Rayzor, '68
3207 Groveland Lane
Houston, Texas (77019)

Dr. Harry V. Richardson, '68
Interdenominational Theological
Seminary
671 Beckwith Street, S. W.
Atlanta, Georgia (30314)

Miss Dorcas Ruthenburg, '68
1202 Kentucky Home Life Building
Louisville, Kentucky (40202)

Mrs. David Terry, '64
411 East Seventh Street
Little Rock, Arkansas (72202)

Mrs. J. Fount Tillman, '68
Palmetto Farm, RFD 1
Lewisburg, Tennessee (37091)

Mrs. M. E. Tilly, '64
Director of Women's Work
Southern Regional Council
5 Forsyth Street, N. W.
Atlanta, Georgia (30303)

Dr. W. D. Weatherford, '64
Black Mountain,
North Carolina (28711)

Mr. Carter G. Wesley, '64
Publisher
Houston Informer
Box 3086
Houston, Texas (77001)

Dr. Benjamin E. Mays, '68
President Emeritus
Morehouse College
3316 Pamlico Drive, S. W.
Atlanta, Georgia (30311)

ATTACHMENT 2

The South of the Future

A Statement of Policy and Aims of the Southern Regional Council
December 12, 1951

EIGHT YEARS AGO, the Southern Regional Council was born out of the conscience and high resolve of a democratic nation at war. Today, in another period of international tension, we are faced with a renewed challenge to provide leadership and direction in a troubled region. It is essential that we assess clearly and wisely the role that the Southern Regional Council is to perform in this critical time.

We do not believe in the exclusive validity of any single approach or any single organization. There is not only room, but a desperate need for a wide variety of programs concerned with broadening democracy through legal, economic, legislative, religious, and educational means. Moreover, such programs are needed on all levels —national, regional, state, and local. Every group, like every individual, should chart its course with due regard for the special contribution it is fitted to make.

The role appropriate to the Southern Regional Council is evident in its origin and make-up. The Council's main asset is and has always been the people of the South who understand and want the full practice of democracy, and who at the same time know intimately the old evils that burden the South, and their causes. From such people is the Council's membership drawn. They have wanted a regional organization, not out of any provincial desire to separate the South's problems from the nation's, but out of the conviction that such an organization has unique advantages. It can express the best and often neglected elements of Southern thought and conscience; it can serve as a convincing demonstration of Southerners working together as fellow citizens without regard to race; and it can tap local resources and initiative often inaccessible to agencies outside the region.

The Council seeks to be a practical organization, emphasizing working solutions rather than spectacular pronouncements. Indeed, that philosophy is basic to an organization which hopes to open closed minds and substitute reason for prejudice.

The Council, by its very nature, is not a "mass pressure" organization. The number of persons in the South who are able and willing to reject the taboos on interracial effort in their own communities is growing, but it has not yet reached mass proportions. Meanwhile, the Council's membership can function effectively as enlightened citizens acting through the civic life of their communities in behalf of our common principles. Their methods are the established ones of conference, factfinding, and persuasion.

The Council takes no part in political activity. However, it can and does consult with public agencies and officials and makes its influence felt for truly representative government.

The council's functions may be briefly summed up as follows:

To serve as a meeting ground for citizens of all races, occupations, and religious persuasions.

To present the facts about the region, and their implications, through newspapers, radio, magazines, pamphlets, and other public media.

To counteract appeals to prejudice and violence by demagogues, professional bigots, and hate organizations.

To provide a program adaptable to local need in both the relatively backward and the relatively advanced areas of the South.

To translate appropriate research findings from universities and other centers to the practical situations with which the action program will be concerned.

To give special emphasis to the devlopment of leadership among promising young Southerners of all races.

To convene, by interest group, key persons in the various fields of Southern life, so that steps to genuine integration may be representatively agreed upon.

To stimulate local initiative to work for local solutions in full democracy, so that legislation and judicial rulings may be translated into justice for the individual in his everyday life.

The basic machinery necessary to enable the Council to work effectively at these tasks is: (1) trained, competent, professional persons of both races working in each Southern state as agents of improvement in public life; and (2) staff in a central office of the Council to direct and service the field people.

The declared purpose of the Southern Regional Council is "to attain through research and action the ideals and practices of equal opportunity for all peoples in the region." This objective has lost none of its timeliness since it was first adopted. Although the past eight years have brought notable progress in the South, the job remaining is a vast one, and the pressures of national and international events demand an even speedier advance. Many of our institutions continue to make unfair and unwarranted distinctions between citizens solely on the basis of race. Outmoded traditions, unjustified fears, and ancient prejudices continue to exact a heavy toll on the unity, productiveness, and integrity of our society.

It is the ultimate hope and aim of the Council that it may help in bringing solution to regional problems that transcend the question of race — problems economic, social, ethical, which affect impartially people of all races. But, for the present, the unique liability under which the South labors arises out of an unreasoning racial disharmony. The first task of informed and conscientious Southerners is to strive to create here the atmosphere in which artificial distinctions and discriminations based upon race will no longer persist. Only when that goal has been attained will the energies of enlightened men be fully released for the great task of realizing all our potential resources, natural and human.

The south of the future, toward which our efforts are directed, is a South freed of stultifying inheritances from the past. It is a South where the measure of a man will be his ability, not his race; where a common citizenship will work in democratic understanding for the common good; where all who labor will be rewarded in proportion to their skill and achievement; where all can feel confident of personal safety and equality before the law; where there will exist no double standard in housing, health, education, or other public services; where segregation will be recognized as a cruel and needless penalty on the human spirit, and will no longer be imposed; where, above all, every individual will enjoy a full share of dignity and self-respect, in recognition of his creation in the image of God.

Equal opportunity, truly defined, includes all this and more. We have no illusion that it can be realized in the South quickly or easily or perfectly. Nor do we imagine that the Southern Regional Council can play more than a modest but creditable part toward its achievement. Yet it is the ideal toward which we strive and, short of which, we have a duty to remain dissatisfied. For it is nothing less than the American ideal.

ATTACHMENT 3

A STATEMENT ON THE VOTER EDUCATION PROJECT
OF THE
SOUTHERN REGIONAL COUNCIL, INC.

* * * * *

The Southern Regional Council launched the first Voter Education Project in 1962. A major purpose of the new undertaking was to be research into the causes of low political participation, particularly among blacks, in the South. And a major method of this research was to be the direct funding of voter registration drives in the South as a means of determining the types of difficulties encountered.

While the SRC Executive Committee felt this project to be of the first importance, it stipulated that the Council could not sponsor this effort without review and assurance from the Internal Revenue Service that this program would be in accordance with tax-exempt activity as interpreted by IRS. The Council received that assurance from IRS on March 22, 1962. In addition, of course, the Southern Regional Council has filed annual reports with IRS on this as well as all of its programs and expenditures.

SRC's first Voter Education Project began in March of 1962 and ended in the fall of 1964. As a result of these efforts, an increase in Negro registration of nearly 700,000 was recorded in 11 Southern states.

The Voting Rights Act of 1965, suspending literacy tests in six states and otherwise providing new protection for prospective black voters, substantially changed the circumstances of civic participation in the South. Accordingly, the Southern Regional Council decided to launch a second Voter Education Project.

This second VEP began work in early 1966 and remains in operation today. Research into the causes of low political participation remains a major function. Support of voter registration activities continues to be a method of determining the causes of low political participation. However, the second Voter Education Project has placed an increasing amount of emphasis on non-partisian citizenship education and leadership training programs, particularly the latter.

As Congress recognized in the adoption of the Voting Rights Act of 1965, the recent history of the South is darkly stained by the systematic exclusion of Negroes from the political process. A summary of the repressive statutes and practices which enforced this exclusion can be found in "Political Participation," published in May of 1968 by the Civil Rights Commission, and in "Climbing Jacob's Ladder," by Pat Watters and Reese Cleghorn, published by Harcourt, Brace and World in November of 1967. The latter book is largely a description of the work of the Voter Education Project. A feeling for the importance of the research activities of VEP may be gained by noting the number of citations of VEP material in the

Civil Rights Commission's report.

The activities of the Voter Education Project have unquestionably brought more Negroes into the political process in the South. With the passage of the Voting Rights Act a contributing factor, the second Voter Education Project---like the first---estimates that its programs have added 700,000 blacks to the registration rolls in the South. Year-by-year progress can be seen in the following table:

INCREASES IN BLACK REGISTRATION - 11 STATES

Year	Black Registration	White Registration
1960	1,463,333	12,276,127
1962	1,480,720	12,109,680
1964	2,164,200	12,263,820
1966	2,689,000	14,309,704
1968 (Summer)	3,112,000	15,702,000

It should be noted that although black registration has risen to 62 per cent of the black voting-age population in the region, white registration stands at 78 per cent of the white voting-age population. Much remains to be done before it can be said that Negroes in the South are full partners in the regional and national political process.

The amount of money allocated for each project hardly can be described as large (although it must seem large to an organization with no other source of support). An average grant for voter registration runs between $1,000 and $2,000. The allocation generally covers a period running from one to two months.

A grant letter is sent to the local organization (see attached sample) which sets out in unequivocal terms that the money is to be used only for non-partisan voter education and voter registration and may not be put to any partisan or other use, and specifically not to serve any political campaign. The grant letter is followed by a research letter which sets our reporting requirements. Organizations receiving funds are required to submit both financial and status reports weekly. These reports are reviewed in the VEP office in Atlanta. All money spent must be accounted for precisely.

Money is supplied on a cash-draw basis. No lump-sum grants are given. This furnishes VEP with a means of cutting off support instantly when a report indicates partisan activities or any other irregularity.

In addition to all this, VEP employs a full-time field director. The field director makes both announced and unannounced visits to all projects receiving VEP support. The field director also visits projects prior to funding to determine that they qualify for support. Non-partisanship is a major item checked by the field director in these on-the-spot inspections.

It should be pointed out that VEP does not endeavor to pay the entire cost of voter registration activities in the South. Local organizations, to the extent possible, are expected to raise funds of their own, particularly in urban areas. Candidates and others directly connected with political campaigns are not permitted to hold positions of responsibility in VEP-supported registration activities

or in any way utilize VEP-supported projects, funds or facilities in aid of their own campaigns. While VEP has never found instances of partisan activity to warrant terminating a grant, several grants have been discontinued on other grounds.

Registration activities are not limited to blacks. Several projects have involved registration of Indians and Mexican-Americans. A few projects have reported registering some white Southerners. Relevant to the last point, however, is the fact that white registration in most of the South already is quite high.

The weekly reports are the backbone of VEP research. It is through these reports that VEP learns of difficulties Negroes continue to encounter in their attempts to register and vote in the South. Directors of voter registration projects supply the research department with a wide variety of facts and figures relating to Negro political participation in the South. VEP is the central point of such information by government, the press, scholars and universities, publications, research organizations, authors, and foreign visitors.

As already mentioned, the registration drives provide tremendous amounts of information and knowledge that otherwise would not be available. For many years, the Southern Regional Council has been the main source of information about black registration and voting in the South. Because several states have discontinued publication of registration figures by race, these local registration drives have become increasingly important in arriving at registration figures by race. The Voter Education Project continues to be the main source of this information.

OTHER ACTIVITIES

During the last three years, VEP has held a number of seminars, workshops and conferences for candidates and officeholders.

We have felt that black candidates and black officeholders, like black voters, have been so long denied a part in the political process that these special educational programs were warranted and, indeed, necessary.

The seminars and conferences are restricted to discussions of the duties and responsibilities of candidates and/or officeholders. Discussion of campaign techniques and strategy, of how to get elected, etc. is not permitted. Incidentally, VEP has consistently rejected requests for funds for get-out-the-vote activities and has cautioned grant recipients against using VEP funds for this purpose. Similarly, we have felt that the new voters should be informed about the government they now are helping elect, and that is the basis for the programs in the field of citizenship education.

As the number of black elected officeholders in the South climbed rapidly toward 400 last year, VEP scheduled the first Southwide Conference of Black Elected Officials. The conference was held in Atlanta last December with approximately 200 black elected officials attending. With the total number of black elected officials now standing at about 460, VEP has set up service centers for elected officials at five predominantly black colleges in the South. Although these centers now serve mostly black officials, we look forward to the day when they will be serving officials of any race who need technical

and research advice. The centers may be compared, in terms of techniques and approach to the problems of government, with the Institutes of Government of the Universities of North Carolina and Georgia.

FINANCES

The Voter Education Project is but one of the many programs conducted by the Southern Regional Council, but it is the largest. Although VEP continues to receive small gifts from individuals, the bulk of funds comes from foundations.

Between 1966 and 1968 VEP received $1,163,446. Foundations which gave $2,500 or more each during this period include Aaron Norman, Abelard, Field, Ford, Irwin-Sweeney-Miller, Mary Reynolds Babcock, New World, New York, Rockefeller Brothers, Robert R. Moton Memorial and Taconic.

Grants for 403 programs, most of which involved voter registration totaled $736,956.70, for an average of approximately $1,830 per grant. The rest of the expenditures went for publications research and consultants, scholarships, student interns, meetings and seminars (including the Southwide Conference), and salaries and administration.

The first Voter Education Project (1962-64) received $870,371. Principal supporters were Taconic Foundation, Field Foundation, and the Edgar Stern Family Fund.

CONCLUSION

The Voter Education Project was formed as a result of

widespread urgings from many concerned persons and groups, including high government officials, particularly in the Justice Department, that the energies of the sit-ins and freedom rides of the early '60s be channeled also into voter registration and citizenship education. It should be noted that there was some resistance within youthful civil rights circles to this development, the objection being that the idea sounded like an "Establishment" effort to blunt the thrust of activist undertakings.

It is true that the voter registration, citizenship education and leadership training programs have sought to bring black Southerners into the political process as a means of correcting the injustices that black people have historically suffered. The registration of thousands and the election of scores of black people have given many blacks in the South some hope of improving their lives through the existing political structure.

The Voter Education Project is the only organization conducting such programs on a region-wide basis. VEP could not have undertaken its task without foundation support. Without foundation support, VEP could not have existed. And without VEP, the black registration in the South would be substantially less than it is today.

Yet, as already pointed out, much remains to be done. Some two million voting-age Negroes in the South have not been registered to vote. Gradually, there are signs that white officeholders are responding to the needs of black voters. There are encouraging signs, here and there across the South, that blacks and whites can work

together in the councils of government.

In large part these gains were made possible through voter registration, which in turn was made possible in large part through foundation support. To continue and sustain these gains will require a continuing effort, which in turn hinges upon continued foundation support. Gradually white Southerners are becoming accustomed to Negroes as a part of the political process. To roll back that trend now would be tragic. Discontinuance of foundation funds for voter registration, coupled with the prospective expiration of the Voting Rights Act, would surely halt and reverse the trend toward full political participation in the South.

Sustained registration campaigns are needed to test the willingness of Southern registrars to follow non-discriminatory procedures (especially if the Voting Rights Act is not extended). However, most black people in the South are poor and can scarcely meet their daily needs. A few communities would be able to raise local funds to finance a voter registration campaign, but most would not. For all practical purposes, voter registration in the South would grind to a halt without foundation support.

In the years after Reconstruction came a dark period called Redemption. During this period, white Southerners turned back the clock and reasserted their control over the lives of black people. Tragic and bloody years followed, and the nation is still undoing the damage. Total exclusion of blacks from the political process was a major factor in that Redemption period.

A second Redemption is unthinkable if the region---and the nation---is to survive as a multi-racial society.

Approved by the Executive Committee
of the Southern Regional Council, Inc.
in Executive Session, June 14, 1969
Atlanta, Georgia

(List of members appended)

Summary of the
Statement of Victoria Popkin
Assistant Director
Washington Office
American Civil Liberties Union

on

H. R. 13270

To reform the income tax laws

September 11, 1969

The ACLU opposes and urges deletion of provisions in H. R. 13270 to drastically restrict the so-called "political activities of private tax-exempt foundations." While there are undoubtedly a number of specific abuses by these foundations which can and should be corrected, the contemplated restrictions jeopardize the continued effectiveness if not the very existence of these unique institutions which have made an enormous contribution to our national well-being.

Attempts to influence legislation.

H. R. 13270 would impose severe tax penalties -- ranging from a tax of 100% on an improper expenditure, to loss of tax-exempt status, to a tax of 50% on the officer authorizing the improper expenditure -- on foundations which "carry out propaganda or otherwise attempt to influence legislation." Specifically barred are attempts to influence legislation by affecting the opinion of the general public or private communication with a legislative body. Specifically permitted is "non-partisan analysis and research."

1. As a standard by which a foundation is to guide its activities, the proposed restriction is too broad and too vague, raising substantial questions under the First Amendment which guarantees the right to publish, to speak and to petition the government. To cite just a few of many possible examples:

- What is propaganda? Is it published material espousing a particular political point of view? Publication by a foundation of a "scientific" opinion on the effects of malnutrition on intelligence could be banned.

- What is an attempt to influence legislation? Is it the mere publication of an opinion with the hope that it will spur a legislative response or must the publication include specific recommendations? Does it include "test-case" litigation, as in the welfare rights cases which have exposed some glaring infirmities in current law?

33-758 O - 69 -- No. 19 -- 5

- What is "non-partisan" analysis? Is it only that analysis specifically sponsored by a recognized political party or does it extend to any analysis likely to be endorsed by such a party? The well known "One Year Later" report on the effects of the Kerner Commission might be precluded.

The effect of this vagueness and uncertainty will be a rigorous self-censorship by foundations far beyond any that exists under present law which provides a "safety-valve" in that its restrictions apply, only to activities which are a "substantial part" of the foundations program.

2. There is also a fundamental question as yet unresolved by the Supreme Court as to the underlying permissibility of so broad a regulation of First Amendment activities. Cammarano v. United States, 358 U.S. 498 (1959), for example, which is usually cited to advance the proposition that restrictions on lobbying are clearly constitutional decided only that Congress was not required to provide a tax deduction to businesses for lobbying. It did not deal directly with the question of severe penalties in the form of complete denial of a tax-exemption and individual tax liability for engaging in First Amendment activities.

Moreover, recent cases have made clear that to be valid, a condition attached to a government benefit which broadly limits First Amendment rights must advance a "compelling" government interest and be no broader than is absolutely necessary to do so. The proposed restriction is apparently intended to ensure that foundations not be used as "tax-dodges" to support a narrow private interest instead of to advance a broader public interest. That admittedly proper interest is adequately protected by present law.

Voter registration activity.

H. R. 13270 also unduly restricts voter-registration activity supported by tax-exemption foundations. If Congress is truly worried about the use of funds for partisan drives or in campaigns aimed at a particular candidate, that can be prevented without curtailing legitimate on-going voter registration merely because the resources available to a foundation be insufficient to support activities in five or more states.

Statement of Victoria Popkin
Assistant Director
Washington Office
American Civil Liberties Union

on

H. R. 13270

To reform the income tax laws

before the

Committee on Finance
United States Senate

September 11, 1969

I am Victoria Popkin, Assistant Director of the Washington, D. C. Office of the American Civil Liberties Union. The ACLU is a private, non-profit organization which devotes its entire resources to the protection of the Bill of Rights of the United States Constitution. We are neither a tax-exempt organization under § 501(c)(3) of the Internal Revenue Code nor are contributions to the Union tax deductible, although we do have a separate tax-exempt and tax-deductible arm, the Roger Baldwin Foundation of the ACLU, which engages in litigation and other charitable activities, primarily in the emerging areas of poverty and welfare law. Thus, we appear here today neither as tax "experts" nor as an organization necessarily affected directly by the proposed tax law changes contained in H. R. 13270. Rather, we appear to voice our profound concern for the deleterious impact on orderly and progressive social change which would result from proposals to restrict the activities of private foundations, and to raise with you important constitutional considerations which must be brought to bear in weighing the proposed restrictions.

There can be no doubt that tax-exempt private foundations have made an enormous contribution to our national well-being and continued social progress. Traditionally, they have engaged in a wide variety of philanthropic work and have been an important source of artistic, cultural and scientific endeavor. In recent years, with the rapid acceleration of social and technological change, both within the country and without, their activities have expanded to include the experiemental and the innovative, and, more importantly, to support and direct the forces of change to which government has been slow to respond. Often this has involved criticism of government action or inaction. As a result, foundations have inevitably engendered controversy and now encounter opposition. Current attempts to restrict their activities are in large part manifestations of this reaction.

We have no doubt that there are a number of abuses by private foundations which can and should be corrected -- as, for example, when a private foundation which enjoys tax-exempt status as an incentive to engage in activities for the social welfare fails to distribute its income or engages in self-dealing. H. R. 13270, however, is not limited to correction of specific abuses such as these. While the provisions in H. R. 13270, as passed, are less restrictive than those originally reported by the House Ways and Means Committee, they remain sufficiently broad and ambiguous to pose a major threat to the independence of private foundations, the inevitable effect of which will be to curtail severely the constructive contribution which these unique institutions have made to American society. Some specific abuses of tax-exempt status which Congress can legitimately prevent may well be cured, but at the expense of crippling the very institutions created by the Congress to carry out what it has deemod to be important and beneficial social ends. A tax on foundation investment income, for example, while contributing little in terms of revenue to the public treasury, will serve only to assure that fewer private funds are available to meet social and charitable needs and that ultimately the public treasury, itself, will have to take up this slack.

Of primary concern to the ACLU are the provisions in Title I of the bill which restrict so-called "political" activities of private foundations, the violation of which would result in severe tax penalties to the foundation and/or its officers and trustees, and, ultimately, to loss of tax-exempt and tax-deductible status.

Any attempt to curtail "political activities," whether those activities are undertaken by individuals, business organizations or, in this case, private foundations, must be reconciled with the First Amendment guarantees of freedom to speak, to publish and to petition the government. While it may be clear that the government is not required to subsidize these activities by way of a tax-exemption or any other means, it does not follow that it is therefore wholly free to limit or ban them as a condition of receiving a benefit to which the taxpayer would otherwise be entitled. See e.g. concurring opinion of Douglas, J. in Cammarano v. United States, 358 U.S. 498 (1959); Speiser v. Randall, 357 U.S. 513 (1958); Sherbert v. Verner, 374 U.S. 398 (1963). Thus, the proposed restrictions on foundation "political activities" must be viewed and judged in the light of established limits on governmental regulation of speech, press and the right to petition the government.

First, the bill would impose a tax of 100% on expenditures by a private foundation,

> "to carry out propaganda, or otherwise attempt to influence legislation."

Such taxable expenditures specifically include (but are 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,"

but specifically permit, ". . . making available the results of non-partisan analysis or research." Trustees and officers of the foundation who knowingly authorize such expenditures incur an individual tax liability equal to 50% of the amount improperly expended. Flagrant or repeated violations can result in the loss of tax-exempt status.

As a standard by which a foundation is to guide its activties on pain of incurring severe financial penalties, the ban on propagandizing or otherwise attempting to influence legislation is both too broad and too vague. It is fundamental that "a law forbidding or requiring conduct in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates due process of law." Baggett v. Bullitt, 377 U.S. 360 (1964); Cramp v. Board of Public Instruction, 368 U.S. 278 (1961). The tremendous "chilling" effect of a vague and uncertain rule on the exercise of First Amendment freedoms has consistently been underlined by the Supreme Court. In Keyishian v. Board of Regents, 385 U.S. 589 (1966) the Court stated,

"We emphasize once again that [p]recision of regulation must be the touchstone in an area so closely touching our most precious freedoms, NAACP v. Button, 371 U.S. 415(438); [f]or standards of permissible statutory vagueness are strict in the area of free expression . . . . Because First Amendment freedoms need breathing space to survive, government may regulate in the area only with narrow specificity. Id. at 432-33. . . When one must guess what conduct or utterance may lose him his position, one necessarily will steer far wider of the unlawful zone . . . Speiser v. Randall, 357 U.S. 513, 526. For '[t]he threat of sanctions may deter . . . almost as potently as the actual application of sanctions. NAACP v. Button, supra at 433 . . . . (at 603)"

The total lack of "precision of regulation" in the proposed restrictions in H. R. 13270 is apparent from even the most cursory examination of their terms.

What is "propaganda?" Is it published material espousing a particular political point of view, or any particular point of view? As commonly used, the term can include spreading a scientific or artistic point of view. Is it forbidden, then, only if it

becomes a topic of political controversy or if it is merely likely to become such a topic. Realizing that the restriction has an exemption for non-partisan analysis and research, which we deal with specifically below, it still must be noted that there may be specific "scientific" opinions which are not strictly speaking objective research reports, for example as to the therapeutic effect of fluoridation of water, or the pathological effect of cigarette smoking, or the effect of television violence on children, or the effect of hunger and malnutrition on a child's intelligence and performance, all of which are highly controversial matters, which could be termed "propaganda" by those who disagree with the opinion expressed as opposed to "analysis" by those who concur. Are foundations to be precluded from sponsoring and disseminating the results of all studies in such areas? If so, the restriction is virtually without limit.

Similarly, what is an attempt to influence legislation? Is it the mere publication of an opinion with the hope that the problem will spur some kind of legislative or executive action? Must the report contain specific legislative recommendations, or is it enough that it be relevant to a specific proposal already known to be under consideration? For example, a study of efforts in European countries to deal with the problems of obscenity and pornography, which reaches a specific conclusion and postulates recommendations for legislative solutions here might be forbidden only if it includes legislative recommendations, or not forbidden at all.

The two specific statements of what the general ban on attempting to propagandize or influence legislation is to include, and the one statement of what it is to exclude, provide little more in the way of precision or clarity of meaning. (And, significantly, it is stated in the bill that the ban is not limited to these examples.)

First, making "available non-partisan analysis and research" is specifically allowed, but, as we have seen, the line between analysis and propaganda is indeed a fuzzy one. Moreover, what does "non-partisan" mean in this context? If it is to include all analysis and research except that specifically sponsored by or to promote a recognized political party it would not appear to be overly restrictive. The same cannot be said, however, if it is to include any analysis or research with which a particular party may or may not agree, or indeed, any analysis and research which has an element of advocacy to it. If the latter is the case, foundation sponsored studies such as the Urban Coalition's "One Year Later" report on the effects of the Kerner Commission would be proscribed. So too would be studies by the American Bar Foundation or the Conservation Foundation and so forth.

Secondly, what is meant by an "attempt to affect the opinion of the general public," which is specifically disallowed?

Any published study or report which is circulated to the public whose conclusions are other than benignly neutral could come within this category. Last year's well-publicized and effective studies exposing hunger in America are examples. Moreover, important activities other than studies and reports could be affected, as well. Litigation, for example, is often more than an attempt to vindicate the rights of a specific individual, but is also an important means of bringing injustices to the attention of the public in the hopes of securing a change in the law. For example, last year's Supreme Court decisions exposing violations of individual rights in administration of welfare programs have had an important impact in focusing public opinion on the need for welfare reform. Such reform has been proposed by the Administration and is becoming a prime legislative topic. One of those cases, Smith v. King was funded by the Roger Baldwin Foundation of the ACLU. Under the new law, is this a forbidden activity?

Lastly, precisely what is included in the prohibition on 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. Is an individual to incur liability by explaining the results or recommendations of a foundation-sponsored study to someone planning to testify before Congress on a bill, and, thus, "participating in the formulation of the legislation?" Government cooperation is often essential to philanthropic projects carried on by private foundations. An example is the renowned Carnegie libraries. Before these could be built, consultation with numerous local officials and actual legislation to make available the land used and guarantee the maintenance costs was necessary. This type of "communication" and activity is surely an attempt to influence legislation, and would be forbidden by H. R. 13270.

The effect of this vagueness and uncertainty on foundation activities will necessarily be profound and far-reaching. Under present law "no substantial part" of the activities of a tax-exempt (§ 501(c)(3)) organization may be used in "carrying on propaganda, or otherwise attempting to influence legislation." While obviously some of the same problems of vagueness inhere in this, the effect on foundation activities is far less severe. While undoubtedly some self-censorship results, in cases of uncertainty a particular project judged to be important may nevertheless be undertaken if it is not a "substantial" activity of the foundation. The proposed changes would eliminate this "safety-valve". Moreover, the new danger of individual liability by the foundation officers and trustees would obviously mitigate in favor of erring on the safe side. Furthermore, the elimination of the "no substantial part" provision in present law would bring a complete halt to joint government-foundation activities which have been so promising in recent years. Where government and foundation join in sponsoring a pilot project or program (such as a children's TV workshop) in which the government itself is interested, since the government funding aspect of this, even though already authorized by specific legislation, will be a line

item in its budget, its implementation involves "formulating legislation."

In short, since the proposed changes are obviously intended to be more restrictive of so-called "political activities" than is current law, foundation officers and trustees, fearing that the foundation may be taxed or that they, themselves, may be subject to severe financial liability, will resort to a kind of rigorous self-censorship, previously unknown, which will likely expand the limitations on First Amendment activities far beyond even those intended by the bill.

> "Seeking to stay on the safe side of an uncertain, often unknowable line . . . [foundations] are likely to eschew any activities that might incur official displeasure. Beneficiaries of government bounty fear to offend, lest ways and means be found in the obscure corners of discretion to deny these favors in the future." Reich, "The New Property," 73 Yale L.J. 5 (April, 1964), at 751.

While the problem of vagueness is the most readily apparent constitutional difficulty evidenced by these restrictions, another more fundamental question also arises which has yet to be finally resolved by the Supreme Court. That is the problem of the underlying permissibility of this kind of broad regulation of First Amendment activities. There have been only a few Supreme Court cases dealing with federal "lobbying" legislation, and for the most part these have been resolved without reaching this constitutional question.

In Cammarano v. United States, 358 U.S. 498 (1959), which is usually cited to advance the proposition that restrictions on lobbying in the form of denial of a tax-exemption are clearly consitutional, it was held that expenses incurred in an attempt to defeat certain legislation threatening the continued existence of petitioner's business were not deductible from income as "an ordinary and necessary" expense of doing business.

The Court dismissed the taxpayer's First Amendment claim, stating,

> "Petitioners are not being denied a tax deduction because they engage in constitutionally protected activities but are simply being required to pay for those activities entirely out of their own pockets, as everyone else engaging in similar activities is required to do . . . ."

That was of course true with regard to the business expense deduction being considered in the case but is not true with regard to a 100% penalty tax or to the complete denial of a tax-exempt

status to a foundation because it engages in First Amendment activities or to the individual tax penalty on its officers for authorizing these. As Justice Douglas concurring in Cammarano, noted,

> "If Congress had gone so far as to deny all deductions for 'ordinary and necessary business expenses' if a taxpayer spent money to promote or oppose initiative measures, then it would be placing a penalty on the exercise of First Amendment rights."

Under H. R. 13270, a foundation could be denied its tax exemption, and its officers penalized if they attempted to influence legislation.

In United States v. Rumley, 345 U.S. 41 (1952), decided on statutory grounds, the Court interpreted a Congressional resolution authorizing the investigation of "all lobbying activities intended to influence, encourage, promote or retard legislation" as limited to inquiry into representations made directly to Congress, explicitly recognizing that

> ". . . the power to inquire into efforts of private individuals to influence public opinion through books and periodicals, however remote the radiation of influence which they may exert upon the ultimate legislative process, raises doubts of constitutionality in view of the prohibition of the First Amendment." (At 46)

Justices Black and Douglas, concurring, specifically pointed out that

> "The privilege of pamphleteering, as well as the more orthodox types of publications, may neither be licensed (Lovell v. Griffen, 303 U.S. 444) nor taxed, Murdock v. Pennsylvania, 319 U.S. 105."

H. R. 13270 apparently places a tax on certain kinds of "pamphleteering" and publications, among other things.

Finally, in United States v. Harris, 347 U.S. 612 (1953), the Court, dealing with a case in which petitioner had failed to register under the Federal Regulation of Lobbying Act (2 U.S.C. §§ 261-270), again avoided the constitutional question of regulaing lobbying activities other than direct communication with Congress by construing the Act as only applying to that kind of activity. Moreover, it stressed that Congress was not prohibiting attempts to influence legislation but was merely seeking to make them public so as to enable Congress to evaluate the pressures being brought to bear upon them. Thus, the case lends no support to the proposition that regulation of propagandizing or influencing the opinion of the general public is constitutionally permissible. Moreover, Justices Black and Douglas dissented, stating,

"Can Congress require one to register before he writes an article, makes a speech, files an advertisement, appears on radio or television, or writes a letter seeking to influence proposed legislation? That would pose a considerable question under the First Amendment as Thomas v. Collins, 323 U.S. 516 indicates . . . I mention the First Amendment to emphasize why statutes touching this field should be narrowly drawn to prevent the 'supposed evil' (see Cantwell v. Connecticut, 310 U.S. 296) . . . .

H. R. 13270 clearly attempts to restrict foundation political activities in ways which have been untested in the Court, and in ways which the Court has itself consistently acknowledged raise profound First Amendment difficulties. In our view, there is reason to believe that even apart from problems of vagueness it could not overcome constitutional barriers. Recent cases have made clear that a condition attached to a government benefit which has the purpose and effect of drastically limiting First Amendment rights is not constitutionally permissible unless a compelling governmental interest is demonstrated. Speiser v. Randall, supra; Sherbert v. Verner, 374 U.S. 398 (1963), and even then, the condition will survive constitutional scrutiny only if it is no broader than necessary to protect that interest. Similarly, a condition used to distinguish those who are eligible for a benefit from those who are not, which in effect broadly restricts First Amendment rights, does not meet the constitutional requirements of due process and equal protection unless it can be shown to be a carefully limited means of advancing a compelling government purpose. Shapiro v. Thompson, 37 U.S. Law Week 4333 (April 21, 1969).

It has not been demonstrated that the government's interest in protecting against propagandizing or attempting to influence legislation by private foundations, or, indeed, any other group is a sufficiently compelling one to justify a prohibition of the breadth contemplated by this bill. The concern which has been evidenced is not that the public be able to evaluate the pressures brought to bear upon it by foundations, or that a large amount of tax-free funds will be channeled into political campaigns, so that foundations can exercise an inordinate influence on elections or on government policies. Rather, it is apparently that such private foundations not become "tax-dodges" allowing funds to be spent to support narrow private interests to secure a benefit intended to advance a broader public interest. That admittedly proper interest on the part of the government, however, can be adequately protected by present provisions denying a tax exemption only when a "substantial" part of the organization's activities can be deemed "lobbying."

The argument is made that to permit private foundations to attempt to influence legislation either by direct communication with legislators or by affecting the opinion of the general public is to give them an advantage not enjoyed by all others and thus inequitable. We disagree. Since the Cammarano case, the Internal Revenue

Code has been amended to allow corporations, businesses and other profit-making organizations to deduct expenses incurred in influencing legislation which directly affects them, by direct communication with legislators. (Sec. 162) H. R. 13270 would deny similar benefits to private foundations. Thus if, for example, Congress was considering proposals to tax motion pictures deemed objectionable for minors, theatre owners lobbying against this would receive tax benefits to spur their drive. Non-profit parent's or citizens' groups who might support it would be denied similar benefits and thus be handicapped in their efforts. The same effect is possible in controversies over commercial development of a natural resource and countless other areas.

Furthermore, while it is still true that businesses and corporations are prohibited from deducting expenses of attempts to influence the general public on legislative matters, they can often accomplish this by way of advertising, the costs of which are deductible. Thus the Internal Revenue Code as a whole under these new provisions would be sharply skewed in favor of those corporate and business interests already most financially able to make their voices heard in the legislative process, and against those traditionally least able to do so, such as consumer groups, the poor, conservationists and so forth, and who in recent years have increasingly relied on private funds channeled through foundations to make their muscle felt. A tax exemption has been a significant incentive for private funds to support these groups, reducing their overall reliance on government to itself initiate and support change. To attempt to reverse this trend at this time would only serve to increase and spur the alienation and frustration already dividing our country and threatening our institutions, and to deny Congress and the country an important source of information and opinion.

Turning briefly to the second major "political activity" restriction of concern to the ACLU, H. R. 13270 provides that amounts payed, "to influence the outcome of any public election (including voter registration) drives carried on by or for such foundation" are "taxable expenditures" and thus prohibited. Excepted are amounts paid or incurred by a § 501(c)(3) organization, the principal activity of which is non-partisan political activity in five or more states, if that organization expends substantially all of its income directly for such activities, is supported by other tax-exempt organizations or by the general public, does not receive more than 25% of its income from a single source, and does not accept contributions earmarked for use in a particular state or election. These provisions amount to legislative "overkill."

If Congress is truly worried about the use of such funds for "partisan" voter activity or in selected campaigns aimed at a particular candidate, surely that possibility can be prevented with a more narrow restriction that does not threaten to curtail

legitimate and important on-going voter registration activity merely because the resources available to a foundation may be insufficient to support activity in five or more states.

The danger which inheres in these new restrictions is not to any one group of persons or single ideological persuasion. Rather it is to the unique role which the tax-exempt foundation so effectively fills in our pluralistic society. Restrictions of this kind, strictly interpreted and enforced, could remove the incentive to innovate, to experiment, to persuade and to act as a source of ideas, which is, after all, both one of the primary purposes for which tax-exempt foundations were created and one of the main advantages of their continued existence. Ultimately it could reduce foundations to mere financial conduits for charitable giving, and dry up a source of information and ideas vital to both the public and the Congress itself.

H. R. 13270 was considered by the House under a closed rule so that amendments could not be proposed. The Senate Finance Committee thus presents the first, if not the last, occasion to consider closely and hopefully to revise the proposed restrictions on foundation political activities. We believe that they are both unwarranted and ill-advised. The grave constitutional questions which they raise cannot be swept under the rug and should not be left to the courts to resolve. We urge that the Finance Committee delete the proposed changes in the law relating to political activities of private foundations from the bill.

SUMMARY

STATEMENT OF
REED LARSON, EXECUTIVE VICE PRESIDENT
NATIONAL RIGHT TO WORK COMMITTEE

Before the
SENATE FINANCE COMMITTEE

Hearings on Tax Reform Legislation,
(H.R. 13270)

October 8, 1969

Due in a large measure to special-privilege loopholes in our tax laws, millions of Americans are today being denied basic civil rights and political freedom. They are compelled, in order to work at their jobs, to help finance political and ideological objectives with which they may strongly disagree.

This Committee has an opportunity and, we suggest, a responsibility to address itself to one of the most basic -- albeit, most politically sensitive -- needs in the whole spectrum of tax reform. That need, in our judgement, is to apply, broadly and evenly, the restrictions on political activities by tax-exempt organizations which spend for political purposes funds collected from individuals as a condition of employment. While officials of labor unions are the most notorious offenders in this connection, the practice is equally objectionable when carried on by any private organization.

The record of union political activity, including admissions by many union officials, demonstrates conclusively that the backbone of union political activity is based on compulsory dues and fees.

Contrary to a widely-held misconception, there is no effective means of escape for the compulsory union member who objects to the use of his dues for politics. The idea that union members can successfully withhold their dues from politics is a snare and a delusion of the cruelest sort.

A golden opportunity now confronts those Members of Congress who are interested in achieving genuine tax justice. Removing the special tax privileges of all private organizations using compulsory dues for any kind of political activity will gain the applause of overburdened taxpayers. Senator Fannin's proposed amendment to H.R. 13270 represents a giant step in the right direction and merits your favorable consideration.

STATEMENT OF
REED LARSON, EXECUTIVE VICE PRESIDENT
NATIONAL RIGHT TO WORK COMMITTEE

Before the
SENATE FINANCE COMMITTEE

Hearings on Tax Reform Legislation,
(H.R. 13270)
October 8, 1969

Mr. Chairman and Members of the Committee:

I am Reed Larson, Executive Vice President of the National Right to Work Committee. Ours is a single-purpose citizens' organization devoted to the concept that no individual should be compelled to pay money to any private organization as a condition of employment.

Our appeal to the Committee is, we believe, in keeping with the spirit in which this broad review of tax legislation was undertaken -- that is, to insure that all persons and organizations receive fair and even-handed justice under the tax law. We are not here to oppose any portion of H.R. 13270, or to ask for relief from its provisions for any group or segment of society.

We are, in fact, in complete accord with the Executive Council of the AFL-CIO in its Resolution calling on the Senate to "improve and strengthen" the tax reform provisions. That same body has pointed out the need to "guard against attempts by lobbyists to preserve and widen their special interest loopholes." It is difficult to believe they mean this since AFL-CIO officials themselves enjoy one of the most flagrant of all "special interest loopholes."

We agree strongly with the drafters of this bill in their recognition of the fact that a comprehensive drive for tax justice must seek not only to broaden the base of tax revenues, but also must reexamine the structure of tax exemption to insure that it serves the public interest and that it does not confer undue privileges upon any special-interest group. In that connection, the present bill endeavors to restrict certain tax-exemptions which tend to thwart or distort the true will of the electorate in choosing its governmental officials and policies. As you know, Section 101(b) of H. R. 13270 takes a step in this direction by limiting the political and lobbying activities of certain tax-exempt organizations. It imposes a heavy tax on any foundation, and on the manager of that foundation, which uses any of its funds "(1) to carry out propaganda or otherwise attempt to influence legislation, or (2) to influence the outcome of any public election including voter registration drives carried on by such foundation . . ."

The bill's drafters must be credited with exceptional insight for recognizing how supposedly nonpartisan voter registration drives may be transformed into highly effective partisan political operations. This fact has been confirmed by AFL-CIO president George Meany, whose organization probably spends more money for voter registration and get-out-the-vote drives than all other tax-exempt organizations combined.

Mr. Meany has observed: "When you pay a candidate's bills you are not so sure where the money is going. When you make a donation to a candidate you can't be sure.

"But when you spend your money to get people registered, and then spend a lesser proportion to get them out to vote, you know you got a vote in the ballot box. Of course, we are a little bit choosy when we choose districts in which we want to better these votes in the ballot box, so that when they go in we have a pretty good idea how they are going to vote."

Due in a large measure to special-privilege loopholes in our tax laws, millions of Americans are today being denied basic civil rights and political freedom. They are compelled, in order to work at their jobs, to help finance political and ideological objectives with which they may strongly disagree.

Thomas Jefferson once wrote "that to compel a man to furnish contributions of money for the propagation of opinions which he disbelieves and abhors is sinful and tyrannical."

Supreme Court Justice William O. Douglas placed this principle in a contemporary setting when he wrote in 1961:

"The collection of dues for paying the costs of collective bargaining of which each member is a beneficiary ir one thing. If, however, dues are used, or assessments are made, to promote or oppose birth control, to repeal or increase the taxes on cosmetics, to promote or oppose the admission of Red China into the United Nations, and the like, then the group compels an individual to support with his money causes beyond what gave rise to the need for group action.

"I think the same must be said when union dues or assessments are used to elect a Governor, a Congressman, a Senator, or a President. It may

33-758 O - 69 -- No. 19 -- 6

"be said that the election of a Franklin D. Roosevelt rather than a Calvin Coolidge might be the best possible way to serve the cause of collective bargaining. But even such a selective use of union funds for political purposes subordinates the individual's First Amendment rights to the views of the majority. I do not see how that can be done, even though the objector retains his rights to campaign, to speak, to vote as he chooses. For when union funds are used for that purpose, the individual is required to finance political projects against which he may be in rebellion."

This Committee has an opportunity, and, we suggest, a responsibility to address itself to one of the most basic -- albeit, most politically sensitive -- needs in the whole spectrum of tax reform. That need, in our judgement, is to apply broadly and evenly the restrictions on political activities by tax-exempt organizations -- including particularly those tax-exempt organizations which spend for political purposes funds collected from individuals as a condition of employment. While officials of labor unions are the most notorious offenders in this connection, the practice is equally objectionable when carried on by any private organization.

The present bill recognizes that this topic is germane to the tax reform issue, but it touches only the remote edges of the real problem. Tax-exempt foundations, whose political activities would be curtailed by this bill, at least use voluntary contributions to finance any politically-oriented undertakings. On the other hand, labor unions, whose open and undisguised politicking dwarfs that of all other tax-exempt organizations, finance their multi-million dollar political "education" campaigns and highly-selective voter registration drives largely with funds collected from individuals as a condition of employment.

Our tax laws, as presently written and interpreted, encourage this practice. Here's what the Internal Revenue Service told us in a letter dated September 28, 1966: "Although certain sections of 501(c) of the Internal Revenue Code and their implementing regulations contain various definitions, limitations and prohibitions relative to political and legislative activities, there is no such proscription with respect to a labor organization otherwise qualifying for exemption from federal income tax under section 501(c)(5) . . . As a matter of law, a labor organization does not lose its right to exemption under Section 501 because it engages in political activity . . ." Mr. Chairman, I request that the full text of this letter and the letter to which it responded be placed in the record.

Some apologists for the union hierarchy have endeavored to maintain the fiction that all union spending for political activities is carried on with voluntarily-contributed funds. This is patently untrue. The record of union political activity, including admissions by many union officials, demonstrates conclusively that the backbone of union political activity is based on compulsory dues and fees.

I have here a wide assortment of authoritative articles and documents which I will summarize as briefly as possible and then request that the full texts be placed in the hearing record.

As far back as 1956 Mr. Joe Rauh, attorney for the United Auto Workers, told the U.S. Supreme Court that "The only funds available to the union are those that come from dues, for the purpose of buying radio time, television time, and newspaper advertising. The small amount that has been collected

"as voluntary dollars has all gone as very small contributions to the candidates . . . when he (a union member) pays his dues, he has paid for his political action."

Spokesmen for fifteen labor unions who were defendants in a lawsuit filed in 1953 (International Association of Machinists et al v. Street, et al, 367 U.S. 740 (1961)) admitted using compulsory union dues "to support ideological and political doctrines and candidates which plaintiffs . . . were, are and will be opposed to and not willing to support voluntarily." The plaintiffs were employees who objected to the use of their forced dues for political purposes.

Justice Hugo Black of the U.S. Supreme Court wrote in 1961: "There can be no doubt that the federally-sanctioned union shop contract here, as it actually works, takes a part of the earnings of some men and turns it over to others who spend a substantial part of the funds so-received in efforts to thwart the political, economic and ideological aims of those whose money has been forced from them under authority of law."

The late Senator Dirksen, revered member of this Senate Committee, dealt with the subject at some length in an article published three years ago by the DePaul University Law Review: "It is well known to everyone that American unions have for the past many years been highly active in politics and have played a very important role in election campaigns of members of Congress, of state legislators, state officials, and local city and county officials. The union chiefs make no apologies for this, but rather assert that it is their right to make sure that those elected to public office are sympathetic towards the aims and purposes of labor unions. Large armies of union staff personnel are assigned to work in political campaigns at the precinct level in getting out the vote for

"union-endorsed candidates; union newspapers and other publications are heavily devoted to promoting favored candidates, and union funds derived from membership dues and fees are liberally distributed to such candidates.

"Where does this leave the individual worker who is required under a compulsory unionism agreement to pay his dues and fees into the union as a necessary condition to holding his job?"

The official magazine of the AFL-CIO for January 1968 reported on that organization's convention held a month before: "The Convention called for top priority for political action . . . All unions are urged to assign as many full-time staff members as possible for full-time political education work as early as possible in 1968 . . ."

On November 11, 1968, U.S. NEWS & WORLD REPORT stated: "Organized labor reported that it spent more than ever before -- in money and effort -- in the drive to elect Hubert Humphrey and save as many pro-union votes as possible in Congress . . . the reports to Congress, however, do not reveal the true extent of the labor campaign. Politicians say the manpower provided by unions is a big asset, going mainly to Democratic candidates."

A long-time union official, Sidney Lens, wrote in the Commonweal magazine May 27, 1966: "Around election time, labor mobilized thousands of workers from the shops as well as many full-time organizers. The offices of the auto union, perhaps the most active of all politically, become depopulated by as much as one-half of the regular staff, all working the hustings for union-endorsed candidates . . . On the first Tuesday in November innumerable union

men, paid from the union treasury, can be seen driving voters to and from the polling booths, acting as watchers to assure an honest count, and calling on 'sure' voters who have not yet cast a ballot."

Authoritative labor columnist Victor Riesel, in a column printed November 11, 1968: "But all this ($7,600,000 in officially reported campaign spending) is petty cash when compared with the local spending from the kick-off, massive Labor Day Parade up Fifth Avenue to the last-minute caravans and get-out-the-vote telephone squads. There were hundreds of radio and television broadcasts. Mr. Labor, himself, George Meany, hit a network of some 330 stations five times. The Ladies Garment Workers put on four national broadcasts . . . America's labor leaders poured out well over $60 million for Hubert H. Humphrey."

An AFL-CIO spokesman said that raising money for favored candidates is not the federation's primary political function, according to a DAILY LABOR REPORT article published on October 29, 1964, by the Bureau of National Affairs. "'Skills and manpower are what labor has to contribute,' says its spokesman."

In his nationally-syndicated column of May 17, 1968, David Lawrence observed: "It is possible in America for a labor organization with a vested interest in legislation to spend a huge sum of money to bring about the defeat of a Member of Congress even though the Federal Corrupt Practices Act bars any corporation or labor organization from contributing 'anything of value' to a federal election, including primaries. Frank J. Lausche . . . was defeated in a Democratic primary for a third term a few days ago by the expenditure of a large sum of money collected in part from dues of labor union members."

"A labor union has shown how to hand $100,000 to Presidential-campaign committees and avoid a law limiting donations to $5,000," U.S. NEWS & WORLD REPORT disclosed in its issue of August 5, 1968. "This lesson in practical politics was given by the Seafarers Union with the money starting to flow to Democratic groups shortly after Secretary of State Dean Rusk declined to extradite a former official of the union . . . Union spokesmen said the money came from members as voluntary contributions for political purposes -- not from regular union dues."

Methods used by the Seafarers Union to obtain "voluntary" contributions for political purposes were questioned by a comprehensive article in the January 3, 1969, edition of the WALL STREET JOURNAL. It reported: "The most ardent opponents of Richard Nixon's incoming Administration apparently are some Japanese and Filipino merchant seamen who have never even voted in an American election. That, at any rate, is the case if dollar donations to election campaigns are a reliable guide to political convictions. For, month after month, these sailors have been contributing as much as a third of their wages to American political candidates, mostly Democrats. The sailors, hundreds and perhaps thousands of them, have given as much as $500 each after a single sea voyage . . . Ostensibly, the money comes in the form of voluntary donations . . . In reality, though, much of the union's contributions represent payments accepted -- or exacted -- from alien seamen who work on high-paying U.S. flag ships bound for Vietnam. Most of these seamen are not even members of the union, which distributes the collected cash to favored political candidates."

In a column headlined "Unions' Wallace Line Out of Line," Washington STAR writer Frank Getlein wrote on September 4, 1968: ". . . in theory, if the members of a union want to support George Wallace, what the leadership ought to be doing is either finding ways to help the members in this political desire or else resigning and going to work for people more in tune with their own feelings . . . When you get right down to it, people don't join labor unions to get their brains washed by their elected leaders on questions with only a remote connection to the conditions and wages of their employment."

According to the September 5, 1968, edition of the ST. LOUIS POST-DISPATCH, "A Cape Girardeau steamfitter told a federal court jury here today that he was 'laid off without reason' in 1963 several days after he refused to make increased contributions to the voluntary political fund of Steamfitters Local 562 . . . (William W.) Copeland was the first witness today in the trial against Local 562 and three of its top officers who allegedly made illegal political contributions through their so-called voluntary political fund."

Four days later the same newspaper reported that another steamfitter "told a jury today that he had signed political fund pledge cards when working on jobs under the jurisdiction of Steamfitters Local 562 because 'I knew I had to sign them or I wouldn't work.' Norman Baker . . . was the first Government witness called today at the trial of Lawrence L. Callanan, business manager of Local 562, and two assistants. They are facing charges of illegally contributing $140,800 to political candidates and campaign organizations."

At the conclusion of the Callanan trial, the ST. LOUIS GLOBE-DEMOCRAT editorialized on September 20, 1968, as follows: "Conviction of Steamfitters Local 562 and three of its top officers on the charge of conspiring

"to violate federal election laws brings nearer a successful close to a long, hard fight by THE GLOBE-DEMOCRAT to bring these men to justice . . . While it is a vindication of THE GLOBE'S efforts, this conviction is a greater victory for the people. It represents the first time that any union has been convicted for this offense. The impact of this verdict will undoubtedly be felt nationwide and could result in a federal crackdown on other unions circumventing the law."

On September 19, 1968, the WALL STREET JOURNAL revealed that "the chieftains of organized labor are about to launch a massive rescue operation designed to save the foundering Presidential campaign ship of their candidate, Vice President Hubert Humphrey . . . participants in the huddles here say the 15-state battle plan envisions putting 'hundreds' of union staff men to work full-time on the Humphrey drive. They report that Mr. Meany has released the entire AFL-CIO organizing staff, totaling around 100 men, to work steadily on recruiting voters for Mr. Humphrey rather than new members for unions. In addition, individual unions are being asked to assign squads of their staff members to the drive."

In its October 2, 1968, issue, the WALL STREET JOURNAL characterized "the AFL-CIO's use of hundreds of paid union staffers to aid Mr. Humphrey's campaign" as "a move that is, at best, in the gray area of legality."

"Many of the political activities of labor and management, conservatives and liberals, border on illegality," according to an article published by the LOS ANGELES TIMES on October 21, 1968. With reference to the Federal Corrupt Practices Act, it quoted a Washington lobbyist for the UAW as follows: "This

"law makes us all terrible fakers. The amount of chicanery being used on all sides to help candidates is becoming a tragic situation."

The same article attributed this statement to AFL-CIO publicity director Al Zack: "Sure, the AFL-CIO News, our official publication, runs pro-Humphrey stories, not pro-Nixon or pro-Wallace ones. But the giant, conservative daily newspapers around the country have been doing just that for years, and still do." (For reasons that are readily understandable, Mr. Zack did not add that American workers are not compelled to subscribe to certain newspapers as a condition of earning their livelihood.)

THE DAILY OKLAHOMAN reported on October 30, 1968, that "Richard Nixon's Oklahoma campaign organization accused the AFL-CIO Tuesday of using dues of union members to campaign for Democratic presidential nominee Hubert H. Humphrey. . . 'This misuse of funds is in direct violation of the regulations that give the AFL-CIO tax-exempt status and it violates the moral obligation of the organization to its members who are not for Mr. Humphrey,' Broaddus (the Nixon spokesman) said."

On June 10, 1969, Victor Riesel wrote about the 1968 political operation of the United Auto Workers. "Virtually all of the union's $2.1 million 'Citizenship Fund' went for political stakes in the '68 race," he reported. "This does not include the pay and expenses for 916 national headquarters field men known as 'International Representatives.' In the final months of the campaign, virtually all of these men spent virtually all their time campaigning against the Republican front runner. On the cost line, as the accountants say, this would come to many millions of dollars."

"AFL-CIO president George Meany -- worried about prospects for Senate and House liberals in the 1970 elections -- already is gearing organized labor for a mighty political effort next year," the CHICAGO DAILY NEWS SERVICE disclosed on September 1, 1969. "He praised the AFL-CIO's Committee on Political Education (COPE) and its director, Al Barkan, for running 'one of the best political machines ever put together.' In a backward glance at the 1968 campaign, Meany aired one of his rare public criticisms of the Democrats. 'Even though the party of our presidential candidate, the Democratic Party, was woefully ineffective and torn asunder by internal strife, the fact that Hubert Humphrey came close is to the credit of COPE, not to the party whose label he carried,' the labor leader said."

Last Friday (October 3, 1969), the WALL STREET JOURNAL reported the AFL-CIO "has also begun to conduct annual rather than biennial voter registration drives, financing them from its general treasury; in the past, COPE had to depend on voluntary union contributions for such work . . . Labor politicians say that Mr. Meany, who once doubted the need for an organization such as COPE, has never been more responsive to their needs. In fact, it was Mr. Meany who proposed in February that registration drives be financed out of the AFL-CIO treasury and conducted on a continuing basis whenever and wherever registration books are open."

From this record, I believe it is clear that the spending by union officials of compulsory dues money for politics is, indeed, astronomical. In our judgement, this practice, whether carried on by a Chamber of Commerce, a labor union, or any other special-interest group, threatens the underpinnings of

representative government. Sixty-three years ago, Samuel Gompers, founder of the AFL, recognized this danger when he said: "It is doubtful to my mind if the contributions and expenditures of vast sums of money in the nominations and elections for our public offices can continue to increase without endangering the endurance of our Republic in its purity and in its essence . . . the necessity for some law upon the subject is patent to every man who hopes for the maintenance of the institutions under which we live . . ."

Contrary to a widely-held misconception, there is no effective means of escape for the compulsory union member who objects to the use of his dues for politics. The idea that union members can successfully withhold their dues from politics is a snare and a delusion of the cruelest sort.

In the only two cases where such a challenge was successfully made, the employees involved spent more than twelve years in litigation at a cost hundreds of times the relief they obtained. And the court acceded to the pleas of union lawyers that the case be decided on a basis which would prevent its being applied as a general rule. In fact, the cases of other groups of employees now making a similar challenge have dragged on for more than two years, and not even the first step toward relief for the aggrieved employees has been made.

The high-handed arrogance of union officials operating under their special tax-exempt shelter was reflected in a recent incident reported in the PHILADELPHIA INQUIRER, Thursday, November 7, 1968: "A group of 104 employes at Leeds & Northrup's North Wales plant have asked for a refund of dues paid to the United Auto Workers which were used for political campaign promotion.

"All members of UAW Local 1350, the workers sent individual letters to local president Arthur Stump stating their demands.

"Stump told The Inquirer that he reacted in direct fashion.

" 'When I got the letters, I threw them all in the wastebasket,' he said."

A golden opportunity now confronts those Members of Congress who are interested in achieving genuine tax justice. Removing the special tax privileges of all private organizations using compulsory dues for any kind of political activity will gain the applause of overburdened taxpayers. It will also demonstrate the willingness of the Congress to deal equitably with a powerful special interest lobby.

The growing public recognition for the need of action in this area is reflected on the editorial pages of hundreds of newspapers across the country. For your interest here are highlights of what a few of them have been saying in recent weeks:

The Chicago Tribune on September 3: "One trouble with trying to eliminate tax loopholes is that the people who holler loudest about loopholes available to others are often trying to divert attention from even bigger loopholes of their own . . . in short, tax reform is for others -- not for the unions."

Wheeling Intelligencer on September 15: "What is hard to understand is why the House has seen fit to tax this type of income if it goes to a church but not if it goes to a labor union."

The Milwaukee (Wisc.) Journal, on July 8: "The tax reformers should show no fear or favoritism. They should close the loophole on labor organizations which have investments in a wide variety of unrelated business activities

"as surely as on churches and any other tax-exempt organizations."

Jacksonville (Fla.) Times Union on September 13: "What's good for tax-exempt foundations and commerical interests of churches should be good for labor unions."

Lancaster (Pa.) New Era, on September 3: "The Senate should most certainly consider taxing private organizations that use compulsory dues for political purposes."

The Daily Oklahoman on August 30: "No justification exists for the taxation of the charitable foundations when the unrelated business activities of the not-so-charitable union bosses continue to be the most noxious tax haven in sight."

The St. Louis Globe Democrat on August 28: "Certainly Congress has an obligation to see that unions neither abuse their members' funds, nor enjoy special benefits from the use of them at the expense of taxpayers. . . And organized labor, which prides itself on being a watchdog against social ills, should volunteer its help in bringing about equitable tax reforms for all -- including unions."

The Richmond Times-Dispatch on September 1: "Congress has an obligation to insure that the funds of union members are not used for political or other purposes without their approval, and to see that unions do not enjoy other special privileges at the expense of the tax payer."

And finally, the New York Daily News said on August 30:

"It is beyond argument, we believe, that political activities of some foundations should cause those outfits to lose some or all tax-exempt status. Nonreligious enterprises of some religious organizations could with justice be taxed . . . So how about labor unions whose leaders habitually (1) take compulsory dues out of their members, and (2) spend large wads of the dough for political purposes -- backing favored candidates, financing lobbies, etc. ?

Senator Fannin's proposed amendment to H.R. 13270 represents a giant step in the right direction and merits your favorable consideration. It would deny tax exemptions to unions which use compulsory dues for political purposes. We support this proposal, and recommend that it be broadened to include not just labor unions, but all private organizations. This Committee has an unusual opportunity to strike a blow for the freedom of all Americans by applying to all tax-exempt organizations the same basic standards of conduct insofar as political activities are concerned.

We urge that you amend the bill to achieve that end.

Statement

filed with

The Committee on Finance
U. S. Senate

on

H. R. 13270 - Section 101, Private Foundations

for

THE DUKE ENDOWMENT

Richard E. Thigpen
Thigpen & Hines
900 NCNB Building
Charlotte, North Carolina 28202
Telephone Area Code 704-333-7125

33-758 O - 69 -- No. 19 -- 7

SUMMARY OF PRINCIPAL POINTS

I. For 45 years The Duke Endowment has distributed 78% of its gross income and 90% of its net distributable income to charity, religion and education in North Carolina and South Carolina. In 1968 these distributions were 83.65% of gross income and 99.5% of net distributable income. (pp. 1-3)

II. The section 506 tax of 7-1/2% would cost the tax-exempt beneficiaries of The Duke Endowment at least $1-1/2 Million each year. If imposed, this tax should not apply to trusts like The Duke Endowment, governed by irrevocable trust agreements. (pp. 4-7)

III. If the tax of 15%, imposed by section 4942, had been assessed for 1968, The Duke Endowment would have paid $1,871,212 out of corpus. If imposed, this tax should not apply to trusts governed by irrevocable trust agreements prohibiting the invasion of corpus and requiring the retention of productive investments. (pp. 8-9)

IV. The exclusion provided in subsection 4 of section 4943 should be enlarged to 75%, and section 4943 made inapplicable to a trust governed by an irrevocable instrument requiring the trustees to hold specified business interests. (pp. 10-11)

V. Conclusion--if section 101 of H. R. 13270 becomes law the payments to charity, religion and education in North Carolina and South Carolina will be reduced. (p. 12)

Statement for THE DUKE ENDOWMENT
on
H. R. 13270 - Section 101. Private Foundations
by
Richard E. Thigpen, Attorney, Charlotte, North Carolina

H. R. 13270 and the committee report thereon have been studied to determine the effect the provisions on private foundations will have upon the operations of The Duke Endowment.

I. BACKGROUND AND OPERATION

The Duke Endowment was created December 11, 1924, by James B. Duke, who placed $40 Million worth of property in trust. The trust agreement is irrevocable. Twenty per cent of the net income is added to corpus, and the balance is distributed to specified tax-exempt beneficiaries. Since creation, The Duke Endowment has operated continuously under the terms of the trust indenture and, up through December 31, 1968, has made the following allocations and appropriations to the beneficiaries named in the governing instrument:

Income available for allocation and appropriation in accordance with the terms of the Trust Indenture	$ 285,182,859
Allocation and appropriation thereof:	
Duke University, Durham, North Carolina	$ 143,226,522
Davidson College, Davidson, North Carolina	10,456,795
Furman University, Greenville, South Carolina	10,533,665
Johnson C. Smith University, Charlotte, North Carolina	7,235,645
Hospitals in North and South Carolina	70,883,301
Orphanages in North and South Carolina	10,585,498

-1-

Methodist Churches in North Carolina:

(a) Superannuated Preachers	$	2,358,693
(b) Building Rural Churches		5,233,998
(c) Operating Rural Churches		4,130,913
Funds set apart as endowment and held for the benefit of Duke, Davidson, Smith and Furman		19,261,228
Funds held for appropriation		1,276,601
	$	285,182,859

These allocations were made from gross income of $331,563,772, of which nearly 63% represents dividends on stock of Duke Power Company. The disbursements to the several beneficiaries totalled $258,564,162, which were about

78% of gross income,

83% of net income, and

90% of net distributable income.

The mandatory accumulations added to principal amounted to $25,698,113 at December 31, 1968. These accumulations produced more than $20 Million of income, which thereby increased distributions to beneficiaries.

The table below summarizes the allocations, appropriations and payments for calendar year 1968.

	Allocations (in thousands)	Payments (in thousands)
Duke University	$ 8,034.3	$ 7,771.7
Davidson College	728.0	716.8
Furman University	708.0	696.8
Johnson C. Smith University	585.1	412.8
Hospitals	6,542.9	6,770.0

Orphanages	$ 742.0	$ 721.2
Methodist Churches in North Carolina:		
(a) Superannuated Preachers	250.7	249.7
(b) Building Rural Churches	259.9	360.0
(c) Operating Rural Churches	341.2	368.9
	$ 18,192.1	$ 18,067.9

The 1968 financial statement shows the following:

Gross Income:		
Dividends	$ 19,474,771.60	90.17%
Interest	2,026,791.57	9.38%
Capital Gains	96,267.05	.45%
Total	$ 21,597,830.22	100.00%
Expenses were	1,615,394.17	7.48%
Net Income	$ 19,982,436.05	
Mandatory Accumulations	1,815,821.87	8.41%
Net Distributable Income	$ 18,166,614.18	
Payments to Beneficiaries	18,067,869.49	83.65%
Balance	$ 98,744.69	.46%

Payments to beneficiaries in 1968 were

83.65% of gross income,

90.9% of net income, and

99.5% of net distributable income.

II. Section 506. THE 7-1/2% TAX

Assuming that on May 27, 1969, The Duke Endowment was, and is now, a private foundation as defined in section 509, it would be liable for the 7-1/2% tax imposed by section 506 upon net investment income for 1970 and subsequent years.

It is estimated that the net investment income of The Duke Endowment, after all expenses for 1969, will be $21,223,000. A tax of 7-1/2% would amount to $1,591,725. Applying the ratios of 1968 payments to this amount of tax would reduce distributions to beneficiaries as follows:

Duke University	$ 684,664.59
Davidson College	63,143.73
Furman University	61,392.83
Johnson C. Smith University	36,370.92
Hospitals	596,419.36
Orphanages	63,541.66
Methodist Church	86,191.91

The Indenture of The Duke Endowment limits the beneficiaries to those listed above, and the Indenture further requires that they be paid specified percentages of the net distributable income. All of these beneficiaries will remain tax-exempt under H. R. 13270. In effect, a tax on The Duke Endowment's net investment income becomes a tax on organizations which remain tax-exempt under the new bill.

The "minimal tax" proposed in section 506 will reduce by at least $1-1/2 Million the distributions to charity, religion and education in the States of North and South Carolina. The Treasury proposals and earlier suggestions

were directed toward current and adequate returns to charity, with a recognition of mandatory accumulations required "by the governing instrument of existing organizations," and as permitted under section 504(a) of the Internal Revenue Code.

The published annual reports of The Duke Endowment show the vast amount of services performed in meeting "the needs of mankind along physical, mental and spiritual lines" in carrying out the responsibilities of the trustees in accordance with the terms of the trust agreement. The 1968 report contains 36 pages of such work in North Carolina and South Carolina. Schedule 2a, attached to Form 990A for 1968, lists on 20 pages the amounts and purposes for the 1968 distributions of more than $18 Million to beneficiaries. The expenses incurred in the proper distribution of the income, like the administrative expenses of a corporation, may not be treated as having been "paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income."

Section 506(a) imposes "a tax equal to 7-1/2 per cent" on the net investment income of every private foundation. Mr. Mills, Chairman of the Ways and Means Committee, compared this tax to the tax a corporation in the 50% bracket paid upon dividends from another corporation, both U. S. corporations (pp. H. 6987-88 Congressional Record, August 6, 1969). In the case of the corporation, dividends are included in gross income, from which all expenses are deducted, and a special deduction for dividends received is allowed for

85% of the dividends received, restricted to 85% of taxable net income. But, section 506 proposes to tax the private foundation upon its gross income, less the "ordinary and necessary expenses paid or incurred in the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income."

Mr. Duke wisely directed that "each trustee shall be paid at the end of each calendar year one equal fifteenth part of three per cent of the incomes, revenues and profits received . . . upon the trust properties and estate during such year . . . in full for all services as trustee hereunder . . . ." (Indenture, Article Second, p. 6). This rate of 3% is less than the rate of 5% allowed trustees in North Carolina. These commissions are proper costs of administration.

Where, as in the operation of The Duke Endowment, there is a consistent and undelayed "flow through" to charity, the actual distributions to charity, religion and education should be deducted. At most--the "minimal tax" should apply only to the net income retained by the foundation, after accumulations (within the purview of section 504(a)), all expenses of the foundation, and distributions to beneficiaries. Section 504(a) should not be repealed. The "minimal tax" is not for the purpose of raising revenue and has been characterized "as being in part a user fee."

If such a minimal tax is to be imposed, then a provision should be added excluding a trust, such as The Duke Endowment, from the application of the tax. The following provisions are suggested:

1. The tax imposed by section 506 shall not apply to a trust governed by an instrument (in effect and irrevocable on December 31, 1969) setting forth the portion of the net income distributable to designated tax-exempt beneficiaries in any year in which the payments to such beneficiaries of the trust exceed 90% of the net income for such year, which under the governing instrument may be distributed.
2. The term "Private Foundation" as defined in section 509 does not include a trust or endowment fund required by terms of the governing instrument (in effect and irrevocable at December 31, 1969) to distribute specified percentages of its net income to specified beneficiaries each year and which is an exempt organization under section 501(c)(3) of the Internal Revenue Code, provided such distributable income is paid over to or set aside for such tax-exempt beneficiaries during or within 180 days after the close of such year.

The provisions (18) and (21) in subsection (j) relating to "technical, conforming, and clerical amendments" should be eliminated and necessary corrections made in order to continue sections 504 and 681 in the Internal Revenue Code (see pp. 66, 70, 71 of H. R. 13270).

III. Section 4942. TAX ON UNDISTRIBUTED INCOME

In addition to the "minimal tax" of 7-1/2% on net investment income, section 4942 of H. R. 13270 imposes an "initial tax" of 15% on undistributed income and an additional tax of 100% of such income "undistributed at the close of the correction period"(the time allowed for paying out amounts treated as undistributed income).

Under this new provision, the "Distributable Amount" is not the actual net income of a foundation, but rather

whichever of the following amounts is higher:

(1) The minimum investment return, or

(2) The adjusted net income.

Minimum investment income is determined for 1970 by applying a 5% rate of return to the "aggregate fair market value of all assets."

If applicable to The Duke Endowment, the effect of the above provisions would be as follows, using 1968 experience as an example:

1.	Gross Income	$ 21,491,553.00
2.	Paid Trustees Commissions & Expenses	1,487,364.00
3.	Mandatory Accumulations	1,815,821.00
4.	Available for Distribution	18,188,366.00
5.	Minimum investment income $613,262,353 (FMV 12-31-67) @5%	30,663,117.00
6.	1968 Distributions	18,192,067.11

7. The undistributed income (under the proposed statute) is

Item 5	$ 30,663,117.00, less
Item 4	18,188,366.00, or
	$ 12,474,751.00.

8.	Tax at 15%	1,871,212.00

The effective date for section 4942 in the case of organizations organized before May 27, 1969, is deferred until taxable years beginning after December 31, 1971, and until it is possible to reform the governing instrument by amendment, judicial proceeding or otherwise to meet the requirements of section 508(g)(1)(A), "so that its income is distributed at such time and in such manner as not to subject the foundation to tax under section 4942."

The Duke Endowment distributes annually all of its distributable income. The application of section 4942 would require a distribution of corpus--which may not be done under the governing instrument. The "minimum investment income" is akin to the "income equivalent requirement" proposed in 1965. Then the Treasury Department stated that: "Provisions for existing organizations whose underlying instruments require an accumulation of current income or prohibit an invasion of corpus may be desirable." The indenture may be "reformed" by judicial proceedings--but a previous attempt at reformation failed (Cocke v. Duke University, 260 N. C. 1, 131 S.E. 2d 909 (1963).

If section 4942, or any similar provision is enacted, there should be a further provision, making such section not applicable to foundations such as The Duke Endowment. The exception might read:

> Section 4942 shall not apply to a trust governed by an instrument (in effect and irrevocable at December 31, 1969) directing the trustees to accumulate a specified portion of the income of the trust, prohibiting the trustees from invading the corpus of the trust, and requiring the trustees to retain investments that do not produce the minimum investment return.

IV. Section 4943. TAX ON EXCESS BUSINESS HOLDINGS

Section 4943 imposes a tax of 5% of the value of excess business holdings in a business at the end of any calendar year and an additional tax of 200% of such excess value at the end of the correction period. Generally, this means the amount of voting stock held by a foundation and disqualified persons in excess of 20% of the voting stock of a corporation with a permissive holding of 35% of such stock where some third party has actual control of the corporation.

Section 4943 does not apply to an organization created by an inter vivos trust which was irrevocable on December 31, 1939, which, together with disqualified persons, owned not more than 55% of the stock of a corporation, the common stock of which was traded on a public stock exchange at all times after 1960 (see Sec. (4), p. 83, H.R. 13270). This exception applies only when (1) the foundation has received at least 80% of its net income in each of the years 1966, 1967, 1968 and 1969 from such stock, (2) neither the donor of such stock nor a member of his family is a foundation manager nor a director of the corporation, and (3) the foundation does not purchase nor acquire any of such stock after July 28, 1969 (see Sec. (5), pp. 84-85, H.R. 13270).

The Duke Endowment and disqualified persons hold 74% of the voting stock of Duke Power Company, a regulated utility corporation whose stock is listed and regularly traded on the New York Stock Exchange. The daughter of the donor is a trustee of The Duke Endowment. The indenture requires the

retention of the Duke Power Company stock. Litigation in 1963 (Cocke v. Duke University, 260 N. C. 1, 131 S. E. 2d 909) sought to revise the investment provisions of the 1924 trust indenture, but without success.

In 1968, the Duke Endowment had net income of $18,188,366 and received $16,945,630 from Duke Power Company, which was 78.85% of the total income and 93% of net income. Other years in the 4-year period would be comparable.

Provisions are made in the proposed statute for the disposition of excess holdings, but such provisions do not adequately provide an exception for existing foundations whose governing instruments, as presently drawn, compel them to hold specified business interests. (Tax Reform Studies and Proposals, U. S. Treasury Department, 2-5-1969, part 3, p. 302).

If section 4943 is adopted, then the excluding provisions of subsection (4) should be changed to cover such foundations and disqualified persons owning "not more than 75 per cent of the stock of a corporation, the common stock of which was traded on a public stock exchange" on July 28, 1969. The percentage change would leave problems created by the special rules of subsection (5), which could be avoided by a provision, such as the following:

> The provision of section 4943 (relating to taxes on excess business holdings) shall not apply to a trust governed by an instrument (in effect and irrevocable on July 28, 1969) which compels the trustees to hold specified business interests, if local law prevents suitable revision of the governing instrument.

CONCLUSION

The Duke Power Company has aided the economic and industrial development of the Carolinas. The power company dividends have provided funds for distributions to

Duke University--a Methodist school,

Davidson College--a Presbyterian school,

Furman University--a Baptist school,

Johnson C. Smith University "an institution of learning for colored people," sponsored by the Presbyterian Church,

Orphanages "for the benefit of white or colored orphans,"

Rural Methodist Churches in North Carolina,

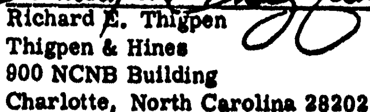
Superannuated Methodist preachers, and

Hospitals--"whether for white or colored, and not operated for private gain."

Mr. Duke saw the need for hospitals and directed $1 per free bed day for charity patients, and funds for building and equipping such hospitals.

For the past 45 years The Duke Endowment has sought to fulfill the vision of James B. Duke and minister to the "needs of mankind along physical, mental and spiritual lines" without regard to race or religion in accordance with the provisions of an irrevocable trust agreement.

The benefits flowing annually to the above named tax-exempt organizations will be proportionately reduced if section 101 of H.R. 13270 becomes law.



Richard E. Thigpen
Thigpen & Hines
900 NCNB Building
Charlotte, North Carolina 28202

August 26, 1969

-12-

BEFORE THE UNITED STATES SENATE

COMMITTEE ON FINANCE

SEPTEMBER 11, 1969

STATEMENT OF ARTHUR J. GOLDBERG ON BEHALF OF THE DENVER POST AND THE DENVER POST EMPLOYEES STOCK TRUST

33-758 O - 69 -- No. 19 -- 8

STATEMENT OF ARTHUR J. GOLDBERG BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

SUMMARY OF PRINCIPAL POINTS

In 1966, the Helen G. Bonfils Foundation received a gift of a 42% stock interest in The Denver Post, subject to the restriction that the stock is to be sold at a fair price to a trust for the benefit of the employees of that newspaper as the employees purchase interests in the trust. The object of this plan was to insure that (a) the value of the stock would be devoted to charitable purposes and (b) the Post would survive as a vigorous and independent newspaper owned by its employees. More than 400 Post employees have purchased interests in the trust in expectation of the full implementation of the plan.

The Post stock was thus received by the Foundation subject to a plan requiring complete disposition of such stock in a manner serving the public interest in maintaining independent newspapers. Accordingly, no substantial legislative purpose would be served, while a desirable and socially useful plan would be frustrated, if this stock were required to be disposed of at a rigidly fixed time schedule as contemplated by the provisions of proposed Code section 4943, or as may be required by the provisions of proposed Code section 4942.

An amendment of narrow application is therefore submitted to prevent the destruction of this pre-existing and socially beneficial plan.

BEFORE THE UNITED STATES SENATE

COMMITTEE ON FINANCE

SEPTEMBER 11, 1969

STATEMENT OF ARTHUR J. GOLDBERG ON BEHALF OF THE DENVER POST AND THE DENVER POST EMPLOYEES STOCK TRUST

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I come before you on behalf of the Denver Post and the Denver Post Employees Stock Trust. This Trust was created in 1961 by the Denver Post and its employees as a means of enabling the employees to purchase a controlling interest in the Post in recognition of their unique contribution to its growth and development, and in order to insure the survival of that newspaper as a major independent voice in Colorado, Wyoming, New Mexico and adjacent states.

The Trust, which thus serves a unique public purpose, would be seriously prejudiced by the application to The Helen G. Bonfils Foundation of proposed Code sections 4943 and 4942 -- the "excess business holdings" and "minimum distribution requirement" provisions of the Tax Reform Bill. The Post and the Trust request that these sections not be rigidly applied to the foundations which are sources of the Post stock to be acquired by the Trust, and for that purpose propose an amendment of special and limited application. Unless there is such an exemption,

The Helen G. Bonfils Foundation will not be able to honor a pre-existing agreement to sell Post stock to the Trust, the owners and employees of the Post will not be able to achieve their goal of passing ownership of the newspaper to the employees, and the survival of the Post as a completely independent newspaper will be threatened.

Since the Plan itself independently provides for the systematic disposition of the Foundation's Post stock, no important advantage is achieved by requiring disposition of such stock under the compulsion of sections 4943 and 4942. But substantial harm would result from such a forced distribution -- namely, the destruction of a carefully conceived and socially desirable arrangement to pass ownership of the Post to the employees of that newspaper. The pertinent facts concerning the Denver Post, The Helen G. Bonfils Foundation, and the Denver Post Employees Stock Trust demonstrate why this is so.

Background

The Denver Post is the largest newspaper and only independent daily in Denver. It is widely distributed throughout Colorado, Wyoming, New Mexico and adjacent states. Its daily circulation is approximately 250,000; its Sunday circulation is approximately 350,000. It has no connection with any

other newspaper or magazine and is completely independent in every sense of the term -- a rarity in the communications industry today.

The Post has been a vigorous and fearless publisher of news and opinion since its founding in 1895 by H. H. Tammen and F. G. Bonfils. It has sought and enjoyed favorable labor relationships, and its approximately 1,300 employees are virtually all represented by bona fide labor unions. Throughout its entire history, it has never been struck.

The president and holder of the largest bloc of voting power in the Post is Miss Helen G. Bonfils, a daughter of the co-founder. Miss Bonfils has been associated with the newspaper all of her adult life and her fondest desire has always been the continuation of the newspaper as a courageous and locally owned institution.

Having this goal in view, Miss Bonfils and the other directors and officers, together with employee representatives, founded the Denver Post Stock Plan in 1961. The Plan's goal is to recognize the contribution to the vitality of the Post made by its employees, by facilitating the acquisition by those employees of controlling stock ownership in the paper and continuation of this ownership among the active and recently retired employees.

Stated very simply, the Plan works in this manner: The Trustees are authorized to acquire Denver Post stock and

issue certificates of beneficial interest in such stock to employees of the newspaper. Employees are designated as eligible by the publisher of the paper on the basis of merit and service. Employees purchase their beneficial interests under a formula price set forth in the Trust Agreement. Interests of employees who retire or leave the paper must be offered for sale to active employees.

At present 780 employees are eligible to participate in the Trust, and 413 of this number have purchased interests. The Trust owns over 6,450 shares of Post stock, or approximately 8% of the outstanding stock; some of this stock was donated by Miss Bonfils and the remainder was purchased from the Post.

It had long been Miss Bonfils' plan to make all of her own personal stock available for the Post's employees. However, Miss Bonfils also desired to have the fair economic value represented by that stock devoted to charitable purposes after her death. To implement this latter objective, Miss Bonfils established The Helen G. Bonfils Foundation in 1960.

To permit the fair economic value of her stock to be devoted to charitable purposes after her death, while assuring that the employees can acquire ownership of the newspaper necessary to insure its continuous independence and vitality, Miss Bonfils in 1966 donated all of her stock -- over 34,000 shares -- to the Foundation. The donation was subject to a reservation of

the income and voting rights for her life and to a proviso that the Foundation was to sell such stock to the Trust from time to time at a reasonable and fair price determined by the formula set forth in the Trust Agreement.

The formula value of the gift stock in 1966 was $5,630,609. This value should increase over the years. The sales to the Trust will, therefore, generate substantial sums for charitable purposes. The income tax benefit to Miss Bonfils for the gift of her remainder interest in the stock, worth $4,523,068 using the formula value, amounted to less than $50,000.

Miss Bonfils' donation represented about 42% of the outstanding Post stock. Purchase of this stock and of treasury stock owned by the Post would insure majority ownership of the newspaper by the employees through the Trust.

The Trust can purchase stock only as funds are made available by the employees and, in order to insure widespread distribution, there are limits on the interests which any employee can purchase. Accordingly, it will take a substantial period of time before the Plan can be fully effectuated. Moreover, the commencement of pending litigation challenging the Trust has impeded employee investments and Trust purchases. For these reasons, it is not possible to predict the rate at which purchases will be made. (Having mentioned the pendency of a litigation, I should add that the amendment proposed by the

Trust will in no way affect that litigation or prejudice the position of the parties.)

The Post and the Trust are confident that this litigation will be defeated as all lawsuits challenging a similar trust established in the 1930s by the Milwaukee Journal were defeated. But, as in Milwaukee, the litigation and the requirement of employee contributions mean that it will take many years before the Plan can be fully effectuated. In Milwaukee it took about 25 years.

However, even if the Denver Post Plan could be effectuated more rapidly than the Milwaukee Journal Plan, purchases by the Denver Post Employee Stock Trust from The Helen G. Bonfils Foundation cannot be made rapidly enough to bring the Foundation within the stock ownership requirements of section 4943. And no matter how rapidly purchases can be made, the "minimum distribution" requirements of section 4942 could serve to defeat the Plan.

The Effect of Sections 4943 and 4942 Upon the Trust

Under proposed Code section 4943, a foundation which, together with certain related parties, owns more than 20% of the voting stock of a business enterprise, must divest itself of sufficient stock to bring such holdings to no more than 20%. All of the excess over 20% must be disposed of within 10 years; at least one-third of the excess must be disposed of within five years; and, under certain circumstances, at least 10% of the excess must be disposed of within two years.

Under these provisions, The Helen G. Bonfils Foundation would have to dipose of over 25,000 shares of Post stock. Its Deed of Gift obliges it to sell these shares to the Trust. But, for the reasons already noted, it is almost inconceivable that the Trust will be able to purchase all of this stock within 10 years or one-third of it within five years. Section 4943 would, therefore, require sales to a third party, which would violate the Foundation's contractual obligations and defeat the entire purpose of the Trust.

Proposed Code section 4942 requires a foundation annually to distribute for specified charitable purposes 5% of the value of its investment assets. The only asset of The Helen G. Bonfils Foundation is its Post stock. Under the Deed of Gift by which it received this stock, the Foundation can generate cash only by sales of stock to the Trust and, after Miss Bonfils' death, by the receipt of dividends from the Post. Accordingly, there is a substantial likelihood that sales of Post stock to third parties would be the only vehicle for meeting this distribution requirement. As stock in the Post is closely held and not publicly traded, third party purchasers might be unwilling to pay a reasonable price for small amounts of stock. Thus, the ultimate result could be substantial sales at inadequate prices which violate the Trust's contractual rights and defeat Miss Bonfils' purpose of having substantial sales proceeds devoted to charitable purposes.

Surely it is not in the public interest to frustrate the Trust and prevent the Post's employees from purchasing ownership of their newspaper. If sections 4943 and 4942 are rigidly applied to the Foundation, a grave injury would be imposed upon the more than 400 employees who have already purchased an interest in the Trust with the legitimate expectation that the Plan would be carried through. The result would be grossly unfair to these employees, whose contribution to the success of the Post the Plan was intended to recognize.

Furthermore, if ownership passes to third parties, the Post could change from a purely independent newspaper to a unit in a chain of newspapers or other communications media. The chances of the Post's ceasing publication would also be increased as no group of outside owners would have as much stake in continuous publication as the employees would have.

These are not idle speculations. The decrease of independent newspapers, the failure of newspapers, and the growth of concentration in the communications industry are serious and persistent problems which are now under study by the Senate Antitrust Subcommittee.

To illustrate the seriousness of this problem, I would like to cite just a few statistics. In 1920, there were 550 cities with fully competing newspapers; by 1965, there were only 43. Between 1920 and 1960, while our population was

growing at a rapid rate, the total number of daily newspapers decreased by 15%. Between these same years, the number of cities in which two or more newspapers were under a single ownership and had no competition increased by 493% from 27 to 160. Chains controlled less than 10% of all daily newspapers in 1920; today they control between one-third and one-half.[1/]

The owners and employees of the Post set up the Trust in order to insure that the Post would not add to these statistics, but would remain a vital and independent newspaper. It would not serve any legitimate legislative purpose if their Plan were inadvertently defeated by tax legislation designed to cope with other matters.

The Purposes of Sections 4943 and 4942

The various reports preceding and explaining sections 4943 and 4942, as well as the language of these provisions, make it clear that the purposes of these sections are to prevent indefinitely continuing foundation and donor control over businesses, to make foundation assets available for charitable use, and to prevent donors from obtaining excessive tax benefits by donating to foundations non-productive property with a low tax basis. In other words, these provisions are designed to insure that foundations exist for charitable purposes and not for purposes of perpetuating donor control or avoiding taxes.

1/ Senate Hearings on S.1312 Before the Subcomm. on Anti-Trust & Monopoly of the Senate Comm. on the Judiciary, 90th Cong., 1st Session, pp. 3107-08, 1280-82.

The Helen G. Bonfils Foundation's temporary ownership of Post stock, under the Deed of Gift and subject to the provisions of the Trust Agreement, does not present any abuse that these sections are designed to cure. The Trust Plan, which was conceived long before sections 4943 and 4942 were formulated, departs from those sections only to the extent that it is implemented under a timetable that depends upon the rate of flow of employee funds for stock purchases. By the terms of the Deed of Gift, the Foundation must dispose of its newspaper stock. Moreover, the Foundation is hardly a vehicle for tax avoidance since the tax benefit to Miss Bonfils represented approximately 1% of the value of the stock which she donated.

Where, as here, a donor in good faith established a program for disposition which serves the public interest and which requires the foundation to convey all of the donated stock, that program ought to be allowed to be implemented without interference by a subsequently imposed legislative timetable that was conceived with a view to totally different situations.

The Proposed Amendment

To prevent the legislation from destroying the Trust Plan, the Trust proposes for your consideration an amendment which is attached to this statement as Exhibit A. Under this amendment, The Helen G. Bonfils Foundation, and any other foundation which acquired holdings in a business enterprise at or before the same time and for the same purpose, would be permitted to dispose of its interest in the enterprise to the trust

for employees in accordance with the pre-existing plan adopted for that purpose. To accomplish this result, the proposed amendment provides that the stock of the enterprise which is to be sold to the employees' trust will not be subject to the disposition of "excess business holdings" requirements of proposed Code section 4943.

In order to preserve the integrity of the Trust Plan, the amendment also eliminates any requirement that stock subject to the plan be sold to meet the minimum distribution requirement of proposed Code section 4942. As the amendment is designed solely to avoid destruction of the Trust Plan, it provides that all other Foundation assets must be applied toward distribution obligations to the full extent dictated by the provisions of that section.

Application to Subsequently Acquired Post Stock

The principal concern of the proposed amendment described above is, as I have said, to exempt the present Post stock holdings of The Helen G. Bonfils Foundation from the excess business holdings and minimum distribution requirement provisions of the Tax Reform Bill. However, it is conceivable that The Helen G. Bonfils Foundation might, in the future, acquire additional shares of Post stock, and that the most orderly and best method of realizing a good price upon sale of that stock would be through sale to the Trust as funds become available to it from employees. To prevent the foregoing Bill

provisions from requiring a sacrifice sale, the proposed amendment has been prepared so as to apply to subsequently acquired holdings of Post stock of The Helen G. Bonfils Foundation, as well as to the present holdings. It is understood, of course, that any sale of such subsequently acquired shares would be made only upon securing approval from the Colorado Attorney General or the State court of such sale and the terms thereof.

Application to Related Foundation

As noted above, the Post stock holdings of The Helen G. Bonfils Foundation, when added to the shares available for sale from the Post treasury and the existing holdings of the Trust, are sufficient to achieve the objective of transferring effective control of the Post to the Trust. However, in addition to the Post stock held by The Helen G. Bonfils Foundation, approximately 5,000 shares of Post stock are owned by The Frederick G. Bonfils Foundation, a private foundation created in 1927 by the father of Helen G. Bonfils. Further, approximately 17,500 shares of Post stock are owned by a trust created under the will of Miss Bonfils' father.[2/] Upon the death of Miss Bonfils, the assets of this trust will be distributed to The Frederick G. Bonfils Foundation, subject to the requirement that they be paid out and expended for public, educational and charitable projects within ten years from her death.

2/ A schedule of the stockholdings in the Post as of June 10, 1969 is attached as Exhibit B.

Because the Trust will be the majority stockholder of the Post, it is possible that the best, if not only, method of realizing a good price for the Post shares held by The Frederick G. Bonfils Foundation would be through sale to the Trust under the Trust formula. To avoid any compulsion to make a sacrifice sale because the Trust has not yet sufficient funds to make purchases on the time schedule required by sections 4943 and 4942, the proposed amendment has been prepared so as to apply to The Frederick G. Bonfils Foundation, as well as to The Helen G. Bonfils Foundation. Again, it is understood that any sale of such shares would be made only upon securing approval of the Colorado Attorney General or the State court of such sale and the terms thereof.

\- - -

I should like to add that the Denver Post Employee Stock Trust Council, representing the employees who have beneficial interests in the Trust, and the labor organizations representing the employees of the Post, join me in urging adoption of the amendment which I have described to you. I am attaching to this statement immediately following Exhibit B hereto, expressions of support for this request from the following:

Denver Newspaper Guild, Local 74, American Newspaper Guild

Lithographers and Photoengravers International Union, Local No. 276

Denver Mailers Union

Paperhandlers Union No. 17

33-758 O - 69 -- No. 19 -- 9

Denver Newspaper Pressmen's Union No. 22

Denver Stereotypers and Electrotypers Union No. 13

Denver Typographical Union No. 49

Denver Post Employees Stock Trust Council

For all of the reasons which I have stated, I respectfully ask the Committee to give favorable consideration to these modest and carefully limited proposals.

Arthur J. Goldberg

EXHIBIT A

Proposed Amendment to H.R. 13270

A new paragraph (7) shall be added to section 101(k) of H.R. 13270, reading as follows:

"(7) Holdings To Be Transferred to Trust for Employees -- In the event that holdings of a private foundation in a business enterprise were acquired by such foundation pursuant to a deed of gift executed on or before August 22, 1966 subject to a restriction providing for such holdings to be sold to a trust previously created for the benefit of the employees of the business enterprise at a price determined under the provisions of the trust, pursuant to a plan for the transfer of effective control of such business enterprise to such trust --

"(A) holdings in such business enterprise by such foundation, or by any other private foundation which is a disqualified person with respect to such first foundation, shall not be treated as excess business holdings for purposes of section 4943, and

"(B) the undistributed income of each such foundation for any taxable year for purposes of section 4942 shall be the lesser of (i) the amount determined for such year under section 4942(c), or (ii) the fair market value of all assets of the foundation as of the end of such year, other than holdings in such business enterprise, and other than assets being used

used (or held for use) directly in carrying out the foundation's exempt purpose, reduced by the amount of the liabilities of the foundation.

EXHIBIT B

Stockholders of Record of The Denver Post, Inc., at the Close of June 10, 1969:

Name of Stockholder	No. of Shares
First National Bank of Kansas City and Denver U. S. National Bank, Trustees Under Will of F. G. Bonfils, Deceased	17,514.6986
Frederick G. Bonfils Foundation	5,028.78
Helen G. Bonfils	1.0
Helen G. Bonfils Foundation	34,093.9089
First National Bank of Kansas City Trustee Under Indenture of Trust of Helen G. Bonfils	1,468.9436
The Herald Company	14,724.0214
Palmer Hoyt	1.0
Donald R. Seawell	1.0
Charles E. Stanton	10.0
Denver Post Employees Stock Trust	6,458.6
SHARES ON WHICH DIVIDENDS ARE PAID	79,301.9525
Denver Post Treasury Stock	14,713.0475
DENVER POST CAPITAL STOCK	94,015.0

Denver Newspaper Guild

Local 74, American Newspaper Guild, AFL-CIO-CLC
521 Empire Building • Tel.: 303/255-6878 • Denver, Colo. 80202

Sept. 5, 1969

Mr. Donald Seawell,
Secretary-Treasurer
The Denver Post
P. O. Box 1709
Denver, Colorado 80201

Dear Mr. Seawell,

On behalf of more than 350 members of the Denver Newspaper Guild who are employes of The Denver Post, the Denver Newspaper Guild endorses the action taken by the Employees' Stock Trust Council in passing a resolution calling for certain amendments to the proposed Tax Reform Act of 1969.

Many members of the Guild are participating in the Post's stock and purchase plan and have been since its inception. We do not believe that legislation should be passed that would in any way hamper the purpose of the stock purchase plan which will eventually allow employes to gain a controlling interest in the Newspaper.

Please convey this endorsement to the appropriate individuals who will be pursuing this request for an amendment before Congress and the U. S. Treasury Department.

Very truly yours,

Richard E. Wanek

Richard E.Wanek
Administrative Secretary

REW/b

FURTHER RESOLVE to ask Mr. Justice Arthur J. Goldberg to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, 1969, at Denver, Colorado by:

William Robert Sturms
President
L.P.I.U., Local No. 276, Denver, Colorado

DENVER MAILERS UNION
NUMBER EIGHT IMU

CHARTERED 1897 AFFILIATED WITH INTERNATIONAL MAILERS UNION

DENVER, COLORADO

DENVER POST MAIL ROOM EMPLOYEES

THE DENVER POST, INC.

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS, the undersigned are members of the Mailers' Chapel who man the Mail Room of The Denver Post, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to The Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if enacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees,

NOW, THEREFORE, WE

RESOLVE to seek recognition by the Congress that this legislation would have the unintended effect of frustrating the laudable purposes of preserving an independent and employee-owned newspaper, and we are

FURTHER RESOLVED to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing the Denver Post Stock Plan to go forward, and we

FURTHER RESOLVE to ask our representatives, including Mr. Justice Arthur J. Goldberg, to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations which we represent, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, at Denver, Colorado by the following members of Denver Post Chapel, Denver Mailers' Union #8, International Mailers' Union:

DENVER POST PAPERHANDLERS

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to the Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if inacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees, and

WHEREAS, we the undersigned Executive Committee of Denver Paperhandlers Union No. 17 acting in behalf of and with the whole-hearted support of our twenty-five members employed in The Denver Post Pressroom,

NOW THEREFORE, RESOLVE: to seek recongition by the Congress that this legislation would have the unintended effect of frustrating the luadable purposes of preserving an independent and employee-owned newspaper, and we are

FURTHER RESOLVED: to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing The Denver Post Stock Plan to go forward, and we

FURTHER RESOLVE: to ask Mr. Justice Arthur J. Goldberg, to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations which are represented, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, 1969 at Denver, Colorado, by:

David Goodlett
President Paperhandlers Union 17

Carl Zeman
Vice President Paperhandlers Union 17

Denver Newspaper Pressmen's Union
No. 22

UNDER THE JURISDICTION OF THE I.P.P. & A.U. OF NORTH AMERICA

Affiliated With
COLORADO LABOR COUNCIL AFL-CIO
ALLIED PRINTING TRADES COUNCIL
DENVER AREA LABOR FEDERATION

PRESIDENT
ROBERT G. McGHEE
11[illegible] LARSEN LANE
DENVER, COLORADO [illegible]
[illegible]

VICE PRESIDENT
VIC BROOKS

RECORDING SECRETARY
JOHN TRACY

BOARD MEMBERS
C. W. BROWN
T. COOKE
R. ELLSWORTH
H. LAUDER

SECRETARY/TREASURER
THOMAS J. ATKINS
[illegible] WEST MEXICO
DENVER, COLORADO [illegible]
[illegible]-1168

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to the Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if enacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees, and

WHEREAS, we the undersigned Executive Committee of Denver Newspaper Pressmen's Union No. 22, acting in behalf of and with the whole-hearted support of our 160 members employed in The Denver Post Pressroom,

NOW, THEREFORE,

RESOLVE to seek recognition by the Congress that this legislation would have the unintended effect of frustrating the laudable purposes of preserving an independent and employee-owned newspaper, and we are

FURTHER RESOLVED to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing The Denver Post Stock Plan to go forward, and we

FURTHER RESOLVE to ask Mr. Justice Arthur J. Goldberg to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations which are represented, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, 1969 at Denver, Colorado.

President

Chapel Chairman

OFFICE OF

ORGANIZED
JULY 3, 1891

THE MILE HIGH CITY

Denver No. 13

DENVER STEREOTYPERS AND ELECTROTYPERS

UNION NO. 13

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS, the undersigned is president of the Denver Stereotypers and Electrotypers Union No. 13 whose members own beneficial interests in Denver Post stock through the Denver Post Stock Plan and its Employees Stock Trust, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to The Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if enacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees,

NOW, THEREFORE, WE

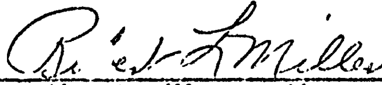
RESOLVE to seek recognition by the Congress that this legislation would have the unintended effect of frustrating the laudable purposes of preserving an independent and employee-owned newspaper, and we are

REMEMBER YOUR COSTELLO HOME

FURTHER RESOLVED to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing the Denver Post Stock Plan to go forward, and we

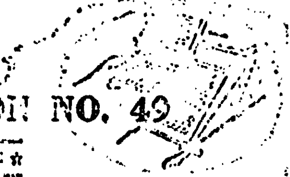
FURTHER RESOLVE to ask our representative, Mr. Justice Arthur J. Goldberg, to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, and the various labor organizations, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, 1969, at Denver, Colorado.



Robert L. Miller, President

DENVER TYPOGRAPHICAL UNION NO. 49



★ IN COLORADO SINCE EIGHTEEN FIFTY-NINE ★

Telephones 825-8773 — 825-6756

SAM A. MANCINELLI, President
PAUL C. LEWIS, Secretary-Treasurer

1224 UNIVERSITY BLDG.
910 SIXTEENTH STREET
DENVER, COLO. 80202

DENVER TYPOGRAPHICAL UNION NO. 49

THE DENVER POST, INC.

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS members of Denver Typographical Union No. 49 of The Denver Post who own beneficial interests in Denver Post stock through the Denver Post Stock Plan and its Employees Stock Trust, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to The Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if enacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees,

NOW, THEREFORE, WE

RESOLVE to seek recognition by the Congress that this legislation would have the unintended effect of frustrating the laudable purposes of preserving an independent and employee-owned newspaper, and we are

FURTHER RESOLVED to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing The Denver Post Stock Plan to go forward, and we

FURTHER RESOLVE to ask Mr. Justice Arthur J. Goldberg to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations which we represent, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, 1969 at Denver, Colorado.

Sam A. Mancinelli, President
Denver Typographical Union No. 49

33-758 O - 69 -- No. 19 -- 10

DENVER POST EMPLOYEES STOCK TRUST COUNCIL

THE DENVER POST, INC.

WHEREAS, The Denver Post Stock Plan was adopted in 1961 as a far-reaching and public-spirited program to enable the employees of The Denver Post to acquire stock ownership of the newspaper and to preserve this newspaper as an independent and leading institution for this region and for the Nation, and

WHEREAS, the undersigned are members of the Employees Stock Trust Council elected as representatives of the over 400 employees of The Denver Post who own beneficial interests in Denver Post stock through the Denver Post Stock Plan and its Employees Stock Trust, and

WHEREAS, Miss Helen Bonfils founded the Stock Plan and has provided the means for it to reach its ultimate goals by donating over 34,000 shares of Denver Post stock to The Helen G. Bonfils Foundation to be held for sale to the employees of the newspaper, and

WHEREAS, legislation now pending in the United States Congress in the Tax Reform Act of 1969, if enacted, would seriously endanger the ability of the Foundation to continue to hold this stock for purchase by the employees and such legislation might have a disastrous effect on the chances of the Stock Plan meeting its goal of placing controlling ownership of the newspaper in its employees,

NOW, THEREFORE, WE

RESOLVE to seek recognition by the Congress that this legislation would have the unintended effect of

frustrating the laudable purposes of preserving an independent and employee-owned newspaper, and we are

FURTHER RESOLVED to request the Congress to incorporate an amendment to the pending legislation eliminating this unintended effect and allowing the Denver Post Stock Plan to go forward, and we

FURTHER RESOLVE to ask our representatives, including Mr. Justice Arthur J. Goldberg, to appear before appropriate bodies of the Congress and Treasury Department and seek to carry out the intentions of these resolutions for the benefit of the public, the various labor organizations which we represent, and all of the employees of this newspaper.

The foregoing resolution was adopted the 5th day of September, at Denver, Colorado by the following members of the Employees Stock Trust Council.

Joe W. Bruce, Chairman
Retail Advertising Dept.

"Tex" Gressett
Retail Advertising Dept.

J. Ivor Jones
Composing Dept.
Denver Typographical Union No. 49

LeRoy Miller
Composing Dept.
Denver Typographical Union No. 49

Barry Morrison
News Room
American Newspaper Guild, Denver Chapter, Local 74, AFL-CIO-COC

Dan Partner
News Room

Paul Hamilton
Stereotype Dept.
Denver Stereotypers & Electrotypers - Union No. 13

Frank Johnson
Editorial Art Dept.
American Newspaper Guild, Denver Chapter, Local 74, AFL-CIO-COC

Archie Lawler
Press Room
Denver Newspaper Pressmen Union No. 22 IPP & AU of America

Mary Fry
Office Mail Dept.

Hugh Kane, Jr.
News Room

Lewis Schaub
Empire Advertising Dept.

I. M. Rosenblatt
Mailing Room
Denver Mailers Union No. 8

Jean Audisio
Accounting and Credit Dept.

Andrew Meesters
Press Room
Denver Newspaper Pressmen
Union No. 22 IPP & AU of
America

Don Davis
News Room

Robert Kruml
Composing Dept.
Denver Typographical Union
No. 49

Bill Cordes
Purchasing Dept.

Rose Hahnn
Classified Advertising Dept.

Shirl Silling
Personnel Dept.

Howard Hosek
Circulation Dept.

SUMMARY OF TESTIMONY OF
DR. KENNETH B. CLARK, PRESIDENT,
METROPOLITAN APPLIED RESEARCH CENTER, INC.,
BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE,
SEPTEMBER 11, 1969

The proposed legislation restricting foundation support of social action-oriented research would be dangerous because:

1) It would deny Congressional support for research in the public interest while the Congress continues to subsidize profitable private interests;

2) It would undermine the uniquely American system of private support for public good through foundations, and would, thereby, increase reliance upon already heavily committed public funds;

3) It would withhold from legislatures and from the public the significant findings of action-oriented applied research;

4) It would curtail or destroy many promising experiments in education, social welfare, and civil rights by denying the right of a "private operating foundation" to receive more than 25% of its income from a single source;

5) It would injure the poor, the deprived, and minorities most of all;

6) It would encourage foundations to withdraw from applied social research or to "play it safe" by avoiding areas of public policy;

7) It would gravely weaken the confidence of the poor and deprived and those in urban ghettos--particularly the young--in the feasibility of non-violent rational means of social change of just grievances and encourage a cynical reliance on non-rational devices, stimulating urban explosions and other violent responses consistent with hopelessness and despair.

American democracy has survived precisely because it has developed flexible means for rational processes of necessary social change. Therefore, it is urgent that the proposed legislation, which would endanger that flexibility, be reconsidered.

TESTIMONY OF DR. KENNETH B. CLARK, PRESIDENT, METROPOLITAN APPLIED RESEARCH CENTER, INC., BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, SEPTEMBER 11, 1969

Mr. Chairman: My name is Kenneth B. Clark. I am professor of psychology at the City University of New York and President of the Metropolitan Applied Research Center, an organization incorporated in New York State.

Let me begin by thanking you, your committee, and the members of your staff for enabling me to appear today to testify on the Tax Reform Act of 1969 as it affects private foundations. From time to time during the past 20 years or so, I have been asked to testify before a Congressional Committee. If my memory is accurate, I have never previously initiated a request to be heard in these chambers. I have done so now because I am deeply concerned about the implications of the legislation before you.

I should like to address my own remarks in regard to the Tax Reform Bill not to the specific prohibitions against the expenditure of funds by foundations--against voter registration, against activities intended to effect legislation, and a tax on foundation income--but, rather, to the implications of the bill as they would affect the democratic process.

The bill now before this Committee would prohibit foundations from:

a) any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof, and

b) any attempt to influence legislation through private communication with any member or employee of a legislative body, or with any other person who may participate in the formulation of the legislation, other than through making available the results of non-partisan analysis or research.

Through this provision that no program can be undertaken which is intended to influence legislation through approaches to members of legislative bodies or through public opinion, Congress would attack action-oriented social research devoted to the public interest while it continues to permit intensive lobbying by vested private interests, such as oil, medicine, agriculture. Groups concerned for self-interest are many and rich. They do not need tax exemption (though many are heavily subsidized by various forms of tax exemptions and governmental subsidies, and in other ways). Those concerned with the public interest, on the other hand, are few, and their total assets are relatively small compared to the wealthy coffers of private interests. How ironic if Congress should abandon its primary responsibility, which is the public interest, while continuing to give support to profitable private interests.

Private foundations are uniquely American institutions. With the exception perhaps of our public education system, there is nothing quite so American as the means we have found over generations to apply private wealth to public causes--private help for public causes instead of public help for private causes.

That part of the legislation with which I am primarily concerned would have the effect of crippling or killing foundation activities in support of social programs the government itself has supported. It would place more and more emphasis on the growth of the central government and public sector, stemming the balancing contribution of the private sector, discouraging American institutions from participation in social research and (relevant) public education. In a representative society, public opinion, and those who will mold legislation, need more not less access to non-governmental and non-profit perspectives.

The pending legislation would also have the effect--through its dangerous provision that no "private operating foundation" can receive more than 25% of its income from a single source--of curtailing or destroying many promising experiments in education, social welfare and civil rights, since the fact is that the

number of foundations willing and eager to support such experiments are few, not many. It would encourage competition among agencies concerned with social action research and divert administrative time and talent away from study to wasteful soliciting of funds.

Those who would be hurt most by such legislation are the poor, the deprived, and those minorities who have not yet been incorporated into the economic and political power of our societies, those who have for so long been excluded from the political process--not the affluent, and not the foundations themselves (as presently defined), most of whom do not engage in imaginative action-oriented applied social research. The masses of your constituencies would be the direct victims of such a bill; and, in the end, the surest victim would be this democratic society itself.

Rather than compel foundations to withdraw from social action research, or to "play it safe" by avoiding areas of public policy, Congress should devise all manner of enticements to encourage foundations to invest even more widely than they do in social research and social programs, and to encourage dissemination of findings and to advocate policies to legislatures. This would certainly increase the chances that desired

social change would occur within the context of rational, systematic and democratic process -- and decrease, I hope, the chances of irrational and demagogic approaches to social change. We must increase the capacity of the society to solve its problems peacefully. To prevent the fruits of the free inquiry of applied social research from reaching the members of the Congress and of State Legislatures would be to deprive them of essential knowledge as a basis for their own actions. In addition, it would deprive the public, who is responsible for the Congress, of an informed perspective on social need.

It is extraordinary that such a bill would see the light of day at this particular time, when the confidence of minority groups and others in the orderly process of social change is at a low ebb. In my testimony before the Kerner Commission, I expressed my frustration about the failure of government to heed the findings of its own research. To document a need, and then to refuse to act on that need is to provide fuel for the cynical who do not believe our government is capable of rational change. For if ever we needed a demonstration of the possibilities of

rational and orderly change, it is now. Many in the urban ghettos--particularly the young--are convinced that democracy is not flexible enough to provide for necessary change. They observe that riots, melodramatic rhetoric, a militant stance, reliance on the irrational, are far more likely to stir leadership to action than are the rational attempts of nonviolent persuasion based on informed research. The legislation proposed would feed this cynicism, this distrust of reason, and the democratic process. For it would legislate rigidity, fear of change, penalizing American institutions for seeking rational nonviolent means to achieve necessary change. This, without question, would encourage, if not stimulate, the resort to the non-rational explosions of frustration and cynical exploitations of just grievances.

American democracy has survived precisely because it has been a flexible institution. It has survived longer than any freely elected government because it has adapted to new requirements; the Constitution has proven extraordinarily flexible for the needs of each new age. This legislation would weaken this living vital instrument and raise doubts about the nation's capacity to admit to past error or new needs. This nation

should have nothing to fear from the search for knowledge, and nothing to fear from rational change.

Should this legislation circumscribing the role of foundations pass as it stands, the Congress must assume responsibility for an impetus toward the final abandonment of the process of reason that is the foundation of any orderly democratic government, and must assume responsibility for any irrational acts of civic disorder engaged in by those despairing people not yet admitted to equality in this society, those for whom the force of reason has become no longer possible. So this legislation would go far beyond a crippling of the freedom of foundations to experiment with new approaches to social problems. It would be a declaration that social research, relevant to social change, is not sanctioned by this society, that human values and the struggle for justice are regarded as unpatriotic, and unworthy of governmental support, and that peaceful social change is now seen as improper and illegal. Two alternatives alone would remain to the deprived should any such stand become the policy of this nation--acquiescence in continued degradation and despair, or a resort to violent, irrational means.

This Congress has given wide support to scientific research in weapons of war--nuclear warfare, nerve gas, and other devastating chemical instruments of destruction. But it has also enabled the nation to achieve scientific triumphs of peace. A nation that has willingly spent billions to send two men to the moon cannot now reject men here on earth. It would be an irony of historic proportion if the strongest and greatest nation on earth retreated in fear in the face of social-action research that could help man to a better life. If social science research is rejected by this Congress, it will be rejecting the essence of democracy--respect for humanity and unquestioned faith in the rational process.

It is, Mr. Chairman, because I believe that this is contrary to the best in the American tradition and in conflict with the urgent needs of our time, that I hope this Committee and the Senate of the United States will reconsider these measures.

Thank you.

Board of Directors
HERMON DUNLAP SMITH
Chairman
Chairman, Finance Committee,
Marsh & McLennan, Incorporated
DAVID PACKARD
Vice Chairman
Chairman of the Board,
Hewlett-Packard Company
JAMES L. ALLEN
Chairman,
Booz, Allen & Hamilton Inc.
ROBERT O. ANDERSON
Chairman of the Board,
Atlantic Richfield Company
JOSEPH L. BLOCK
Chairman, Executive Committee,
Inland Steel Company
MARY I. BUNTING
President,
Radcliffe College
WILLIAM G. COLE
President,
Lake Forest College
JACK T. CONWAY
United Auto Workers of America
ALBERT W. DENT
President,
Dillard University
LEE A. DuBRIDGE
President,
California Institute of Technology
ROBERT L. FOOSE
Principal,
Westfield Senior High School
PAUL A. GORMAN
President,
Western Electric Company, Inc.
ROBERT E. JENKINS
Superintendent,
Unified School District of San Francisco
Rev. C. ALBERT KOOB, O. Praem.
Executive Secretary,
The National Catholic
Educational Association
SIDNEY P. MARLAND, Jr.
President,
Institute for Educational Development
MILTON C. MUMFORD
Chairman of the Board,
Lever Brothers Company
JOHN M. STALNAKER
President,
National Merit Scholarship Corporation
THOMAS E. SUNDERLAND
Vice Chairman,
United Fruit Company
HOBART TAYLOR, Jr.
Partner,
Dawson, Quinn, Riddell, Taylor & Davis
ELLSWORTH TOMPKINS
Executive Secretary,
National Association of
Secondary-School Principals

NATIONAL MERIT SCHOLARSHIP CORPORATION
990 Grove Street, Evanston, Illinois 60201 area code 312/869-5100

September 5, 1969

To: The Honorable Russell B. Long

Chairman, Senate Committee on Finance

Summary of statement of testimony to be given to Senate Committee on Finance, relating to portions of Tax Reform Act of 1969 (H.R. 13270) concerning private foundations and their relationship to sponsorship of undergraduate scholarships by John M. Stalnaker, President Emeritus, National Merit Scholarship Corporation of Evanston, Illinois.

My name is John M. Stalnaker. I am president emeritus of National Merit Scholarship Corporation of Evanston, Illinois, and have been associated with it since its founding in 1955.

I am executive director of the Commission on Presidential Scholars, chairman of the Midwest Regional Panel for White House Fellows, and have served as chairman of the Board of Foreign Scholarships (Fulbright Program). Presently I am also a member of the Board of Higher Education of the State of Illinois.

National Merit Scholarship Corporation operates the nation's two most widely known and most influential public scholarship competitions --- the National Merit Scholarship Program and the National Achievement Scholarship Program for outstanding Negro students. Some 800,000 students enter these programs each year representing over 17,500 high schools. Over 25,000 scholarships have been awarded to date.

Some 500 organizations sponsor the scholarships, including corporations, colleges, labor unions, professional societies, other organizations, individuals, as well as private foundations, including many corporate foundations.

In no case do the 500 sponsoring organizations of the Merit and Achievement programs award their scholarships directly to individuals; the awards are made by National Merit Scholarship Corporation.

The programs are extremely competitive as is detailed in our written testimony. Most of the winners are in the upper one half of 1% of the secondary school graduates.

33-758 O - 69 -- No. 19 -- 11

Many of the sponsors provide funds for completely unrestricted scholarships that anyone can win. Almost all of them also offer scholarships for the most outstanding students who meet certain criteria of interest to them. Thus, the Army and Air Force Central Welfare Funds limit their scholarships entirely to children of members of these services. Corporations and corporate foundations provide awards for the most highly qualified children of employees. Labor unions specify children of members. Those wishing to help Negro students use the facilities of the National Achievement Scholarship Program for outstanding Negro students.

National Merit Scholarship Corporation has been ruled to be an exempt organization under Section 501(c)(3) of the Internal Revenue Code. We believe that it will continue to be an exempt organization under the changes in the Tax Reform Bill of 1969, and would also qualify as a publicly supported organization. Contributions to it would continue to be deductible by the donors under Section 170 of the code.

Most of the 500 scholarship donors are also not private foundations. However, a significant number are, and while they do not make their scholarship grants directly to individuals, the restrictions of this bill dealing with direct grants to individuals may be subject to differing interpretations. This may result in interruption or widespread cancellation of completely desirable scholarship programs, and we would not believe this to be in the national interest. We are concerned with Section 4945(e), pertaining to taxable expenditures, which requires that individual grants be "awarded on an objective and nondiscriminatory basis

pursuant to a procedure approved in advance by the Secretary or his delegate." We fear that this standard may be so imprecise as to cause a private foundation to hesitate to award scholarships, even to the winners of bona fide scholarship competitions such as that conducted by National Merit Scholarship Corporation. Because an advance ruling must be obtained and because of the severe penalties attaching should such a grant be ruled to be a taxable expenditure, some private foundations may be inclined to suspend their scholarship support activities pending clarification.

We do not believe that the word nondiscriminatory, as read in the bill, is meant to affect competitive scholarship programs with criteria similar to ones that are limited to children of members of the armed forces, to children of employees of corporations, or who are Negroes, or American Indians, or children from low income families. But some private foundations may not wish to risk the severe penalties to find out.

We are also concerned with the employment of the word nondiscriminatory because of the possibility that the wording and interpretations which may develop concerning it in the context of the provisions governing private foundations will be extended and used as precedents in Treasury rulings on other scholarship programs. National Merit Scholarship Corporation, for instance, operates one of the nation's major competitive scholarship programs for Negro students. We think that the nation truly would be the loser if this voluntary program, which is entirely privately supported, were to become the unintentional and indirect

victim of this bill. The Negro community would have lost a valued friend.

We are also concerned that some private foundations which are donors to national public scholarship competitions administered by organizations which the Treasury has ruled tax-exempt may now conclude that for safety's sake, they should now also get a Treasury ruling themselves for their scholarship grants to that program. Obtaining a ruling typically requires many months, and could result in substantial interruptions of these activities and the nation's more able students would be the losers.

Some clarification of the bill is needed where grants to individuals are concerned, especially to undergraduate students. The public supports public scholarship competitions which are important to the national welfare, as interest in the Merit Program attests. Private foundations play an important part in making such competitions possible. Regardless of the intent of this bill, we believe that some interpretations may place new restrictions on these worthy activities. The possible penalties associated with misinterpretations may cause some donors who want to be certain beyond a shadow of a doubt to cancel their scholarship programs.

There are undoubtedly a number of ways in which the ambiguity of Section 4945(e) might be eliminated.

One possibility might be to simply exempt from the bill expenditures for undergraduate scholarships, the winners of which are chosen in a bona fide competition conducted by an independent organization which has been ruled exempt by the Treasury.

Another approach might be to exclude from the term taxable expenditures, "scholarship and fellowship grants which are subject to the provisions of Section 117(a) and are to be used for study at an educational institution described in Section 170(b)(1)(B)(ii)", the language used in Section 4941(d)(2)(G)(ii) of the Tax Reform Bill of 1969.

There may also be unfortunate implications in Sections 4941 and 4946 for scholarship programs supported by private foundations. These have to do with self-dealing and disqualified persons. As our more detailed testimony indicates, these sections might be interpreted to bar a highly qualified student from winning a scholarship because the father was a substantial stockholder of a corporation. Our detailed testimony suggests modifications to avoid this result.

We believe that the problem areas we perceive in the tax bill as now written could cause interruption or curtailment of important scholarship programs which are in the nation's best interest. We also believe that some modification in the manner which we have suggested or in some other appropriate manner is necessary to eliminate these problem areas. We urge that such modification be considered.

We are at your disposal to explain further any aspects of this testimony either with the committee or with the appropriate members of your staff.

NATIONAL MERIT SCHOLARSHIP CORPORATION

990 Grove Street, Evanston, Illinois 60201 area code 312, 869-5100

Board of Directors
HERMON DUNLAP SMITH, Chairman, Chairman, Finance Committee, Marsh & McLennan, Incorporated
DAVID PACKARD, Vice Chairman, Chairman of the Board, Hewlett-Packard Company
JAMES L. ALLEN, Chairman, Booz, Allen & Hamilton Inc.
ROBERT O. ANDERSON, Chairman of the Board, Atlantic Richfield Company
JOSEPH L. BLOCK, Chairman, Executive Committee, Inland Steel Company
MARY I. BUNTING, President, Radcliffe College
WILLIAM G. COLE, President, Lake Forest College
JACK T. CONWAY, United Auto Workers of America
ALBERT W. DENT, President, Dillard University
LEE A. DuBRIDGE, President, California Institute of Technology
ROBERT L. FOOSE, Principal, Westfield Senior High School
PAUL A. GORMAN, President, Western Electric Company, Inc.
ROBERT E. JENKINS, Superintendent, Unified School District of San Francisco
Rev. C. ALBERT KOOB, O. Praem., Executive Secretary, The National Catholic Educational Association
SIDNEY P. MARLAND, Jr., President, Institute for Educational Development
MILTON C. MUMFORD, Chairman of the Board, Lever Brothers Company
JOHN M. STALNAKER, President, National Merit Scholarship Corporation
THOMAS E. SUNDERLAND, Vice Chairman, United Fruit Company
HOBART TAYLOR, Jr., Partner, Dawson, Quinn, Riddell, Taylor & Davis
ELLSWORTH TOMPKINS, Executive Secretary, National Association of Secondary-School Principals

September 5, 1969

To: The Honorable Russell B. Long
Chairman, Senate Committee on Finance

Statement of testimony to be given to Senate Committee on Finance, relating to portions of Tax Reform Act of 1969 (H.R. 13270) concerning private foundations and their relationship to sponsorship of undergraduate scholarships, by John M. Stalnaker, President Emeritus, National Merit Scholarship Corporation of Evanston, Illinois.

My name is John M. Stalnaker. I am president emeritus of National Merit Scholarship Corporation of Evanston, Illinois, and have been associated with it since its founding in 1955.

I am executive director of the Commission on Presidential Scholars, chairman of the Midwest Regional Panel for White House Fellows, and have served as chairman of the Board of Foreign Scholarships (Fulbright Program). Presently I am also a member of the Board of Higher Education of the State of Illinois.

National Merit Scholarship Corporation operates the nation's two most widely known and most influential public scholarship competitions --- the National Merit Scholarship Program and the National Achievement Scholarship Program for outstanding Negro students. Some 800,000 students enter these programs each year representing over 17,500 high schools.

The primary objective of these two nation-wide programs is to identify publicly each year the most promising high school seniors in the 50 states --- on a state by state basis --- and to encourage scholarship donors throughout the United States to provide these students with the financial assistance they need to attend college.

The National Merit Scholarship Program is now in its 15th year, and over 25,600 scholarships have been awarded in these Merit and Achievement programs to date. This year some 12,000 students will be in college with assistance from NMSC and several times as many will have been benefitted in some way from participation in the program.

The scholarship assistance awarded to students through the Merit and Achievement Scholarship programs comes from some 500 sponsoring organizations, a total which has increased each year. These include corporations, colleges, labor unions, professional societies, other organizations, individuals, as well as private foundations, including many corporate foundations. This complex of sponsors, nearly all non-governmental, but including such federal instrumentalities as the U.S. Army and Air Force Central Welfare Funds, makes it possible for this country to have a massive public talent search and the stimulation of a 50-state scholarship competition without dependence upon federal or state funds.

In no case do the 500 sponsoring organizations of the Merit and Achievement programs award their scholarships directly to individuals. A group of Merit and Achievement finalists are selected by rigorously defined procedures.

The selected students in the Merit program for example, are in the upper one half of 1% of the secondary school graduates. They are so highly selected that all are assumed to be fully qualified for scholarship help. The object of the Merit program is to obtain financial assistance to the extent such assistance is required by the student so that all of the finalists will be able to attend the college of their choice and to study in the field of their interest. Sponsors are invited to support scholarships for any of the finalists since every finalist is qualified and they may define the type of person they wish to have receive their awards. However, the awards are made by NMSC and where appropriate, the need for financial aid is determined by NMSC and NMSC handles all details administering the scholarship.

While no Merit scholarships are awarded to anyone who does not qualify as a finalist, some sponsors wish to offer a fixed number of awards each year and in those cases NMSC, where it cannot meet the full requirements from the finalists, will award a special scholarship to the next candidate in line who meets the criteria for that award. The selection of special scholars is made by NMSC and the scholarships administered by NMSC and all details handled in a way which is parallel to that of the Merit program.

The Merit Scholarship sponsors, collectively, offer some 1000 Merit Scholarships each year that can be won by any student in the country --- they are completely unrestricted as to who can win. Winners are chosen by a national committee of educators skilled in academic selection.

Nearly all the sponsors, including the private foundations, also offer Merit and Achievement and Special scholarships for the most outstanding students who meet criteria of interest to the sponsors and these total 2700 a year at present.

For example, the Army Central Welfare Fund and the Air Force Central Welfare Fund limit their Merit Scholarships to children of members of the U.S. Army and the U.S. Air Force.

Several hundred corporations and corporate foundations, besides giving unrestricted Merit Scholarships, provide awards for the most highly qualified children of employees.

Over a hundred and fifty colleges provide that their Merit Scholarships be awarded to Merit finalists who choose to attend their colleges.

Labor unions specify some of their awards for children of members, a medical research fund for potential workers in the health care field, etc. Organizations wishing to award scholarships to the nation's outstanding Negro

students use the facilities of the National Achievement Scholarship Program in a similar manner.

National Merit Scholarship Corporation has been ruled to be an exempt organization under Section 501(c)(3) of the Internal Revenue Code of 1954. We believe that it would continue to be an exempt organization under the changes in the Tax Reform Bill of 1969 and would also qualify as a publicly supported organization. Contributions to it would continue to be deductible by the donors under Section 170 of the code. National Merit Scholarship Corporation itself will be affected by the Tax Reform Bill of 1969 chiefly if the influence of the bill causes sponsors to withdraw scholarship support in the face of possible severe government penalties.

Most NMSC donors are not private foundations and would not be directly affected. However, a significant number of the donors are private foundations that do come under the bill. These sponsoring foundations do not make their scholarship grants directly to individuals, but to NMSC, and to this extent they would not constitute the type of activity at which the bill seems to aim.

However, it appears to us that the sections of this bill dealing with direct grants to individuals may be subject to differing interpretations, and could unintentionally affect the continuity of various independently

operated scholarship activities which are in the public interest but which make scholarship awards directly to able students. We fear that the enactment of this legislation in its present form will cause sponsors of completely desirable scholarship programs to suspend their scholarship programs until further clarification is made. Such effects could result in widespread cancellation of privately supported scholarship activities and thus would be undesirable for education generally. It would not be in the national interest if there were, at this time, a significant reduction in undergraduate scholarship support by private foundations, both because it would reduce the amount of student aid available nationally, and even more significantly because the nation would lose the very important side benefits of these activities --- talent search and student encouragement.

In particular, we are concerned with Sections 4945(e), 4941 and 4946 of the Tax Reform Act as they may relate to grants made by private foundations directly to individual undergraduate students and students about to enter college.

Specifically, Section 4945(e), pertaining to taxable expenditures, requires that individual grants must be "awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary or his delegate." We fear that this standard may be so imprecise

as to cause a private foundation to hesitate to award scholarships, even to the winners of bona fide scholarship competitions such as that conducted by National Merit Scholarship Corporation. Because an advance ruling must be obtained and because of the severe penalties attaching should such a grant be ruled to be a taxable expenditure, some private foundations may be inclined to suspend their scholarship support activities pending clarification.

In a sense, any scholarship competition by its very nature must be discriminatory. A scholarship competition distinguishes winners from losers.

This point aside, a great many scholarship activities in this country are discriminatory in the sense that the donor, even if it be the federal government, limits eligibility to students who meet some specified criteria. Some examples are programs that are:

1. Limited to children of members of the Air Force and Army.
2. Limited to members of certain churches.
3. Limited to children of employees of companies.
4. Limited to Negroes, or American Indians.
5. Limited to students willing to attend a certain college.
6. Limited to members of a Boys' Club from a certain city.

7. Limited to students from low income families.
8. Limited to students wishing to major in certain fields.

There are many other types.

One commonly used criterion is that of being a child of an employee of a sponsoring corporation. Many corporate foundations have scholarship programs for children of employees. In fact, many of the Merit Scholarships and Achievement Scholarships for outstanding Negro students are designed for children of employees. The number of students receiving awards is a very small fraction of the total number of employee children of the age group --- the programs are extremely competitive. There is a very large number of non-winners for every winner.

We do not believe that the word nondiscriminatory, as read in the bill, is meant to affect such programs, but some private foundations may not wish to risk the severe penalties to find out.

We are also concerned with the employment of the word nondiscriminatory because of the possibility that the wording and interpretations which may develop concerning it in the context of the provisions governing private foundations will be extended and used as precedents in Treasury rulings on other scholarship programs. National Merit Scholarship Corporation, for instance, operates one

of the nation's major competitive scholarship programs for Negro students. We think that the nation truly would be the loser if this voluntary program, which is entirely privately supported, were to become the unintentional and indirect victim of this bill. The Negro community would have lost a valued friend.

We are also concerned that some private foundations which are donors to national public scholarship competitions administered by organizations which the Treasury has ruled tax-exempt may now conclude that for safety's sake, they should now also get a Treasury ruling themselves for their scholarship grants to that program. Obtaining a ruling typically requires many months, and could result in substantial interruptions of these activities and the nation's more able students would be the losers.

Some clarification of the bill is needed where grants to individuals are concerned, especially to undergraduate students. The public supports public scholarship competitions which are important to the national welfare, as interest in the Merit Program attests. Private foundations play an important part in making such competitions possible. Regardless of the intent of this bill, we believe that some interpretations may place new restrictions on these worthy activities. The possible penalties associated with mis-interpretations may cause some donors who want to be

33-758 O - 69 -- No. 10 -- 12

certain beyond a shadow of a doubt to cancel their scholarship programs.

There are undoubtedly a number of ways in which the ambiguity of Section 4945(e) might be eliminated.

One possibility might be to simply exempt from the bill expenditures for undergraduate scholarships, the winners of which are chosen in a bona fide competition conducted by an independent organization which has been ruled exempt by the Treasury.

Another approach might be to exclude from the term taxable expenditures, "scholarship and fellowship grants which are subject to the provisions of Section 117(a) and are to be used for study at an educational institution described in Section 170(b)(1)(B)(ii)", the language used in Section 4941(d)(2)(G)(ii) of the Tax Reform Bill of 1969.

There also may be unfortunate implications in Sections 4941 and 4946 for scholarship programs which are supported by private foundations. Section 4941

pertains to self-dealing between private foundations and disqualified persons. Section 4946 defines disqualified persons to be, among others, members of families who own more than 20% of the voting control of a corporation which is a substantial contributor to the private foundation. Among the acts which will be considered to amount to self-dealing under Section 4941 are the "transfer to or use by a disqualified person of the income or assets of the private foundation" and "agreement by the private foundation to make any payment of money or other property to a government official...." Section 4941(d)(2)(G)(ii) specifically exempts scholarship and fellowship grants from the penalties for self-dealing, but only in the case of government officials. The presence of this limited exemption in the statute in its present form leads to the implication that other scholarship payments will not be so exempted. As a result, it could be interpreted that the child of a substantial stockholder of a corporation, qualified in every other way as a recipient of a scholarship, would be disqualified. While we do not believe that this result was intended, even if it was intended we believe any abuses at which it might have been directed are adequately prevented by Sections 117 and 1170.

The absence of any significant number of either Treasury rulings or reported cases indicates to us that this has not been an area in which there has been abuse by private foundations. Our personal experience supports this conclusion.

Therefore, we would again suggest some modification of the bill as presently written. One possible way of taking care of this problem might be to extend the exemption of qualified scholarship payments from the self-dealing provisions so that it would apply to all such scholarship payments and not just to those made to government officials or their children. Of course, there may be other ways of solving this problem.

We believe that the problem areas we perceive in the tax bill as now written could cause interruption or curtailment of important scholarship programs which are in the nation's best interest. We also believe that some modification in the manner which we have suggested or in some other appropriate manner is necessary to eliminate these problem areas. We urge that such modification be considered.

We are at your disposal to explain further any aspects of this testimony either with the Committee or with the appropriate members of your staff.

SUMMARY OF
STATEMENT OF ROGER A. CLARK, COUNSEL TO THE
MORRIS AND GWENDOLYN CAFRITZ FOUNDATION BEFORE
THE SENATE FINANCE COMMITTEE REGARDING H.R. 13270

Three narrow aspects of the business ownership and self-dealing provisions of H.R. 13270 will have severe, unnecessary and completely unwarranted consequences on the Cafritz Foundation -- which during the past 15 years has distributed over 123% of its annual income to charity -- and other foundations similarly situated. These consequences can be avoided or their impact reduced without in any way blunting the effectiveness of the proposed reforms.

These three aspects of H.R.13270 and the reasons that they warrant revision or clarification can be summarized as follows:

1. Passive real estate investments should be expressly exempted from the excess business holdings provisions of the bill. The reasons for this are:

(a) Real estate investments of a passive nature have traditionally been recognized as appropriate investments for private foundations.

(b) The Treasury Department has consistently recommended that they be excluded from the business ownership limitation.

(c) There is no evidence in the extensive hearings that they present a potential for abuse or are otherwise contrary to the public interest.

(d) Neither of the arguments advanced for the business ownership limitation apply to passive real estate investments.

2. The transition provisions of the bill need additional flexibility so as to permit orderly separation of interests owned by foundations in combination with disqualified persons. Under the will of its donor, the Cafritz Foundation will receive a 2/3 interest in a number of business and investment assets while the remaining 1/3 of each asset will be owned by a marital trust. The resulting combined ownership of assets is probably common to many foundations. To avoid unnecessary hardship and the risk of serious loss, foundations and disqualified persons need to be expressly allowed to separate their combined ownership during the 10-year disposal period by

(1) exchanging stock or property interests in commonly owned assets and

(2) employing any of the wide range of corporate techniques, such as liquidations or redemptions, which would achieve the same purpose.

This will result in reduction of risk of serious loss since fewer forced sales will be required and foundations will be able to sell full ownership interests, which are far more marketable. At the same time, the purposes of the bill will be fully served.

In this regard, it is also important that nonrecognition of gain or loss be permitted in connection with exchanges of stock for stock which are made in order to comply with the bill.

3. Continuation of common management services should be permitted.

(a) All Cafritz real estate properties are managed by a common management company which will also be owned 2/3 by the foundation and 1/3 by the marital trust.

(b) Unless this management company can continue to manage all of the properties, its business will be severely disrupted and the value of its stock as an asset of the foundation will sharply decline. Moreover, the foundation's ability to maximize its income from its real estate investments might also be diminished since it would not have the services of a highly efficient managerial staff which is fully familiar with the properties involved.

(c) There is no possibility for abuse in permitting a continuation of common management services on a nonpreferential basis since such services are commercially available and their value can be readily determined.

STATEMENT OF ROGER A. CLARK, COUNSEL TO THE MORRIS AND GWENDOLYN CAFRITZ FOUNDATION BEFORE THE SENATE FINANCE COMMITTEE REGARDING H.R. 13270

My name is Roger A. Clark and I am a partner in the law firm of Royall, Koegel & Wells which is counsel to The Morris and Gwendolyn Cafritz Foundation. My testimony is limited to the following narrow aspects of the business ownership and self-dealing provisions of H.R. 13270:

1. The apparent limitation upon ownership by private foundations of real estate investments of a passive nature.
2. Inadequacies in the transition provisions with respect to divestitures of excess business holdings in the common situation where a testator has left fractional interests in business and investment assets to a private foundation and other members of his family.
3. The self-dealing rules insofar as they prohibit a disqualified person from supplying services to a foundation at nonpreferential commercially available rates.

These aspects of the bill will have severe, unintended and completely unwarranted consequences for the Cafritz Foundation and many other private foundations similarly situated -- consequences which can be avoided without in any

way blunting the effectiveness of the reform proposals. This statement outlines these consequences, the public policy considerations which require that they be remedied, and our recommendations as to the technical modifications of the bill necessary.

THE CAFRITZ FOUNDATION

The Cafritz Foundation was formed in 1948. Until recently, the foundation has had relatively modest assets amounting at the end of last year to approximately $2.4 million. Over the past 15 years, however, it has contributed over $1.7 million -- amounting to over 123% of its income -- to charity. In addition to regularly supporting established charities, major contributions have been made to the Cafritz Memorial Hospital in Southeast Washington and to the Smithsonian Institution, the latter in the form of a gift of the monument by the renowned sculptor, Alexander Calder, located at the west end of the New History and Technology Building.

The foundation is the principal beneficiary under the will of Morris Cafritz, a major builder in the Washington area who died in 1964 leaving an estate of very substantial value. Mr. Cafritz's will adopted a common estate plan, the effect of which is that a fractional 2/3 interest in most of his assets is soon to be distributed to the Cafritz Foundation with the remaining interest in each asset going to a marital trust for the benefit of his widow. These assets consist primarily of stock in numerous corporations which directly or indirectly own a number of highly valuable real estate in-

vestment properties such as office buildings, apartment buildings, warehouses and unimproved land. In addition, there is a hotel, a construction company and a real estate management company. Thus, the foundation will soon own 2/3 of the voting stock in each of these corporations, with the remaining 1/3 stock interest owned in each instance by a marital trust.

Since Mr. Cafritz's death in 1964, the intention of the executors of his estate, the directors of the foundation and the trustees of the marital trust has been to conserve the valuable assets of these corporations so that, upon distribution, they can be operated in a manner which will maximize annual income to the foundation and the marital trust.

Continued ownership of these assets by the foundation presents no realistic basis for potential abuse -- and at the same time offers the clear prospect of a high yield for worthwhile charitable causes.

Unless H.R. 13270 is clarified or modified in the respects requested herein, however, the foundation may be forced to sell -- possibly within a two-year period -- its entire interest not only in the hotel, construction and real estate management businesses, but also in the remaining real estate investments which are of a passive nature. Moreover, because of practical limitations upon the sale of fractional interests in real estate ventures, it may be necessary for the marital trust to dispose of some or all of its holdings during the same period. Not only would the foundation and the marital trust be deprived of valuable income-producing interests, but a possible forced

sale of very substantial real estate holdings in a single metropolitan area -- even over a 10-year period -- would undoubtedly risk serious losses.

Such drastic consequences would be completely unwarranted and contrary to the public interest. They can be avoided -- or at least reduced -- without undermining the proposed reforms if:

1. foundations are permitted to own real estate investments of a passive nature, and
2. there are adequate transition provisions to allow the foundation and the marital trust to separate their combined ownership of the various holdings.

PASSIVE REAL ESTATE INVESTMENTS SHOULD NOT BE LIMITED

Real estate investments of a passive nature have traditionally been recognized as appropriate investments for charitable foundations. When the Congress in 1951 first provided that normal tax rates would apply to unrelated business income of charitable foundations, it specifically excluded from such taxation all rents from real property (except with respect to business leases in excess of five years on property acquired with borrowed funds). (Code §512(b)(3)) The rationale for this exclusion was clearly stated in the report of the House Ways and Means Committee of the 81st Congress as follows:

> The tax applied to unrelated business income does not apply to dividends, interest, royalties (including, of course, overriding royalties), rents (other than certain rents on property acquired with borrowed funds), and gains from sales of leased property. Your committee believes that such "passive" income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations. (Emphasis supplied) H. Rep. 2319, 81st Cong., 2d Sess., p. 38.

The propriety of foundation real estate investments was reaffirmed in the 1965 Treasury Department Report on Private Foundations which concluded that real estate investments of a passive nature should be excluded from its recommended business ownership limitations. Thus, the report stated (p. 36):

> Appropriate standards should be developed to identify leases of real property (and associated personal property) which are of a clearly passive nature, and rent arising from such leases should not be deemed to derive from the conduct of a business.

Elsewhere in the report, it was assumed that a private foundation could properly own an office building or other type of commercial building. See, e.g., pp. 22-3.

In 1969, the Treasury again recommended to the House Ways and Means Committee that the proposed business ownership limitations specifically exempt "holding of leases of real property (and associated personal property) of a passive nature." Hearings on Tax Reform Before the Committee on Ways and Means, 91st Cong., 1st Sess., Pt. 14, p. 5100.

There is nothing in the hearings before the Ways and Means Committee or in the earlier Patman Committee Hearings on private foundations (Hearings Before Subcommittee No. 1 on Foundations of the Select Committee on Small Business, 88th Cong., 2d Sess., 90th Cong., 1st Sess.) that challenges these consistent recommendations by the Treasury that private foundations should be allowed to retain their real estate investment holdings provided they are of a passive nature.*

H. R. 13270, in its present form, however, does not expressly exempt passive real estate investments from the 20% business ownership limitation. Moreover, while the bill qualifies the broad term "business enterprise" by reference to the definition of unrelated business income in Section 513 of the Code, it fails to pick up the long-standing exception to that definition for passive rental income contained in Section 512(b)(3) of the Code. As a result, there is a real danger that H. R. 13270 will be construed to require that foundations severely limit their real estate investments despite the fact that such investments are completely passive in nature.

Such a drastic limitation -- which would require wholesale divestitures of foundation real estate holdings with attendant risks of substantial

---

* Foundation ownership of passive income-producing property was criticized in these hearings in only two respects, neither of which is relevant here. The first situation involved acquisitions through borrowing and will be adequately covered by the proposed Clay Brown provisions (§121 of H. R. 13270). The second situation involved the alleged tying up by a single foundation of large tracts of undeveloped real property which will be effectively prohibited in the future by the mandatory distributions of income provisions (Proposed Code §4942).

loss -- clearly cannot be justified in view of the complete absence of any evidence in the extensive hearings with respect to private foundations that such real estate investments present a potential for abuse or are otherwise contrary to the public interest.

Indeed, the principal argument advanced for the business ownership limitation is that a foundation's ownership of an operating business will tend to divert the interest of the foundation managers to the maintenance and improvement of the business and away from their charitable duties.* This argument is completely inapplicable to foundation ownership of passive real estate investments for three reasons:

1. Under present law, passive real estate investments by definition cannot involve substantial activity on the part of the foundation or its managers. Thus, the regulations interpreting Section 512(b)(3) of the Code strictly proscribe any activities by the foundation beyond simply renting the premises and maintaining the public areas. See Reg. §1.512(b)-1.(c)(2).
2. Most commercial buildings are managed, like the Cafritz buildings, by professional real estate management companies which make all of the day-to-day de-

* Summary of H.R. 13270 prepared by the staffs of the Finance Committee and the Joint Committee on Internal Revenue Taxation, p. 15.

cisions with respect to the operation of the buildings. In the normal situation, the foundation managers consult with the management company only as to general policy questions in much the same manner as they would need to consult with a broker or investment advisor with respect to a securities portfolio.

3. The proposed income distribution requirement in H. R. 13270 and, to a lesser extent, the proposed Clay Brown provision will effectively deter foundation managers from any temptation to attempt to expand the foundation's real estate-holdings by accumulating tax-free earnings or borrowing.

Thus, there is very little possiblity that the interest of foundation managers will be diverted from their charitable duties as a result of foundation ownership of passive real estate investments.

These same reasons equally refute the other argument advanced in support of the business ownership limitation, which is that a foundation may operate a business "in such a way that it unfairly competes with other businesses whose owners must pay taxes on the income they realize."* Indeed, the complete lack of relevance of this argument to passive real

* Summary of H. R. 13270 prepared by the staffs of the Finance Committee and the Joint Committee on Internal Revenue Taxation, p. 15.

estate investments -- as distinguished from operating businesses -- was recognized by the Congress in 1951 when, as noted above, it exempted the income from such investments from the tax on unrelated business income.

The only specific example of possible unfair competition developed during the hearings was the alleged ability of private foundations to accumulate tax-free earnings to acquire additional business interests at higher prices than could be paid by taxpaying businessmen.* As noted above, this is effectively precluded in the future by the requirement that the foundation pay out to charity its entire net income annually. If anything, this requirement will place the foundation at a slight disadvantage vis-a-vis other real estate owners who will be free to accumulate their earnings for expansion or other competitive purposes.

Thus, there is no real or even theoretical justification for limiting foundation ownership of passive real estate investments. Accordingly, it is urged that Section 4943 of H. R. 13270 be amended to expressly exclude such investments from the proposed business ownership limitation. This would be accomplished by adding a new subsection (5) to proposed Section 4943(d) [pp. 41-2 of the bill] which would provide as follows:

---

* Hearings on Tax Reform Before the Committee on Ways and Means, 91st Cong., 1st Sess., Pt. 3 at 968.

33-758 O - 69 -- No. 19 -- 13

> (5) Ownership of Real Property - The term "business enterprise" does not include ownership of real property the income from which, except for the provisions of Section 514 (relating to debt financed property), would not constitute unrelated business income under Section 512(b)(3).

Two important collateral points with respect to foundation ownership of passive real estate investments are:

1. Depreciation Deductions Should be Expressly Allowed

The proposed income-distribution requirements do not expressly allow deductions for depreciation in computing "net investment income" under Section 506 and "distributable amount" under Section 4942. As a practical matter, a foundation could not continue to own real estate investments unless a deduction for depreciation is allowed in these computations. The foundation would not only have to pay the investment income tax on the depreciation allowance, but it would incur a confiscatory penalty if it failed to fully distribute that allowance as income. As a result, the foundation would be left without funds for necessary capital improvements and replacements. Accordingly, we suggest that the phrase "and depreciation provided for in Section 167" be added at the end of Section 506(b)(3) [pp. 5-6] and Section 4942(f)(3)(A) [p. 29] and that the following new paragraph be inserted after Section 4942(e)(3) [pp. 27-8]:

> (4) Adjustment for Depreciation - The minimum investment return for any taxable year shall be reduced by the deduction for depreciation allowable with respect to such taxable year by Section 167.

2. Combined Ownership May Be Prohibited

The Treasury has recommended that passive real estate investments be subjected to the 20% business ownership limitation to the extent

that they are owned jointly by a foundation and disqualified persons.* The Cafritz Foundation is not opposed to separating its ownership interests in the various properties from that of the marital trust provided there are adequate provisions for doing so in an orderly and equitable manner.

THE TRANSITION PROVISIONS SHOULD PROVIDE FULL FLEXIBILITY FOR SEPARATION OF COMBINED OWNERSHIP

The business ownership limitation will require divestitures by private foundations of substantial business assets. The bill contains two principal transition provisions -- a 10-year disposal period and a limited exception from the self-dealing prohibitions for sales to disqualified persons -- which are designed to enable the required divestitures to be made in an orderly manner thereby minimizing the risk of losses. The transition provisions, however, do not provide adequate flexibility where there is combined ownership of business and investment assets by a private foundation and disqualified persons.

The problem of combined ownership should not be unique to the Cafritz Foundation. The plan of distribution adopted by Mr. Cafritz in his will, whereby fractional interests in his estate were left to a foundation and a marital trust, is, and has been for some time, a very common and frequently recommended estate plan. It would not be surprising, therefore, if there are a number of other foundations similarly situated.

---

* Hearings on Tax Reform Before the Committee on Ways and Means, 91st Cong., 1st Sess., p. 5103.

Unless adequate provision is made for the separation of these combined ownership interests in an orderly and equitable manner, the number of the divestitures required may be greater and their potential adverse effect unnecessarily magnified. This clearly will be the case in the Cafritz situation -- particularly if the 20% combined ownership limitation is applied to those passive real estate investments that are owned jointly by a foundation and a disqualified person. For, unless the Cafritz Foundation and the marital trust -- which will be a disqualified person -- can separate their combined ownership interests, the Foundation may have to sell its entire 2/3 interest in all of the Cafritz companies to comply with the 20% limitation.

The risk of possible loss would be great not only because of the magnitude of the divestitures required, but also because the substantial minority interest of the marital trust in the properties might well inhibit outside purchasers and make it extremely difficult for the foundation to realize full value.

The marital trust, on the other hand, would be faced with a "Hobson's Choice" of either also selling its 1/3 interest in the companies, thereby reducing its corpus -- at least to the extent of any capital gains taxes payable -- and possibly its income, or retaining its stock as a minority owner vis-a-vis new owners who may not share its desire to maximize current income. In this latter regard, most potential customers for large commercial real estate holdings are likely to be interested in speculative

development and capital appreciation rather than in simply collecting rents and distributing them as ordinary income.*

These consequences can be avoided -- or at least minimized -- if during the 10-year disposal period the foundation and the marital trust are given full flexibility to, in effect, "swap out" between themselves their respective fractional interests in the various companies. To the extent that the foundation ended up with full ownership of real estate investments of a passive nature and such investments are not limited by the bill as previously recommended, forced sales would be avoided. Conversely, if the foundation ended up with an operating business, the greater salability of its full ownership interest in that business would facilitate its divestiture and reduce the risk of loss. In both cases the purposes of the bill would be fully served.

The proposed transition provisions, however, do not provide the flexibility needed to achieve this result. The inadequacies that exist and our technical suggestions for remedying them are set forth in Appendix A. Briefly, we recommend that H. R. 13270 be clarified or modified to clearly allow private foundations and disqualified persons to separate their combined ownership of business or investment assets during the 10-year disposal period -- without incurring confiscatory tax penalties -- by (1) exchanging

---

* For this reason, while the Foundation and the marital trust might try to dilute their combined ownership below the 20-35% limitation by a public offering or merger with a large company, it is doubtful that such a solution would meet their common need for maximum distributable income.

stock or property interests in commonly owned assets and by (2) employing any of the wide range of corporate techniques, such as redemptions or liquidations, which would achieve the same purpose. Existing law would, of course, require that the foundation receive full value in any such transactions.

To produce a fully equitable result, provision must also be made for nonrecognition of gain or loss in connection with exchanges of stock for stock to comply with the bill. Otherwise the marital trust -- which except for the bill would have no need or desire to enter into such exchanges -- may be severely penalized in that it may be forced to incur substantial capital gains taxes which would reduce its corpus and earning capacity. There are ample precedents in the Code for comparable relief in connection with forced divestitures. See, for example, Section 1071 relating to gain from sales or exchanges pursuant to orders from the Federal Communications Commission; Section 1081 relating to the nonrecognition of gain or loss on exchanges or distributions pursuant to orders of the Securities and Exchange Commission; Section 1101 pertaining to distributions pursuant to the Bank Holding Act of 1956, and Section 1111 pertaining to distributions pursuant to an order enforcing the antitrust laws.

The appropriateness of similar relief here is particularly compelling since the stock interests involved were acquired pursuant to an estate plan encouraged by the Code which was adopted well before the proposed stock ownership limitation was even suggested.

Accordingly, we suggest that a new provision be added to the Code patterned on Section 1071, allowing:

> the sale or exchange of property (including stock in a corporation) between a private foundation and a disqualified person (within the meaning of Sections 509 and 4946(a), respectively) pursuant to a plan, approved by the Secretary or his delegate, to enable the foundation not to be liable for tax under Section 4943 (relating to taxes on excess business holdings)

to be treated by either party as an involuntary conversion of such property within the meaning of Section 1033.

CONTINUATION OF COMMON MANAGEMENT SERVICES

The third area in which H. R. 13270 will have a severe impact upon the Cafritz Foundation raises a more difficult problem of balancing legislative interests.

All of the Cafritz real estate investment properties are managed by a common management company, the Cafritz Company, which in turn will be owned 2/3 by the Foundation and 1/3 by the marital trust. Through the years, the Cafritz Company has developed a highly efficient staff which is familiar with the properties involved.

In order for the Cafritz Company to continue to function efficiently, it is necessary for it to be able to continue to provide management services for all of the various Cafritz buildings. This will not only maximize the income to the foundation from its holdings in the various buildings, but it is essential to maintain the value of the Cafritz Company stock itself as an

asset of the foundation. For unless the foundation and the marital trust were both willing to enter into long-term management contracts with respect to all of their properties, which might well be unwise in connection with a change-over in management, it would be very difficult to find any purchaser for the company at a reasonable price.

If Cafritz Company's services are provided to all of the properties on a nonpreferential basis, i.e., at the same rates commercially available from outside companies in the same business, the potential for abuse is negligible, the interests of charity will be better served and the unnecessary and unwarranted destruction of this valuable business will be avoided.

Section 4941(d)(2)(C) [p. 21], however, excludes from prohibited self-dealing the furnishing of goods, services or facilities by a disqualified person to a private foundation only if "the furnishing is without charge and if the goods, services or facilities so furnished are used exclusively for purposes specified in Section 501(C)(3)." The effect of this provision will be to prevent the Cafritz Company from continuing to render management services at least to those properties which the foundation holds outright.*

---

* Since there is no prohibition against self-dealing between disqualified persons, Cafritz Company presumably could continue to manage those properties which the foundation continues to hold in corporate form. If this were not the case, Cafritz Company's business would be seriously disrupted and possibly destroyed immediately upon the effective date of the self-dealing provisions.

The harsh consequences of the self-dealing rule in this situation can be avoided by a limited exception permitting services to be provided by disqualified persons with respect to property in which the foundation and the disqualified person had a joint or common interest on the operative dates in Section 4943. Such an exception is fully warranted since it is necessary to prevent a substantial loss in value of the business involved and the services to be provided are generally available commercially so that their fair market value will be readily evident and the potential for abuse nonexistent. Accordingly, we suggest that a new Section 101(k)(2)(E) be added as follows:

> (2) Section 4941. -- Section 4941 shall not apply to --
>
> * * * *
>
> (E) the furnishing of services by a disqualified person to a private foundation with respect to property in which the foundation and the disqualified person had a joint or common interest (either directly or through ownership of stock in a corporation which owned such property) on May 27, 1969 (or acquired under the terms of a will executed on or before July 28, 1969, which are in effect on such date and at all times thereafter) if the compensation received by the disqualified person for such services is at a rate comparable to that at which such services are commercially available and such rate does not exceed the lowest rate charged by the disqualified person for furnishing similar services with respect to any other property.

At the very least, such an exception is absolutely essential during the full 10-year divestiture period in order to permit an attempt to dispose of the Cafritz Company in an orderly manner without a substantial loss in its value.

CONCLUSION

H.R. 13270 will have a severe, unnecessary and completely unwarranted adverse impact upon the Cafritz Foundation and many other foundations unless (1) the apparent limitation upon foundation ownership of passive real estate investments is removed and (2) necessary flexibility is provided in the transition provisions for separating the combined ownership of business and investment assets by foundations and disqualified persons in an orderly and equitable manner.

Real estate investments of a passive nature have traditionally been recognized as appropriate investments for charitable foundations, and the Treasury Department has consistently recommended that they be excluded from the business ownership limitation. Moreover, there is a complete absence of any evidence in the extensive hearings with respect to private foundations that such real estate investments present a potential for abuse or are otherwise contrary to the public interest.

The need is equally clear for adequate transition provisions to avoid unnecessary forced sales by foundations of partial interests at the risk of substantial loss.

With respect to the third concern of the Cafritz Foundation -- the need for continuation of common management services -- we recognize that the Congress may be concerned about granting an exception to the general prohibition against self-dealing. We respectfully urge, however, that any such concern should be more than outweighed by the severity of the consequences to charity and upon a valuable business of blind application of the self-dealing rules in a situation that presents no realistic potential for abuse.

APPENDIX A

TECHNICAL RECOMMENDATIONS WITH RESPECT TO THE TRANSITION PROVISIONS

To avoid severe and unnecessary hardship, foundations and disqualified persons should be given full flexibility during the 10-year disposal period to eliminate or separate their combined ownership of business and investment assets in an orderly and equitable manner by (1) exchanging stock or property interests in commonly owned assets and (2) employing any of the wide range of corporate techniques for achieving the same purpose.

The 10-year divestiture period in Section 4943 and the limited exception from the self-dealing rules for divestiture sales in Section 101 of the bill are clearly not adequate to permit such a necessary unscrambling of property interests and an orderly divestiture of the excess business holdings that remain outstanding for the following reasons:

A. Exchanges

Section 101(k)(2)(B) [p. 81] excludes from the self-dealing rules only "the sale of property which is owned by a private foundation on May 26, 1969...." Limiting the exemption to the "sale" of property could be construed to prevent exchanges of stock or property. Moreover, keying the exemption to property which is "owned on May 26, 1969" may make it completely inapplicable to the stock interests which are yet to be distributed to the Cafritz Foundation under Mr. Cafritz's 1964 will. It is suggested that Section 101(k)(2)(B) be amended to provide as follows:

(2) Section 4941. -- Section 4941 shall not apply to --

* * * *

(B) The sale or exchange of property interests held by a private foundation or a disqualified person on May 26, 1969 (or acquired under the terms of a will executed on or before July 28, 1969, which are in effect on such date and at all times thereafter) if such sale or exchange is required in order for the foundation not to be liable for the tax under Section 4943 (relating to taxes on excess business holdings)

> and the foundation receives in such sale or exchange an amount, or an interest in property having a fair market value, which equals or exceeds the fair market value of the property sold or exchanged by it; and

B. Section 351 Organizations

Section 4941(d)(2)(F) [p. 22] does not specifically encompass a Section 351 organization which might be necessary to consolidate the various corporations if a public offering of the foundation's stock interests proved to be the only feasible method of divestiture. For complete clarity, it is suggested that the word "organization" be inserted after the words "corporation adjustment" on page 22, line 10.

C. Non-Pro Rata Redemptions

The report of the Committee on Ways and Means [p. 21, n. 1] clearly envisions a non-pro rata redemption by a corporation of its stock which is excess in the hands of a private foundation as one method of achieving a divestiture required by the excess business holdings rule. Section 4941(d)(2)(F) [p. 22], however, may cast doubt on the availability of this necessary divestiture technique since it permits redemptions and other corporate adjustments only if "all of the securities of the same class as that held by the foundation are subject to the same terms...." It might be argued that all of the securities of the same class in a non-pro rata redemption are not "subject to the same terms." The possible ambiguity regarding this important corporate technique can be eliminated by (1) deleting the phrase quoted above from Section 4941(d)(2)(F); or (2) clarifying what is meant by "subject to the same terms"; or (3) the following amendment to Section 101(k)(2)(A):

> (2) Section 4941. -- Section 4941 shall not apply to --
>
> (A) Any transaction between a private foundation and a corporation which is a disqualified person (as) defined in Section 4946), pursuant to (i) the terms of securities of such corporations in existence at the time acquired by the foundation before May 27, 1969; or (ii) any liquidation, merger, redemption, recapitalization or other corporate adjustment, organization or reorganization, the purpose of which is to enable the foundation to dispose of property in order not to be

liable for tax under Section 4943 (relating to taxes on excess business interests) and the foundation receives in return an amount, or an interest in property having a fair market value, which equals or exceeds the fair market value of its stock interest; and

D. Carry-over of the Holding Period

It is not clear that the 10-year divestiture period would carry over to assets acquired by the foundation as a result of an exchange or a corporate redemption, liquidation, organization or reorganization. Unless there is such a carry-over of the holding period, such transactions will not be a meaningful method of complying with the excess business holdings requirement since the foundation would be required to immediately divest itself of any business holdings received as a result thereof. It is recommended that the following provision be added to the bill, possibly as a new Section 101(k)(2)(D):

> (D) The divestiture periods provided for in Section 4943(c)(4) shall carry over to any property interests acquired by a private foundation pursuant to a transaction referred to in subsection (B) above or Section 4941(d)(2)(F).

Before the

SENATE FINANCE COMMITTEE

Statement on Behalf of

KOHLER CO.
KOHLER, WISCONSIN

Re. H.R. 13270

LYMAN C. CONGER
Chairman of the Board
Kohler Co.

Date: October 8, 1969

SUMMARY

Kohler Co., a privately held corporation, opposes the proposed tax reform legislation as passed by the House because it unjustly requires the Kohler Foundation, an eleemosynary organization, to divest itself of its stock holdings in Kohler Co.

For Kohler Foundation to sell this stock would require the creation of a public market for the Kohler Co.'s stock which is now privately held or a merger of Kohler Co. with some conglomerate.

The proposed legislation goes beyond the raising of revenue and correction of abuses and penalizes foundations which have not been guilty of abuses.

The proposed legislation is harsh and punitive. It affects—not only foundations—but corporations in which foundations own stock. It requires drastic changes in existing ownerships—ownerships established years ago in reliance on then existing law. As a consequence it would force a drastic reorganization of Kohler Co. (p. 9)

The definition of "substantial contributor" in the bill as presently drafted has no relevance to the size of the foundation, and is consequently unrealistic. The definition of "substantial contributor" should bear a reasonable relationship to the size of the foundation. In our proposed amendment we propose defining "substantial contributor" as one who has contributed more than 5% of the total assets of the foundation. (pp. 9-10)

The bill is aimed at private control of corporations and assumes that private control of a corporation is an evil to be tolerated as short a time as possible. This is an unsound assumption. (pp. 11-12)

An alternative to private control is the conglomerate or merger route. (pp. 13-14)

The conglomerate-merger type of organization is not so clearly superior to the private corporation that it should be encouraged

33-758 O - 69 -- No. 19 -- 14

by legislation which discourages and makes the continuance of private corporations more difficult. (p. 13)

If this bill is enacted into law it will force a drastic reorganization of Kohler Co., requiring it to change its status as a private corporation—and, quite likely, to merge with a conglomerate. (pp. 14-15)

The bill, as drafted, goes far beyond the mere objective of preventing the use of foundations to control business enterprises. It establishes presumptions of control, not realistic in many cases. Unrealistic presumptions are:

(1) that a percentage of voting stock less than 50 per cent can be presumed to constitute control;

(2) that all "disqualified persons" will always act in unison and never disagree among themselves, and

(3) that the stock of any private foundation will always be voted the same as the stock of "disqualified persons" regardless of the extent of control of the foundation by such "disqualified persons".

We submit that regulation should apply on the actual facts of the situation—not on arbitrary and unrealistic presumptions.

The amendment which we suggest makes actual control the test and—if the disqualified persons in fact control the foundation—adds their stock to that of the foundation in determining control. (pp. 15-18)

The provision relating to the distribution of income has objectives with which we do not quarrel, i.e., (1) to insure that the income of a foundation will be distributed on a reasonably current basis and not be re-invested for "growth" purposes, and (2) to require that the resources of the foundation be invested mainly for the production of distributable income and not principally for capital gain. But the bill attacks the problem circuitously rather than directly and goes too far.

The "minimum investment return" prescribed in the bill, or any "minimum investment return", is unrealistic. Of the 30 industrial corporations whose stocks are included in the Dow Jones

averages only 4 had a dividend yield of over 5 per cent and the average dividend yield was 3.54 per cent. The bill creates enormous administrative difficulties where a foundation's investment is in stock of a private corporation, or in other property not having an established market value.

The objectives can be accomplished by requiring a reasonable concurrent distribution of actual income and by prohibiting foundations from investments solely for capital gain. (pp. 18-20)

The harshness of the bill has been recognized by tailoring exemptions to fit the specific circumstances of two foundations. This is the wrong approach. The bill as a whole should be amended so that it will be fair and equitable to all foundations, regardless of their specific circumstances. (pp. 20-21)

We believe that our proposed amendments would accomplish this purpose.

4

STATEMENT ON
BEHALF OF KOHLER CO.
ON H. R. 13270

STATEMENT ON BEHALF OF KOHLER CO. ON H.R. 13270

KOHLER CO.

Kohler Co., a Wisconsin corporation founded in 1873, is a prominent manufacturer of plumbing fixtures and fittings, small gasoline engines, engine driven electric generating plants and precision controls.

It has, since its inception, been a privately held corporation. Its stock has never been listed on any stock exchange or over the counter market and there has never been any public market or established market price for its stock.

Its outstanding common (voting) stock is distributed as follows:

Employees	8.4%
Individuals or trusts whose stock was acquired through inheritance	58.5% [1]
Kohler Foundation	28.4%
Others	4.7%
	100.0%

Only one of its eleven directors is a "disqualified person" as defined in H.R. 13270. Only one of its eleven officers (one of five vice presidents) is a "disqualified person".

Kohler Co. has an outstanding record of length of service of employees.

With a present complement of approximately 5,500 employees, over 1,300 have become members of the 25-year club (25 or more years of continuous service) of whom over 780 are still actively employed.

Many Kohler Co. employees including management personnel have been attracted to and remain associated with Kohler Co. because it is a privately owned corporation and they can expect to receive, and do receive, more individualistic treatment

[1] Included in this percentage is 31.7 per cent of the outstanding stock owned, directly or by beneficial interests, by individuals who are within the definition of "disqualified persons" in H.R. 13270.

than they would from an absentee owned company under policies made elsewhere and applied arbitrarily and sometimes ruthlessly. One of the most unsalutary features of the present rash of mergers and conglomerates has been the disruption of personnel of acquired companies, and the arbitrary and often ruthless dumping of management personnel, many of whom have devoted much of their lives to the acquired company and are at an age where they find it difficult or impossible to secure equivalent employment elsewhere.

For Kohler Co. to be forced to merge with a conglomerate or to be subjected to "raiding" would seriously disturb the personal plans and expectations of its present personnel.

KOHLER FOUNDATION, INC.

Kohler Foundation is a Wisconsin non-profit corporation, incorporated in 1940. It is restricted by its articles of incorporation to charitable, religious and educational activities.

It conducts no foreign activities or philanthropies and is limited by its articles of incorporation to disbursement of funds exclusively within the State of Wisconsin.

The original incorporators were—

Evangeline Kohler
Marie C. Kohler
Lillie B. Kohler
Herbert V. Kohler
O. A. Kroos

All the original incorporators are now deceased.

All persons who made any contributions to Kohler Foundation are now deceased.

The principal contributors were Marie C. Kohler (by bequest) and Lillie B. Kohler (by inter vivos gift).

All of the incorporators, with the exception of O. A. Kroos, would be "substantial contributors" as defined in H.R. 13270, Sec. 507(b)(2)(A). Although Herbert V. Kohler gave no Kohler Co. stock to the Foundation and contributed less than 2 per cent

of its total assets, he is within the definition of "substantial contributor" contained in H.R. 13270 since he gave more than $5,000 in a single calendar year. Consequently his "lineal descendants" would be "disqualified persons" as defined in H.R. 13270.

Kohler Foundation has 10 members (reduced from 12 by two recent deaths) of whom only 3 are "disqualified persons" as defined in H.R. 13270. It has 5 directors of whom only 2 are "disqualified persons". Only 2 of its 6 officers are "disqualified persons".

Kohler Foundation does not operate any business or commercial enterprise and has no interest in any business or commercial enterprise other than as a stockholder.

Kohler Foundation presently owns a beneficial interest in 47,606 and a fraction shares of Kohler Co. common (voting) stock which is 28.4 per cent of the 167,403 and a fraction shares outstanding and 23.8 per cent of the 200,000 shares authorized. It has owned most of this stock for 15 years and nearly half of it for 25 years.

It also presently owns 4,154 shares of preferred (non-voting) stock of Kohler Co., a Wisconsin Corporation, which is 43.2 per cent of the 9,625 shares outstanding and 10.4 per cent of the 40,000 shares authorized.

Kohler Foundation makes direct expenditures of approximately 15 per cent of its total disbursements for certain cultural programs, scholarship awards, and for the operation and maintenance of a building used as a meeting place for Girl Scouts and a woman's club.

The balance of its income is distributed by contributions to organizations conducting educational, historical and cultural, religious or charitable activities.

Kohler Foundation, in the past ten years, has made actual disbursements of $1,812,562.45 for educational, cultural and other philanthropic purposes out of a total income (before expenses) of $1,826,486.11.

No officer, director or member of Kohler Foundation receives any salary or compensation for his services. It employs no professional managers.

In the past ten years Kohler Foundation's administrative expenses have been less than $13,500.00 or seven-tenths (00.7%) of one percent of its income.

Thus Kohler Foundation has, over the past ten years, distributed practically 100 per cent of its *actual* net income after expenses.

PROVISIONS OF H.R. 13270 RELATING TO PRIVATE FOUNDATIONS

Alleged Purposes of the Bill

The bill purports to be a revenue bill and in some respects it is.[3] On the other hand some of the regulatory provisions of the bill, by increasing administrative costs, will reduce net revenues.

The bill also purports to correct abuses by foundations. We do not deny that *some* foundations have been guilty of abuses, although we would not agree that all practices which are characterized by some as abuses actually are abuses. But we do deny that the majority of foundations have abused their status or have been guilty of acts detrimental to the public welfare.

But the bill goes further than the mere prohibition of abuses. There is a clear distinction between prohibition of abuses and regulation of details of operation of foundations which deprives foundation managers of the ability to exercise sound judgment in good faith in the management of the assets of the foundation.

KOHLER CO. POSITION ON H.R. 13270

We do not oppose all of the provisions of H.R. 13270 relating to foundations.

We recognize the objectives of raising revenues and correcting abusive practices and to the extent that the bill would actually accomplish these purposes we do not oppose it.

But the legislation should not penalize foundations which have not been guilty of true abuses. The innocent should not be punished along with the guilty.

---

[3] The 7½ per cent tax imposed by Sec. 506 (a) (p. 5) is a revenue provision.

Because it applies retroactively the proposed legislation is harsh and punitive.

It does not seek merely to regulate *future* conduct.

It would seriously disrupt existing ownerships and corporate organizations—ownerships and organizations which were established many years ago in reliance on then existing law.

As we show later, it would force a drastic reorganization of Kohler Co. making it difficult, if not impossible, for it to continue as a private corporation—and making it likely that its best course would be to merge with some conglomerate.

We submit that legislation having such disruptive and retroactive effect is not warranted.

SUBSTANTIAL CONTRIBUTOR

The definition of "substantial contributor", Sec. 507(b)(2)(A)(B) p. 8, is unrealistic in the extreme.

It bears no relationship to the size of the foundation, its total assets or the total of contributions by others.

One who contributed $5,000 in any one year would have contributed only one-half of one percent of the assets of a foundation having assets of one million dollars. He would not be a "substantial contributor" in any ordinary or common meaning of the term.

Yet under the definition of Subsection (A) he is a "substantial contributor" as are also his children, grandchildren, great-grandchildren and other "lineal descendants" in perpetuity.

Many foundations have assets of more than a million dollars and at least one is reputed to have assets in excess of three billion dollars.[3]

---

[3] Subcommittee Chairman's report to Subcommittee No. 1 Select Committee on Small Business, House Representatives, 90th Congress, Sixth Installment 8-26-68, p. 242, Ford Foundation. See also Kellogg Foundation Trust p. 236.

The same source reports 26 foundations having assets in excess of 100 million, pp. 228-259, yet anyone who donates $5,000.00 or five-thousandths of a per cent would be "substantial contributor" under the definition of H.R. 13270.

The definition of subsection (B) is even more unrealistic. One who gave a donation of $1,000 or one-tenth of one percent of the total assets of a foundation having assets of a million dollars would be a "substantial contributor" if that fortuitously happened to be the only contribution in that calendar year.

We submit that what is a "substantial contributor" or a "substantial contribution" should be *relevant to the total contributions.*

One who contributed less than 5 per cent would not be considered a "substantial contributor" in the general understanding of the term, nor would he be in a position to exercise much domination over the foundation.

The amendment which we suggest (Proposed Amendment—Exhibit 1) would make one who contributed more than 5 per cent of the total contributions to a foundation a "substantial contributor".

BASIC PHILOSOPHIES UNDERLYING THE BILL

Our main objection to the bill in its present form is to the basic economic philosophies underlying some—but not all—of its provisions.

Implicit, albeit unstated, are certain economic assumptions which are accepted as truisms.

The bill departs from basic revenue purposes and enters the field of economic regulation. And it does so on the basis of certain economic assumptions which we believe to be false.

Certainly they are not so self-evident as to be accepted without consideration on their merits and hearing arguments against them.

We submit that Congress should not adopt these far-reaching regulatory measures—which affect not only taxes but the general economy—as an appendage to a revenue bill but that if they are to be considered at all they should be considered as

frankly regulatory measures with full appreciation of their consequences and after adequate hearing on the objections to them.[4]

Assumptions basic to the bill to which we object are—

PRIVATE CONTROL OF CORPORATIONS

The underlying philosophy behind the bill (particularly Sec. 4943 which limits the *combined* holding of a foundation *and* "all disqualified persons" to 20 per cent of any corporation's voting stock)[5] is that private control of a corporation is bad per se—that it is an evil to be discouraged as much as possible and to be tolerated, if at all, only for a limited time.

That this is the assumption and the purpose clearly appears from the report of the House Committee on Ways and Means accompanying H.R. 13270 (Part 1, Page 28) where it is suggested that the limit of 20 per cent combined holding of corporate stock by foundations and "disqualified persons" may be met without the foundation disposing of its so-called "excess holdings" but by the "related parties" disposing of *their* stock.

Clearly the bill is directed not at *foundation* control but at private control of a corporation.

This is also shown by the suggestion (Id. p. 28) that if "disqualified persons" hold more than 20 per cent of the voting stock, the foundation's holding of *non-voting* stock "might effectively remove from *outsiders* any practical opportunity to gain control."[6] (emphasis supplied)

---

[4] There has, up to now, been no hearing or opportunity for hearing on the provisions to which we object. The House Ways and Means Committee did hold hearings but that was *before* any bill had been drafted. The present bill differs in important respects from proposals considered at the hearings. The present definitions of "substantial contributor", "disqualified persons", etc. appeared for the first time in the draft of the bill, little more than a week before passage, with no hearing held on them or opportunity given to consider objections or to present amendments.

[5] Under some circumstances an additional 2 per cent would be permitted under the so-called "de minimus" provision, Sec. 4943 (c)(2)(C) p. 37.

[6] Of course the statement that ownership of non-voting stock can, as a "practical" matter, affect the control of the corporation—which rests in the *voting stock*—is far-fetched in the extreme.

Implicit in this statement is the assumption that battles for control of corporations are in the public interest. We *question this assumption.*

The "raiding" tactics which have accompanied some of the present mergers and attempted mergers are one of the most unsalutary features of our present corporate financial picture.

The managements of many corporations are today spending more time trying to defend the corporation against "raiding" tactics, than in the actual operation and management of the business. We cannot see how this is in the public interest.

It is significant that the control provisions of this bill have no relevance to any *revenue* objective. Whether a corporation is or is not privately controlled makes no difference in the taxes it will pay on its income. Nor would it result in any increase in revenue from tax on the income received by a foundation. So long as the foundation avoids owning more than 20 per cent of the stock of any corporation having "disqualified persons" as stockholders, it may still receive 100 per cent of its income tax exempt.[7]

The proposal is clearly directed against private control of corporations.

Respectfully we ask, why this bias against private corporations? The private corporation has traditionally played an important role in the economic development of this country. Individuals start a small business as individual owners or partnerships. If the business serves the public need, is successful and grows it becomes a private corporation. If it continues to grow and prosper it may become a public corporation—but it will do so as a result of economic conditions—by a process of natural development and at a favorable time—not by legislation.

Many, if not most, of the large commercial enterprises today had their start through the private corporation route—Du Pont, Chrysler, Ford, Allis Chalmers, Kimberly Clark, etc. to name but a few.

[7] Except for the flat 7½ percent tax proposed by Sec. 506 (a) p. 5.

We submit that it is not in the public interest to destroy or to sterilize this seed bed by legislation.

The *assumption* that private control of a corporation is an evil to be terminated as soon as possible deserves more careful consideration than it has received in the drafting of this bill.

In particular it demands consideration of the *alternatives* to private control.

Corporations must be controlled by someone.

If this proposal is adopted it will make mandatory the disruption of many private corporations.

The alternative is obvious. The past few years have seen an amazing proliferation of a relatively new form of commercial organization—the "conglomerate" corporation created by mergers.

The impact of this development on the economy is questionable. Some view it with alarm.[8]

It is not our purpose to review the pros and cons of the present trend toward mergers, acquisitions, conglomerates and toward debt rather than equity financing.

What we do want to point out is that if—through adoption of this proposal—liquidation of private control is made mandatory—the presently most available market is through the conglomerate merger route. Unquestionably most private or foundation holdings would be divested in that manner.

For Congress to adopt this proposal would be tantamount to saying "We think that private control of a corporation is evil—the conglomerate merger is preferable—therefore we will force private corporations to merge with conglomerates."

We submit that Congress should not adopt a proposal having such implications without careful consideration of the consequences—which go far beyond any revenue consideration.

---

[8] Burck—"The Merger Movement Rides High"—Fortune Magazine, February 1969, p. 79 et seq.

The conglomerate-merger type of organization is not so clearly preferable to a privately controlled corporation that it should be made virtually mandatory by legislation.

If this bill, as presently drafted, is enacted into law, it will:

1. Require Kohler Foundation to dispose of 28.4 per cent of the outstanding common (voting) stock of Kohler Co.
2. Require Kohler Foundation to dispose of 43.2 per cent of the outstanding preferred (non-voting) stock of Kohler Co.[9]

There is no presently established market for either of these securities. They are not listed on any exchange or traded on any over-the-counter market.

Since sale to any "disqualified person" is restricted, (Sec. 4943(c)(1)), for the Kohler Foundation to sell this stock would require either:

(a) The creation of a now non-existent public market for both classes of stock thus forcing Kohler Co. to become a public rather than a private corporation, or

(b) The sale to a single purchaser. In practical effect this means a merger or conglomerate.

This appears at present to be the easiest way out of the dilemma which would be created by the enactment of this bill as presently drafted.

Either alternative would mean a drastic reorganization of Kohler Co.—a reorganization not compelled or induced by any economic or business considerations.

We submit that such drastic reorganizations of corporations and disruption of long existing situations should not be compelled by purportedly tax reform legislation, particularly when the purposes of tax reform can be accomplished by less drastic and disruptive means.

[9] Even to apply the so-called "de minimus" rule would require an estimate of the value of each of these two classes of stock (Sec. 4943 (c)(2)(C) p. 37), an estimate which would always be subject to challenge by the Internal Revenue Service.

THE PRESUMPTION OF CONTROL

The Bill (Sec. 4943(C)(2) p. 36) seeks to prevent the use of foundations to control business enterprises.

But, as drafted, it goes far beyond this objective and becomes a punitive rather than a remedial measure, particularly as it requires *change and divestiture* of ownerships established long ago in reliance on the then existing law.

This is because it seeks to base the regulation on arbitrary and unrealistic *presumptions* rather than on the *actual* facts existing in each particular case.

This proposal is based on several unrealistic presumptions, namely:

(1) The prima facie presumption that ownership of 20 per cent of the voting stock (one-fifth of the total) constitutes control of a corporation.

(2) An *irrebuttable* presumption that ownership of 35 per cent of the voting stock constitutes control of a corportation.

(3) An *irrebuttable* presumption that *all* "disqualified persons", regardless of the number, will always be in agreement and will vote their stock unanimously.

(4) An *irrebuttable* presumption that the stock of "any private foundation" will always be voted the same way as the stock of "disqualified persons" regardless of the extent of participation in or control of the foundation by "disqualified persons".

The basic defect of this proposal is that it seeks to do the impossible—to substitute some arbitrary percentage assumed, usually incorrectly, to constitute control—for the *actual facts.*

Obviously complete and permanent control of a corporation requires ownership of more than 50 per cent of the voting stock. It may be true that at times ownership of less than 50 per cent can enable an individual or group to appear to exercise control but this apparent control is always subject to divestiture by the

owners of a majority of the stock whenever they become dissatisfied with the manner in which the enterprise is being run.

The assumption that 20 per cent constitutes control means that there could be at *least four groups each having control.* The 35 per cent assumption means that there could be two groups each *conclusively* presumed to have control.

Such situations are neither impossible nor unlikely. Privately held corporations frequently develop out of partnerships —not merely out of individual or one family ownerships. Hence there may well be two or more individuals or family groups each conclusively presumed to have control.[10]

Nor is there any arbitrary percentage of stock ownership having universal application which can be said to afford even temporary control. The percentage varies from company to company and even *from time to time with the same company.*

In these days of mergers, raids, acquisitions, etc. numerous examples could be cited where 20 per cent, 30 per cent or even 40 per cent voting stock ownership has not constituted control —but three will suffice.

WESTINGHOUSE AIR BRAKE CO.

1. As shown by the attached Exhibit 2, Crane Co. desired to effect a merger with Westinghouse Air Brake.

In pursuance of this objective Crane Co. acquired 31 per cent of the stock of Westinghouse Air Brake Co., 11 per cent more than the 20 per cent which the bill presumes constitutes "control".

So, Crane Co. having "control", the merger should have proceeded without difficulty.

But, on the contrary, despite Crane Co.'s "control", Westinghouse Air Brake merged with American Standard, Inc., a *competitor* of Crane Co.

---

[10] Kohler Co. developed out of a partnership—Kohler, Hayssen & Stehn.

ALLIS-CHALMERS CO.

2. As shown by the attached Exhibit 3, White Consolidated Industries, Inc. announced its intention to acquire Allis-Chalmers Manufacturing Company. In pursuance of that objective it acquired one-third of Allis-Chalmers stock, 13 per cent more than the 20 per cent which, according to the bill gave it "control".

But the acquisition did not take place. 33⅓ per cent was *not* "control".

PIPER AIRCRAFT CORP.

3. As shown by the attached Exhibit 4, Bangor Punta Corp. and Chris Craft Industries both desired control of Piper Aircraft Corp.

Although *each* owned more than the 35 per cent of voting stock—which under the bill is *conclusively* presumed to constitute control—neither was able to exercise control. Bangor Punta was forced to acquire 50.7 per cent of the stock to have *actual* control.

THE ASSUMPTION THAT FAMILIES ALWAYS ACT IN CONCERT IS CONTRARY TO HUMAN EXPERIENCE

This bill impliedly assumes—as an *irrebuttable presumption*—that members of a family or related parties always see eye to eye and act in unison. This is contrary to all human experience. Families fall out—family feuds develop as frequently, perhaps more frequently, than feuds between unrelated individuals. And they are often pursued more intensely and obdurately than disagreements between unrelated persons.

Family feuds and interfamily litigation may be unfortunate—but they are not uncommon. The history of Kohler Co. includes an instance of such interfamily litigation.[11]

Members of a family may be engaged in a family feud and battling each other for control of a corporation yet under this bill, as presently drafted, they are *conclusively* presumed to be acting in concert.

---

[11] *Kohler* v. *Kohler Co., Herbert V. Kohler, et al.*, 208 F. Supp. 808, 319 F.(2d) 634.

33-758 O - 69 -- No. 19 -- 15

Similarly the bill *conclusively* presumes that stock owned by a foundation will be voted the same as that owned by the "disqualified persons".

Proof that the "disqualified persons" did not control the foundation—or even had no connection with it—or that the foundation stock was actually voted differently than that of the "disqualified persons" would not overcome the conclusive presumption of the bill as presently drafted. The foundation would still have to dispose of its stock at a probable loss.

We submit that rather than relying on percentages and presumptions which will fit few if any actual cases, the regulation should be based on the *actual facts.*

The question is "Does the foundation together with any 'disqualified persons' who actually control the foundation, *in fact* have control of the corporation?"

The amendment which we suggest, (Proposed Amendment—Exhibit 5), makes this the test by providing that no foundation together with any "disqualified persons" who actually control the foundation may own more than 50 per cent of the voting stock of a corporation. It substitutes fact for fallacious theory.

DISTRIBUTION OF INCOME

Sec. 4942 (p. 25 et seq.), has, as we understand it, two principal objectives:

1. To insure that income of a foundation will be distributed on a reasonably current basis and not re-invested for growth of the foundation, and
2. To insure that the resources of the foundation would be invested with the main purpose of producing distributable income and not mainly for capital gain.

We do not quarrel with these purposes but here again the bill, as presently drafted, attacks the problem circuitously rather than directly, and in so doing goes too far and creates more problems that it solves.

"MINIMUM INVESTMENT RETURN"

Subsection (e)(3) prescribes a "minimum investment return" of 5 per cent for 1970 and thereafter such return as is fixed in the discretion of the "Secretary or his delegate".

This provision casts almost intolerable burdens on the managers of foundations. It requires foundation managers to commit themselves to obtain a minimum fixed return on investments, each and every year, regardless of economic conditions. Yet, at the same time, it greatly restricts their investment opportunities.

How are foundation managers to meet this new and onerous responsibility?

1. As shown by attached Exhibit 6, of the 30 companies the market price of whose stock is included in the Dow Jones average, only 4 had a dividend yield for 1968 of 5 per cent or over on the basis of the market price. The average dividend yield was 3.54 per cent.

Furthermore were foundation managers to invest in one of these four companies that do presently yield 5 per cent in dividends they would constantly have to watch the fluctuations of the market, guess at probable dividends and dump the stock, possibly at an inappropriate time whenever it appeared likely that market fluctuations and/or dividend prospects might reduce the yield below 5 per cent.

This proposal, as a practical matter, bars foundations from investing in the stock of any industrial corporation.

2. The situation is still worse where stock in a private corporation, having no established market value is concerned.

This bill requires foundation managers to guess, at their peril, what market value the Internal Revenue Service will agree to.

Suppose the managers of Kohler Foundation in good faith determine that the market value of Kohler Co. common stock would be $125 per share and make the 5 per cent distribution on that basis.

But the Secretary, perhaps years later, says "Oh, no. The stock is worth $200 a share. You should have distributed 5 per cent of $200. A penalty of 15 per cent is due and if you do not yield to my arbitrary edict within 90 days, no matter how unreasonable you deem it to be, the penalty becomes 100 per cent."

If this bill passes in its present form there appears to be only one logical thing for a foundation owning unlisted corporate stock to do—dump it as fast as possible no matter what the loss to the foundation and to charity or the damage to the corporation may be.

It is not necessary to prescribe a harsh and arbitrary rule which requires foundation managers to obtain a fixed minimum return on investments to accomplish the objectives of the bill.

PROPOSED AMENDMENT—EXHIBIT 7

The purposes can be accomplished by

1. Requiring a reasonable distribution of *actual* net income within a reasonable period.

   We think that the requirement of 100 per cent distribution is too rigid and the distribution period of one year too short. A more realistic requirement would be 90 per cent of actual income distributed within two years.

2. Amending Sec. 3944 to specify that investments made solely for capital gain purposes be considered investments which would jeopardize the carrying out of the exempt purposes of the foundation.

THE DRAFTERS OF THE BILL HAVE RECOGNIZED THE HARSHNESS OF THE BILL BY MAKING SPECIAL EXCEPTIONS FOR INDIVIDUAL FOUNDATIONS

The drafters of the bill have recognized the harshness of the bill by making special exceptions, tailored to fit the specific circumstances of two individual foundations.

Subchapter F(4) Section 4943
p. 83 (Kellogg Foundation)
p. 83-84 (Benwood Foundation)

We agree that the Kellogg Foundation and the Benwood Foundation are deserving of relief from the harsh and punitive provisions of the bill.

But to give them this relief by exemptions tailored to meet their peculiar circumstances is the wrong approach.

There are many other foundations equally deserving of exemption from the harsh and punitive provisions of the bill.

We submit that the bill should be amended to treat *all* foundations fairly and equitably—without discrimination or favoritism.

The bill should be amended so that its effect will not be harsh or punitive as to any foundation which has not been guilty of abuses.

CONCLUSION

We submit that any legislation passed should be remedial—not punitive. It should not penalize the many for the misdeeds of a few. It should be directed to revenue purposes and the prevention of true abuses—not to the prescription of arbitrary rules which will damage or destroy legitimate, properly conducted foundations nor to discourage or destroy private corporations.

Respectfully submitted,

KOHLER CO.

By: /s/ L. C. CONGER
L. C. Conger
Chairman of the Board

Exhibit 1

PROPOSED AMENDMENT TO H.R. 13270

Sec. 507(page 8)

Substitute the following in paragraph (2) hereunder as a definition of "Substantial Contributor":

"(2) SUBSTANTIAL CONTRIBUTOR: For purposes of paragraph (1), the term 'substantial contributor' means—

"any person who (by himself or with his spouse) contributed or bequeathed more than 5 percent of the total contributions to the foundation since it was originated. Contributions or bequests other than cash shall be valued as of the date of such contribution or bequest.

"In the case of a trust, such term also includes the creator of such trust."

Exhibit 2

THE WALL STREET JOURNAL,
Monday, June 3, 1968

Westinghouse Air Holders Approve Merger With American Standard; Judge Bars Delay

A WALL STREET JOURNAL News Roundup

Westinghouse Air Brake Co. announced in Pittsburgh that its shareholders approved a proposed merger with American Standard Inc., and a Federal judge in New York said he wouldn't interfere with the merger despite pending lawsuits that seek to prevent it.

Westinghouse Air Brake management promptly filed certificates of merger with the secretaries of state of Pennsylvania, where Westinghouse Air, is incorporated, and Delaware, where American Standard is incorporated. The companies could merge as soon as Wednesday if further legal action doesn't interfere.

The lawsuits seeking to prevent a merger were filed in recent weeks by Crane Co., New York, which owns directly or beneficially about 31% of Westinghouse Air's outstanding stock. Crane has challenged both the validity of proxy statements sent out by Westinghouse Air concerning the merger and the validity of certain votes cast by shareholders in favor of the merger.

The suits filed by Crane challenging the merger attempt have been combined into a single action before Federal Judge Sylvester J. Ryan in New York. He hasn't yet ruled on the case, but said Friday that he would permit the merger to proceed nonetheless.

Approved by American Standard Holders

Crane has sought to merge with Westinghouse Air and continued to acquire Wabco stock through a tender offer even after its merger offer was rejected. The Wabco-American Standard merger was announced in March and already has been approved by American Standard holders.

In trading on the New York Stock Exchange Friday, Westinghouse Air rose $1.875 to $47.50; American Standard climbed $3.375 to $38.

Westinghouse Air, based in Pittsburgh, makes railway, construction and mining equipment; Crane and American Standard are competitors in the plumbing and heating-supply field and both are engaged in other manufacturing businesses as well.

Westinghouse Air holders approved the proposed merger by a vote of 2,903,868 to 1,190,298, company officials announced at a special shareholders meeting on Friday. The meeting originally was convened on May 16, but was postponed three times while judges of election conducted their tally of ballots.

As soon as the results were announced, Crane lawyers objected on the ground that the proxy statements were invalid, that certain votes were invalid and that Crane was entitled to vote more shares than it had been permitted to vote—essentially the same contentions contained in Crane's lawsuits.

However, A. King McCord, chairman of Westinghouse Air, declared the merger resolution adopted and adjourned the meeting.

Annual Meeting Convened

Immediately afterward, Mr. McCord convened the annual meeting; this also had been postponed pending outcome of the merger vote.

But the annual meeting was recessed immediately to permit a tally of votes cast on a Crane Co. proposal to eliminate staggered terms for Westinghouse Air directors. The meeting is scheduled to reconvene today.

The Crane proposal would reverse an action taken by Westinghouse Air directors in December, when they changed the company's bylaws to permit election of only three of the nine directors at a time for staggered three-year terms. Mr. McCord stated then that the company feared a take-over attempt.

Crane has nominated three candidates to the Westinghouse Air board, including Thomas Mellon Evans, Crane's chairman. Voting on directors also is scheduled today—though, of course, election of directors will be moot if the Westinghouse Air-American Standard merger is completed.

Exhibit 3

8 THE WALL STREET JOURNAL,
Thursday, February 20, 1939

Allis-Chalmers Is Sued By White Consolidated To Rescind Acquisition

White Says $8 Million in Common Paid by Allis for Standard Steel Was an 'Unconscionable Price'

Special to THE WALL STREET JOURNAL

MILWAUKEE — White Consolidated Industries Inc., a Cleveland conglomerate, filed suit in Delaware Chancery Court, Wilmington, asking that the acquisition of Standard Steel Corp. of Los Angeles by Allis-Chalmers Manufacturing Co. be rescinded.

Allis-Chalmers completed the acquisition in January. Standard Steel, a manufacturer of asphalt plants, fishmeal plants, small kilns and rotary dryers and coolers, has factories at Los Angeles and Decatur, Ill.

The agreement called for Allis-Chalmers to purchase the assets of Standard Steel for 280,000 Allis-Chalmers common shares, then trading at $28.75 each. That represented a market value of about $8 million.

The White suit charges that Allis-Chalmers paid an "unconscionable price" for Standard Steel, and that Standard Steel knew the price to be unconscionable.

The suit also says the purpose of the acquisition of Standard Steel was an attempt by Allis-Chalmers management to dilute White's holdings in Allis-Chalmers, which White has announced it intends to acquire.

White currently owns about one-third of Allis-Chalmers' 10,365,000 outstanding common shares. It purchased 3,248,000 of them last Dec. 6 from Gulf & Western Industries Inc., a New York conglomerate.

Allis-Chalmers has filed several suits in an attempt to stave off acquisition by White, which in turn has filed counter suits for the acquisition.

White's newest suit asks for damages from Allis-Chalmers' directors and Standard Steel for the alleged dilution of White's interest in Allis-Chalmers. The suit also asks that Allis-Chalmers directors be enjoined from entering into certain other negotiations or acquisitions in the future.

Allis-Chalmers attorneys called White's action "a nuisance suit brought in an effort to harass the Allis-Chalmers management. The facts are that negotiations for purchase of assets of Standard Steel Corp. began long before White purchased its block (of stock in Allis-Chalmers) from Gulf & Western. Also, the purchase of Standard Steel's assets was a good and wise investment for Allis-Chalmers."

Exhibit 4

* * *

Bangor Punta said it has won the battle for control of Piper Aircraft by boosting its holding to 50.7% from 44.3% in open-market purchases. But rival suitor Chris-Craft Industries, which owns 40% of Piper, replied that ownership of a 15% Piper interest claimed by Bangor Punta is being contested.

(Story on Page 4)

4 THE WALL STREET JOURNAL, Thursday, September 11 1969

Bangor Punta Claims 50.7% Piper Control; Rival Chris-Craft Insists Fight Isn't Over

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—Bangor Punta Corp. claimed victory in the battle to acquire control of Piper Aircraft Corp. But Chris-Craft Industries Inc., rival suitor for Piper, contended the battle isn't yet over.

Bangor Punta said it raised its Piper holdings to 50.7% of Piper's 1,640,000 shares outstanding by purchasing, on the open market, an additional 101,864 shares. The purchases, at prices that weren't disclosed, were made after approval was given Aug. 7 by Bangor stockholders to Bangor's recent exchange offers for Piper stock, Bangor said. Bangor said it filed a statement with the Securities and Exchange Commission reporting the purchases and stating that a portion of the shares haven't yet been delivered.

In its last previous public announcement of its holdings, Bangor said it owned 44.3% of Piper stock.

Chris-Craft, which previously reported a 40% ownership of Piper, said it currently owns 42% of Piper stock outstanding.

Chris-Craft contended that Bangor Punta owns only 36% of Piper on an uncontested basis. Chris-Craft has filed suit against Bangor, asking that Bangor be required to divest itself of blocks representing 15% of Piper stock.

Last month, a Federal district judge denied a preliminary injunction requested by Chris-Craft to restrain Bangor from retaining the stock in question. But Chris-Craft announced yesterday that the U.S. Court of Appeals for the Second Circuit has granted an "expedited hearing" Sept. 19 on an appeal of the lower court's ruling.

Chris-Craft said its appeal is based on an alleged "irreconcilable" conflict between the district court ruling and an SEC action that resulted in Bangor agreeing to cease "gun jumping" in making statements about its exchange offers.

Bangor Punta also has filed suit against Chris-Craft. When asked if Bangor would continue its suit, David W. Wallace, Bangor's president and chief executive officer, said yesterday that the suit was filed "in response" to Chris-Craft's, seemingly indicating that if Chris-Craft withdrew its litigation, Bangor would reciprocate.

Mr. Wallace said also that Bangor has "no immediate plans" to bid for Chris-Craft's stock in Piper.

Last month, Bangor gained control of Piper's eight-man board. Four Bangor officers were elected and a fifth member, William T. Piper Jr., president of Piper, said that "with my affirmative vote" Bangor would have a 5-to-3 majority. Piper management and the Piper family has supported Bangor's bid for the company.

Piper is a Lock Haven, Pa., maker of low and medium-priced airplanes. Bangor makes pleasure boats, textiles, and law-enforcement equipment and operates farms, a railroad, and consulting firms. Chris-Craft makes pleasure boats, plastic and latex foams, organic chemicals, carpet yarns and operates television stations.

Mr. Wallace said Piper's operating results will be consolidated with Bangor's by 1970. Aircraft sales then will represent about 25% of Bangor's revenue, he said.

Exhibit 5

PROPOSED AMENDMENT TO H.R. 13270

Sec. 4943 (C)(2)(A)(B) (page 36)

Substitute the following for Subsections (A) & (B)

"(A) In General

No private foundation shall have voting rights in more than 50 percent of the voting stock of any incorporated business enterprise.

If said foundation is controlled by one or more disqualified persons the permitted percentage as above shall be diminished by the percentage of stock owned by said disqualified persons."

Change the heading of (C) to (B)

Exhibit 6

DIVIDEND YIELD OF INDUSTRIAL CORPORATIONS INCLUDED IN DOW JONES AVERAGES

	December 31, 1968		
	Yearly Dividend	Market Price	Yield
Allied Chemical	1.725	36	.0479
Aluminum Co. (Alcoa)	1.80	73	.0247
American Can	2.20	57¼	.0384
American Tel & Tel	2.40	53	.0453
Anaconda	2.25	64½	.0349
Bethlehem Steel	1.60	31⅜	.0510
Chrysler	2.00	56	.0357
Du Pont	5.50	165	.0333
Eastman Kodak	1.74	73¼	.0238
General Electric	2.60	93⅞	.0277
General Foods	2.40	81½	.0294
General Motors	4.30	79⅛	.0543
Goodyear	1.425	56	.0254
International Harvester	1.80	37¼	.0483
International Nickel	2.10	39	.0538
International Paper	1.38¾	37⅝	.0369
Johns Manville	2.20	87¼	.0252
Kimberly Clark	2.20	72⅞	.0302
Owens-Illinois	1.35	71½	.0189
Procter & Gamble	2.30	86½	.0266
Sears Roebuck	1.20	62¼	.0193
Standard Oil of California	2.70	72⅛	.0374
Standard Oil of New Jersey	3.65	78⅝	.0464
Swift & Co.	.90	29¾	.0303
Texaco	2.90	83¼	.0348
Union Carbide	2.00	45¼	.0442
United Aircraft	1.70	65⅞	.0258
U. S. Steel	2.40	42⅞	.0560
Westinghouse Electric	1.80	68¼	.0264
Woolworth	1.00	32⅞	.0304

Average
.0354

Exhibit 7

PROPOSED AMENDMENT TO H.R. 13270

Sec. 4942 (page 25)

Substitute the following in paragraph (a)

"(a) Initial Tax—

There is hereby imposed on any undistributed income under 90 per cent of a private foundation for any taxable year, which has not been distributed before the first day of the third (or any succeeding) taxable year following such taxable year (if such first day falls within the taxable period) a tax equal to 15 per cent of the amount by which the undistributed income is less than 90 per cent of the adjusted net income at the beginning of such third (or succeeding) taxable year. This section shall not apply to a private foundation which is an operating foundation (as defined in subsection (J)(3)) for the taxable year.

(b) No change

(c) Undistributed Income

For purposes of this section, the term 'undistributed income' means, with respect to any private foundation for any taxable year, the amount by which—

(1) the distributable amount for such taxable year, exceeds

(2) the qualifying distributions made out of such distributable amount prior to the first day of the third taxable year thereafter.

(d) Distributable Amount

For purposes of this section, the term 'distributable amount' means, with respect to any foundation for any taxable year, 90 per cent of the adjusted net income.

(e) Eliminate

(f) Change subsection designation to (e)—no other change

(g) Change subsection designation to (f)—no other change

(h) Change subsection designation to (g)—no other change

(i) Change subsection designation to (h)—no other change

(j) Change subsection designation to (i)—no other change

Sec. 4944

Substitute—

INVESTMENTS WHICH JEOPARDIZE CHARITABLE PURPOSE

(a) Tax On The Private Foundation

If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes there is hereby imposed on the making of such investment a tax equal to 100 per cent of the amount so invested. The tax imposed by this subsection shall be paid by the private foundation. Any investment in non-income producing property solely for capital gain will be considered as jeopardizing the carrying out of the exempt purposes of the foundation for purposes of this section, to the extent of such investment.

BEFORE THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

Statement of Albert E. Arent, in Behalf of the
Phoebe Waterman Foundation, Inc.
Philadelphia, Pennsylvania
In Opposition to Stock Ownership Limitation
For Private Foundations
In H.R. 13270

SUMMARY OF PRINCIPAL POINTS

I. The provisions of H.R. 13270 (proposed section 4943 of the Internal Revenue Code) which would force a private foundation to divest itself of stock in a family-controlled business are unsound as a matter of public policy and unfairly retroactive in stripping away family control.

II. Existing policy which encourages the use of business holdings to fund charity has --

A. enlarged the scope and dimensions of charitable giving, and

B. helped to preserve the independence of family-controlled businesses.

III. Specific abuses arising in connection with the operation of private foundations can be and are dealt with by specific provisions relating to the abuses. A measure as extreme and damaging as divestiture is unnecessary.

IV. Persons who, in reliance upon the long-standing public policy favoring the creation of private foundations, have committed to charitable purposes stock needed for the protection of a family business from corporate raiders should not have their control jeopardized by new ground rules having retroactive effect.

BEFORE THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

Statement of Albert E. Arent, in Behalf of the
Phoebe Waterman Foundation, Inc.
Philadelphia, Pennsylvania
In Opposition to Stock Ownership Limitation
For Private Foundations
In H.R. 13270

My name is Albert E. Arent. I am an attorney in Washington, D. C. and am appearing before the Committee on behalf of the Phoebe Waterman Foundation, Inc. of Philadelphia, Pennsylvania. This Foundation, established in 1945 by Mr. and Mrs. Otto Haas, who are now both deceased, owns approximately 19 percent of the stock of the Rohm and Haas Company, a manufacturing company listed on the New York Stock Exchange. Haas family interests beneficially own approximately 14 percent of the stock and nonexempt trusts, paying their entire income to charity, own approximately 16 percent.

Under the provisions of H.R. 13270, the Phoebe Waterman Foundation would be classified as a private foundation and, pursuant to proposed section 4943 of the Internal Revenue Code (which would be added by section 101(b) of H.R. 13270), would be forced to dispose of practically all of the stock it owns in the Rohm and Haas Company. I respectfully submit that these provisions are unsound as a matter of

33-758 O - 69 -- No. 19 -- 16

public policy and unfair in their retroactive effect of stripping a family of management control of the business which it created and successfully developed.

Public Policy Favors Family Control of Business

A significant number of private foundations now in existence, and probably the great majority of them, came into being primarily because of the impact of the Federal estate tax on family businesses. The availability of private foundations has permitted a family to fund its charitable activities with the principal wealth of the family -- its business holdings -- without jeopardizing the family control of the business. Were it not for the available alternative of creating private foundations to hold substantial interests in such businesses, the extremely high rates of estate tax would have caused the disassembly of a great many successful family businesses. Unquestionably, the charitable deductions provided in the tax laws, and available for contributions to private foundations, have intentionally encouraged the establishment of private foundations.

This was no loophole. It was not an abuse or perversion. Rather, it was a matter of national policy. Giving up beneficial ownership of substantial interests in a family business in favor of charity was the price to be paid for preserving to the family voting control of the business. Private foundations so established have played two important roles: (1) the public and social role of supporting charitable

endeavors and supplying human needs; and (2) the private role of preserving the independence of family businesses.

These are not inconsistent roles. They can and do co-exist. Thousands of private foundations have performed both functions with complete fairness and without abuse. In their charitable functions they have relieved both taxpayers and Government of the burden of such social obligations. They are a major source of funds for local hospitals, schools, churches, and other community services. Because of the zealous interest of the founding family, they are usually among the group most responsive to the special needs of the community and most ready to take the initiative in meeting new problems or bringing new solutions to old problems.

The preservation of family control of a business originated, managed, nurtured, and brought to a position of outstanding success by an individual family cannot be socially undesirable, sinister, or evil in itself. On the contrary, the traditions of the United States have fostered such enterprises. Congress has previously recognized this policy in the tax laws: section 303 of the Internal Revenue Code precludes dividend treatment on the redemption of stock to pay death taxes, and section 6166 of the Code provides a ten-year period for

the payment of the estate tax in respect of a closely-held business.[*]
No aspect of national or other public policy would be served by legislation which would either deter the creation of new charitable foundations or force existing foundations to dispose of those business interests which enable the founding family to preserve management control of the very businesses that begot the foundations.

Indeed, the forced sale of business interests held by private foundations would make the businesses highly vulnerable to acquisition

---

* See Report of Committee on Finance to Accompany Revenue Act of 1950, relating to Section 303, and Report of Committee on Ways and Means to Accompany Small Business Tax Revision Act of 1958, Relating to Section 6166. S. Rept. 2357, 81st Cong., 2d Sess. (1950) states:

> "It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country."

by conglomerates and lead to a field day for corporate "raiders". This would be inimical to the public interest and in conflict with national antitrust policy. Does it not seem strange that the same House Bill which seeks in section 411 to impede conglomerate mergers by limiting the deductibility of interest on corporate acquisition indebtedness, should by the divestiture provisions of section 101 weaken or destroy the ability of many independent businesses to ward off the corporate raiders and avoid being swallowed up by corporate giants?

That there have been some instances of abuse does not warrant wholesale punitive legislation unjustly affecting the hundreds of private foundations and family-controlled businesses which have long functioned in exemplary fashion. The instances of abuse -- which must certainly be comparatively few in the whole broad range of private foundation endeavors -- can be corrected by adequate enforcement of existing laws and by the enactment of narrow remedies limited to the specific problem areas, as provided in other provisions of H. R. 13270.

Unfair Retroactivity

In any event, if there is to be a change in national policy it should be prospective only. Even if it should be deemed socially desirable for the future to take away the incentive for the creation

of new private foundations, principles of fair play and elementary justice dictate that there be no retroactive legislation penalizing existing foundations and the families who created them.

It must not be forgotten that Government policy until now offered the inducement -- the consideration so to speak -- for the establishment of private foundations. In reliance thereon the creators of private foundations contributed to charity far more stock than would have had to be reserved for estate taxes. In forcing the divestiture, the proposed section 4943 has the brutally retroactive impact of stripping a family of the control of its business even though the family has irrevocably relied upon the existing law to satisfy its philanthropic goals without endangering such control.

Although the bill purports to allow reversion of control to the family by exempting from the self-dealing provisions arm's-length sales of stock in the family business by the foundation back to the family, this does not provide the necessary relief. The proposal in H. R. 13270 to limit the deduction of interest to acquire or carry investment assets, as well as Federal Reserve Board margin requirements, will probably preclude financing of the purchase of substantial blocks of stock; and, in any event, family resources may be insufficient in relation to the

present value of the stock which must be repurchased in order to maintain control.

At the very least, the divestiture provisions of the bill should not apply to existing arrangements. This can be accomplished simply by inserting the words "acquired after May 26, 1969" in the definition of "excess business holdings" contained in proposed section 4943(c)(1) of the Code. It may be noted that this would eliminate the need for the three pages of the bill (sec. 101(k)(4) and (5)), containing the special exemptions for two existing foundations.

Without any doubt private charitable foundations fulfill an urgent social need. They have played a vital role in the betterment of mankind. They can and do perform some functions which neither individuals nor public agencies can do as well. Society would be the loser if new legislation should either impair the effectiveness of existing foundations or discourage the creation of new ones.

Respectfully submitted,

Albert E. Arent

[With corrected page 1.]

TAX REFORM ACT OF 1969

Statement on H. R. 13270
To be delivered September 11, 1969
Before Committee on Finance, U. S. Senate
By: Isaac N. P. Stokes
Chairman of Board and General Counsel of Phelps-Stokes Fund

SUMMARY OF PRINCIPAL POINTS

1. The Phelps-Stokes Fund is a relatively small, independent foundation (with assets of about $3,000,000), devoted primarily to the improvement of Negro education in the U. S. and Africa. Its investment income (about $100,000) is substantially all required for staff and other administrative expenses, and the Fund depends on grants (averaging about $500,000 a year for the past five years) from larger foundations, the U. S. government, and other contributors to finance its operations. The Bill would subject it to restrictions on its activities and on grants to it that would seriously impair its usefulness.

2. Contributions to a foundation from tax-exempt organizations - as distinct from individuals or business corporations - should be included without limitation in determining whether it comes within the description of broadly supported organizations that are excluded from the definition of "private foundation" by proposed section 509(a)(2)(A) of the Code.

3. In the same definition, payments from foreign governmental agencies for services or facilities should likewise be included without limitation.

4. The waiting period for termination of status as a private foundation under section 507(e) should be left to administrative discretion instead of being fixed at 60 calendar months.

5. The provisions regarding influencing legislation in sections 4945(b)(1) and 4945(c) would involve unreasonable restrictions on the rights of foundations and their managers to communicate with legislative and other officials. The constitutionality of these restrictions on free speech should be studied. As a minimum, section 4945(c) should be amended to permit communications regarding a government grant to a foundation in the public interest.

6. The requirement of section 4945(b)(4) that a private foundation making a grant to another private foundation - other than an operating foundation - must assume expenditure responsibility, would unnecessarily discourage grants from large private foundations to small ones like the Phelps-Stokes Fund. The definition of "expenditure responsibility" in section 4945(f) should be amended to place reliance on audits by approved independent certified public accountants.

7. The definition of "operating foundation" in section 4942(j) should be clarified. The 25% limit on support from any one exempt organization should be increased to 33 1/3% or made inapplicable to grants that are subject to expenditure responsibility. Government support should be included without limit.

8. The statement includes the text of proposed amendments.

TAX REFORM ACT OF 1969

Statement on H. R. 13270
To be delivered September 11, 1969
Before Committee on Finance, U. S. Senate
By: Isaac N. P. Stokes
Chairman of Board and General Counsel of Phelps-Stokes Fund

I am appearing before this Committee to urge that the proposed Tax Reform Act be modified so that it would permit the Phelps-Stokes Fund and other [illegible] foundations similarly situated to carry on their present valuable functions of performing specialized services for the benefit of the public with funds largely furnished by the bigger foundations and the United States Government itself. I represent the Fund as Chairman of its Board of Trustees and general counsel. Its address is 22 East 54th Street, New York, N.Y. 10022.

The Phelps-Stokes Fund

The Phelps-Stokes Fund was incorporated in 1911 by special act of the New York State legislature to receive and administer a bequest under the will of Caroline Phelps Stokes.* Its purposes, as stated in the act of incorporation, are to apply the income from this bequest and such other funds as it may receive "to the erection and improvement of tenement house dwellings in the City of New York for the poor families of that city..."; and for the education of Negroes, both in Africa and the United States, North American Indians and needy and deserving white students, through industrial schools, the founding of scholarships, and the erection or endowment of school buildings or chapels." The corporation is authorized "to use any means to such ends which shall from time to time seem expedient to its members or trustees including research, publication, the establishment and maintenance of

*The official corporate name of the organization is "The Trustees of the Phelps-Stokes Fund". It is generally known as the Phelps-Stokes Fund.

charitable or benevolent activities, agencies and institutions, and the aid of any such activities, agencies or institutions already established."

The Fund has concentrated its activities in recent years on improving the education of black Americans and Africans, and on related services. In the field of New York City housing, it has confined its activities recently to the making of small grants to other organizations, because it has not found it practicable to develop a staff with the experience to operate directly in this field, as it does in the educational area.

Over the period of more than half a century during which it has been in operation, the Fund has achieved a reputations as, I think it is fair to say, the outstanding institution devoting its activities specifically to the improvement of the education of Negroes. I will mention only a few of its principal contributions.

In 1916 a survey entitled Negro Education in the United States, prepared by the Phelps-Stokes Fund was published by the United States Government. This provided the first authoritative compendium of information about all Negro institutions of learning in the United States, together with studies of public facilities for Negro education in the states operating separate facilities for Negroes. Among other things, this study brought to public attention the relative expenditures per student devoted to the public education of Negroes and whites in separate school systems.

Before the end of official segregation in state public school systems, the Fund undertook an extensive program for improving the standards of education in public high schools for Negroes, with the active cooperation of state school officials. This involved conferences and refresher courses for Negro high school teachers to enable them to keep up with improvements in teaching methods.

In Africa, the Fund conducted surveys in the 1920's of the educational facilities and programs of the British colonies. The resulting reports were important landmarks in the development of the educational policy of the British Colonial Office and resulted in redirection of that policy to give the Africans an education more suited to their local needs. Although most of the recommendations

of these reports have been overtaken by events, they are of such historical importance that they were recently republished to meet the demands of students of African education.

The major current activity of the Fund is the Co-operative College Development Program, under which thirty predominantly Negro colleges are learning the techniques of efficient planning and financing. The results have been most encouraging in terms of greatly increased alumni support for these institutions and also improved relations with, and financial support from, the communities in which they are located. With funds contributed by the United States Government under Title III of the Higher Education Act of 1965 as well as one of the larger foundations, this program has been expanded to include predominantly white colleges.

The full-time President of the Fund, Dr. Frederick D. Patterson, formerly President of Tuskegee Institute, has devoted a substantial part of his time, with the encouragement of the Fund, to service on the boards of educational institutions and to service with committees of the United States Government, international organizations and other institutions concerned with Negro education in the United States and Africa, and related activities. The Trustees of the Fund feel that this is a very important part of the contribution of the Fund to the public service, although he acts in these capacities as an individual rather than as a representative of the Fund.

The Fund played a leading role in establishing the Robert R. Moton Memorial Conference Center, at Capahosic, Virginia, which has been the scene of many important interracial conferences on education, housing and related matters of interracial concern, attended by educators, students, governmental officials and representatives of interested organizations.

In cooperation with two other foundations which provide the financing, the Fund administers a program which grants fellowships for post-graduate study by Africans in the United States. The Fund also provides financial assistance to African undergraduates in this country to enable them to complete their studies.

The recognized special competence of the Fund in the field of its activities is evidenced by the many grants it has received for

the purpose of carrying out programs either proposed by it or undertaken at the suggestion of the grantors. In the past five years, these grants have included over $1,000,000 from the United States Government and nearly $1,500,000 from other sources, mostly larger foundations. In addition, two old established organizations, the American Colonization Society and the New York Colonization Society, recently turned over all their remaining assets to the Fund for use in improving education in Africa.

With the exception of one activity, the Fund does not seek support from the general public. The contributions on which it depends for its operations come from larger foundations, the United States Government, and occasionally from corporations or other organizations or individuals who are especially interested in its work. The only exception is that it has organized an affiliate known as the African Student Aid Fund, which actively seeks and receives public support for the specific purpose of furnishing financial assistance to destitute African students in the United States.

The Phelps-Stokes Fund is relatively small as foundations go. It has total assets of approximately $3,000,000 including partial ownership of the small building which it uses for offices. Its annual income from investments is approximately $100,000, which does not even cover salaries of its 7 professional and 7 staff and other expenses of administration. To carry on its services, it is dependent on the contributions I have mentioned, averaging over half a million dollars a year during the past five years.

After the original bequest from the founder, the Fund received a gift of about $65,000 from the founder's sister during the latter's lifetime and bequests of $87,000 at her death in 1927. Otherwise, it has received no financial support from the family of the founder other than a bequest of $500 from a nephew of the founder who died in 1957. Its investments are in no way connected with any business of the founder or the founder's family except for a holding in a small, inactive family corporation, which is expected to be liquidated shortly on a basis that will provide a final distribution of less than $1,000 to the Fund. The Fund has no other connections with the founder's family,

except that four of the eighteen members of the Board of Trustees, including myself as Chairman, are grandchildren of a brother of the founder.

Status as Private Foundation

The Fund is near the borderline between publicly supported "thirty-percent organizations", as to which contributors may take income tax deductions up to 30% of income, and organizations as to which deductions are limited to 20%. Which side of the line the Fund will fall on, depends on the amount of contributions received from the federal government, which vary substantially from year to year, and on detailed analysis of the varying sources and amounts of other contributions in the light of the applicable Treasury Regulations defining public support. The sources and amounts of future contributions are so uncertain, that we must assume that the Fund will not be excluded from the definition of "private foundation" in proposed section 509(a)(1) as a "thirty-percent organization" described in section 170(b)(1)(B).

Nor will the Fund come within the second excluded category, described in proposed section 509(a)(2) and referred to in the House Committee Report as "broadly supported organizations", receiving more than a third of their support from certain sources. This is because the specified sources exclude grants or contributions from any "disqualified person" as defined in section 4946 and that definition includes any "substantial contributor", a term which is defined, by reference to section 507(b)(2), as any person who either contributes more than $5,000 to the foundation in a year or is the largest contributor in a year.* This brings me to the first specific changes in the Bill which I would like to propose.

*"Thirty-percent organizations" that are substantial contributors are apparently qualified sources for the "broadly supported" category, but this would not substantially affect the Fund's status because most of its large contributions are from organizations that are not "thirty-percent organizations".

6. (corrected)

Proposed Amendments of Section 509(a)

In view of the undesirable influence which large individual or corporate contributors may exert over foundations to which they contribute, there are obvious reasons for treating them as "disqualified persons" for purposes of the provisions of proposed section 4941 regarding self-dealing. I submit, however, that the position of contributors that are themselves tax-exempt organizations is quite different, as long as they have no connection with the organization to which they are giving. If such contributing organizations are not themselves private foundations, their gifts are not likely to involve any risk of the sort of impropriety which the Bill aims to prevent. If they are private foundations, any abuse should be adequately discouraged by the provisions of the Bill (especially section 4945(f) regarding expenditure responsibility) which will be applicable to them as contributors. An organization which otherwise meets the test of being a broadly supported organization exempt from treatment as a private foundation, should not be disqualified by accepting a contribution of any size from a tax-exempt charitable organization. I suggest, therefore, that section 509(a)(2)(A) be amended by inserting after "with respect to the organization," the words "from any unrelated organization described in section 170(c)(2) which would not be a disqualified person as so defined if it were not a substantial contributor as defined in section 4946". The term "unrelated organization" could be defined by regulation so as to preclude undesirable relationships between granting and receiving foundations.

The category of broadly supported organizations that are excluded from private foundation treatment contains another limitation which I believe should be likewise amended. This is the provision that gross receipts from performance of services exclude receipts from any person which are in excess of 1% of the organization's support in the year of receipt. As in the case of contributions from substantial contributors, I submit that this limitation should also be qualified to exclude

receipts from ~~[struck-out text]~~ non-profit institutions ~~[struck-out text]~~. For example, in the Cooperative College Development Program of the Phelps-Stokes Fund, which I referred to in describing the functions of the Fund, a substantial part of the financing of the program comes from payments made by the participating colleges. An organization which, like the Phelps-Stokes Fund, is engaged in furnishing extensive services to ~~[struck-out text]~~ unrelated tax-exempt organizations, should not be discouraged from making reasonable charges for such services but should, on the contrary, be encouraged to make its services as broadly available as possible by receiving payment from those recipients that can afford to pay. I would, therefore, suggest that section 509(a)(2)(A)(ii) be amended by inserting after "receipts from any person" the words "(other than an unrelated organization described in section 170(c)(2) or which would be so described if it were created or organized in the United States)" ~~, a governmental unit described in section 170(c)(1), or a governmental agency of a foreign state)"~~

A further difficulty with the present definition of the category of broadly supported organizations is that the reference to support from "any person other than a disqualified person..., or from any organization described in section 170(b)(1)(B)" excludes contributions from foreign governments. Organizations like the Phelps-Stokes Fund, whose services include technical assistance to foreign governments, should not be discoouraged, or perhaps precluded, from receiving payment for such services. There is always the possibility that newly discovered mineral wealth or other resources will put the governments of the developing countries in a position where they will have ample funds but will still be desperately in need of the kind of technical assistance which an organization like the Phelps-Stokes Fund can furnish. I therefore suggest adding to the language I have quoted the words "or from any governmental agency of a foreign state in payment for performance of services or furnishing of facilities".

33-758 O - 69 -- No. 10 -- 17

Tax on Private Foundation Investment Income

For the reasons already stated, I would hope that the Bill will be amended in a manner that will exclude organizations such as the Phelps-Stokes Fund from the definition of private foundation . In case these amendments are not adopted, however, I feel I should call the Committee's attention to certain other provisions which would affect the Phelps-Stokes Fund as a private foundation.

The first of these is the tax on private foundation investment income under proposed section 506. I will not discuss the general arguments against this tax, which are well known to the Committee, but I would like to point out that it would impose a special hardship on organizations, like the Fund, which now devote substantially all their investment income to administrative expenses, relying on outside support for their operating budgets. Unless contributors can be induced to make bigger allocations than they now do for the overhead expenses involved in the programs which they finance, this tax will probably require a substantial reduction of staff on the part of the Fund or its gradual liquidation.

Termination of Status

The provisions of sections 507 and 508 relating to termination of status as a private foundation apparently require that an organization which in all respects has ceased to come within the definition

of a private foundation must nevertheless continue to be treated as such for a minimum of five years, unless it terminates its entire existence by distributing all of its assets to other organizations meeting specified requirements. Since the Secretary has complete discretion under the proposed provisions to impose a drastic tax upon termination of status, it would seem that this would provide sufficient deterrence to termination for improper purposes. There does not appear to be any reason why a private foundation whose sources of support and methods of operation have changed so that it no longer comes within the category of private foundation should nevertheless continue to be treated as one for five additional years. I suggest that section 507(e)(1) be modified by changing the words "for a continuous period of at least 60 calendar months beginning after December 31, 1969" to read "for such period as the Secretary or his delegate deems appropriate to establish termination ~~in good faith~~ of its status as a private foundation."

<u>Influencing Legislation</u>

The provisions regarding the influencing of legislation by private foundations in proposed section 4945(b)(1) and (c) give me grave concern as a private citizen and a lawyer, because I believe that they would violate the constitutional guarantee of free speech. They would cut off, with certain narrow exceptions, any private communication between foundations and legislators "or any other person" (including apparently even private citizens) participating in the formulation of legislation. This, I submit is to preclude foundation managers from exercising the normal rights of citizens in a democracy. I believe that the remedy for improper pressures on the legislative process lies in enforcement and, if necessary, revision, of existing legislation with respect to lobbying.

I hope the Committee will instruct its staff to make a careful study of the constitutional issues involved. However, if these provisions are not to be eliminated, I would like to propose a specific modification to take care of a practical problem that could be faced by organizations such as the Phelps-Stokes Fund which receive grants from governmental agencies that enlist their aid in service to the public. Such grants may require legislative approval in the form of authorization or appropriation. Private communication between the organization which will administer a grant and legislators or officials

concerned with the necessary legislative action will often be a normal part of this process, and may even be requested by the legislators or officials involved. I suggest, therefore, that the exceptions contained in the last sentence of proposed section 4945(c) be expanded by inserting a reference to any communication with respect to "a government grant to the private foundation for activities to be conducted in the public interest".

Expenditure Responsibility

The most serious effect on the operations of the Phelps-Stokes Fund from treatment as a private foundation would probably arise from the taxable expenditure provisions of proposed section 4945(b)(4) which would preclude any other private foundation from making a grant to the Fund unless the granting foundation exercises "expenditure responsibility". Under proposed section 4945(f) the grantor would apparently have to supervise the Fund's conduct of the program and audit the Fund's books with respect to expenditures under the grant. It is obvious that grantor foundations will find this a burdensome responsibility and will prefer, wherever possible, to make their grants to foundations which are not private foundations, so that they will not have to undertake this task. Moreover, in the case of organizations like the Phelps-Stokes Fund, which often receive grants from several foundations for a single program, the duplication of expenditure responsibility would be a virtually insuperable obstacle to multiple grants.

I believe that the purpose of the provision for expenditure responsibility could be adequately achieved in a way that would avoid all the duplication of effort involved in having the granting foundation supervise and audit the operations of the receiving foundation. This would be to place the responsibility where it normally rests: in the hands of independant certified public accountants. I suggest that section 4945(f) be revised by changing subparagraphs (1)-(3) to read as follows:

> "(1) to see that the books of the grantee are audited by an independent certified public accountant approved by the auditorsof the grantor,
>
> "(2) to provide as a condition of the grant that any failure to spend the grant solely for the purpose for

which granted must be fully corrected to the satisfaction of the grantor's auditors, and

"(3) to make such reports with respect to the foregoing as the Secretary or his delegate may require."

Definition of Operating Foundation

The amendment which I have suggested regarding expenditure responsibility would remove one of the impediments to the receipt of grants by the Phelps-Stokes Fund from the larger foundations, but it would not remove the other: the fact that grants by the big foundations to the Fund would not be qualifying distributions for purposes of their own compliance with the mandatory distribution requirements of proposed section 4942, because proposed section 4942(g)(1) excludes from the definition of a qualifying distribution a payment to a private foundation which is not an operating foundation. It is therefore important that organizations such as the Phelps-Stokes Fund should, if they are to be treated as private foundations, be included in the category of operating foundations.

I trust that the description which I have furnished of the operations of the Fund indicates that it comes within the class of organizations which the House Committee had in mind when it made the following statement regarding operating foundations:

> "...it has come to the attention of your committee that a number of charitable foundations are regularly used by many private foundations to funnel charitable contributions into certain areas. The operating foundations, in such circumstances, have developed an expertise which permits them to make effective use of the money through grant programs or otherwise." House Report, p. 26.

But the definition of operating foundation in proposed section 4942(j)(3) does not fit organizations such as the Phelps-Stokes Fund. The first requirement of the definition is that substantially all of the income must be "expended directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated". This provision is difficult to understand, since

every non-profit organization is required by law to use its income only for its authorized purposes. If "expended directly for the active conduct" excludes grant making organizations, then the Phelps-Stokes Fund would apparently not qualify, because it does make grants to students and to other organizations. A possible interpretation is that "income" in this context means only investment income. If so, the Fund could probably arrange its expenditures so that grants made by the Fund would be made out of grants received, but it is difficult to see what public purpose would be served by this arrangement. I submit to the Committee that the language of proposed section 4942(j)(3)(A) needs substantial clarification or that the entire requirement be eliminated.

To qualify as an operating foundation the Phelps-Stokes Fund would also have to comply with the limitations of proposed section 4942(j)(3)(B) with respect to more than half the assets being devoted to its lawful activities and with respect to sources of support. If the former limitation means that half the assets cannot be in the form of investments, which is the apparent intention, then the Fund could not qualify under the first test. As to the second, or support test, the language of the Bill requires that substantially all of the support, excluding investment income, come from five or more unrelated exempt organizations, or from the general public, and that no more than 25% of such support be received from any one such exempt organization. In recent years, the exempt organizations contributing to the Fund have been normally five or more in number, and we hope that this situation will continue. However, it is very likely that in some years more than 25% of such support will come from a single organization. Generally speaking, different organizations support different programs of the Fund, and if one program happens to be much larger than the others, it is quite likely that the support received from the organization sponsoring this program will constitute more than 25% of the Fund's entire support from sources other than investment income.

This 25% limitation must be considered in relation to the expenditure responsibility which is placed by proposed section 4945 on the granting foundation. It may be possible, especially if this responsibility is modified in the manner which I have suggested, to get private foundations to make grants to other private foundations for specific programs. But if a program is to be supported by grants of more than one private foundation, it will obviously be highly impractical to impose expenditure responsibility on each of them. In other

words, the expenditure responsibility provisions of section 4945 are designed to limit the financing of a particular program to a single foundation grantor, whereas, the 25% limitation in section 4942(j)(3)(B)(ii) would preclude this in the case where the program in question represents 25% or more of the activities of the recipient organization. I suggest that the 25% limit be increased to 33 1/3% or that it be made inapplicable to grants which are subject to expenditure responsibility on the part of the grantor.

A third difficulty, as far as the Phelps-Stokes Fund is concerned, with the support test for qualification as an operating foundation is that it eliminates support from governmental agencies unless these are deemed to be included in support "from the general public". There would seem to be no reason why an organization which otherwise qualifies as an operating foundation should lose this status merely because a government agency thinks well enough of it to make a large contribution to its support. I suggest that the definition of operating foundation be amended to include government support as described in the definition of private foundation in section 509(a)(2)(A) with the additional inclusion of payments from foreign governments which I have proposed above for that definition.

Conclusion

The Phelps-Stokes Fund is ~~a relatively small,~~ an independent foundation engaged primarily in operations which are financed by grants from the United States Government, larger foundations and various other sources. As such, it should not be treated as a private foundation. The Committee is requested to consider the amendments I have proposed, which would exclude foundations of this kind from the definition of private foundation. Private foundations should not continue to be treated as such for five years after their activities cease to come within the statutory definition. The provisions regarding influencing legislation and expenditure responsibility would impose impractical restrictions on grant-receiving foundations, which would be alleviated by the amendments I have suggested. Finally, the definition of operating foundation should be broadened to include organizations of the type I have described.

Respectfully submitted,

Isaac N. P. Stokes

SUMMARY OF PRINCIPLE POINTS OF STATEMENT OF THE KRESGE FOUNDATION ON THE FOUNDATION PORTION OF TAX REFORM ACT OF 1969

1. The Kresge Foundation has net assets with a present market value of approximately $410,000,000 and has given away about $100,000,000 in grants during the forty-five years of its existence.

2. The proposed 7½% tax on net investment income is discriminatory, reverses long standing policy and deprives both public and private health, welfare and educational institutions of badly needed support. If the foundations must provide funds for their own supervision, it should be done by an audit or filing fee of 1%.

3. Long term capital gains should not be included in the concept of net investment income.

4. Allowable deductions from gross investment income should include all expenses reasonable and necessary to carry out the exempt purpose which are not excessive. This formula should also be used in calculating adjusted net income in the distributions section of the Act.

5. The application of the minimum investment return concept in connection with required distributions should be delayed until taxable years following January 1, 1975. In addition, the applicable percentage of 5% used to calculate such return is too high and should be reduced to 3½% or 4%.

6. The valuation provisions to be used in calculating minimum investment return should be clarified.

7. Conditional challenge grants which are charged to income at the time of appropriation should be given the status of qualifying distributions.

8. The provisions concerning speculative investments (sec. 4944) should be eliminated or clarified.

9. Restrictions on program, explicit and implicit, in the taxable expenditures section, create a dangerous precedent for future more wide-spread regulation of foundation activities.

William H. Baldwin
President and Trustee

STATEMENT OF THE KRESGE FOUNDATION TO SENATE FINANCE COMMITTEE WITH RESPECT TO THE TAX REFORM ACT OF 1969

THE HISTORY AND POLICIES OF THE KRESGE FOUNDATION:

The Kresge Foundation is a private trustee corporation organized under the laws of the State of Michigan. Its purpose is the promotion of the well-being of mankind and its six trustees are authorized to expend the income of the Foundation toward this purpose. The Foundation is not associated or affiliated with any other corporation or organization.

The Foundation was established in 1924 by Sebastian S. Kresge and he was the sole donor of all of the principal assets of the Foundation. The market value of such gifts when made by him was approximately $60 million. The present market value of the net assets of the Foundation is approximately $410 million. For the year 1969, approximately $8.3 million has been granted largely on a conditional challenge basis to some 158 grantees out of the total of 514 applicants who made requests. Including the year 1969 to date, The Kresge Foundation has, in the 45 years of its existence, made grants from income totaling approximately $100 million to over 1800 recipients. Reports have been published covering each of these years containing complete financial and grant data. In the main, Kresge Foundation grants are concerned with construction projects and capital equipment for colleges, universities, hospitals, graduate theological schools and homes for the aged. In addition, the Foundation makes grants for the providing of buildings to house projects involving music and the arts, youth development and medical research. The Foundation ordinarily makes grants on a challenge or conditional basis and its grants are principally extended to non-profit tax exempt well established institutions which combine sound character and stability with progressiveness and purpose. The Foundation generally excludes from consideration all

applications for grants for operating budgets, for loans of all types, for debt retirement, for endowment, for church building programs, for educational institutions of less than four-year college and university levels, for scholarships, for research programs and for grants to individuals for any purpose.

KRESGE FOUNDATION COMMENT ON PRIVATE FOUNDATION PORTION OF TAX REFORM ACT OF 1969 (H.R. 13270)

GENERAL:

At the joint request of the Senate Finance Committee and The House Ways and Means Committee the Treasury Department in 1965 reported at length on private foundations and repeated many of their 1965 findings in part 3 of the 1969 Treasury Department Tax Reform Studies and Proposals. In brief, The Treasury Department findings were and are that foundations play a special and vital national role, have the virtues of quickness, flexibility and dedication and that they perform functions not possible for government to fill. In this assessment, we concur. The Report also set out certain specific serious tax abuses of the foundation form. We agree that abuses exist and should be corrected. The Report indicated that such abuses existed among a "minority" of private foundations. We have never seen figures from the Treasury Department or any other source which would demonstrate more precisely the quantative or qualitative extent of such abuses. Using either total number of foundations or total amount of foundation assets as a base, we would guess the percentage of those abuses to be an extraordinarily small "minority." If we are correct in this assumption, and if the Congress is not to repudiate the

affirmative statements by the Treasury Department about Foundations, then great care should be taken to be certain that the means of correcting admitted abuse is not horrendously disproportionate to the amount of abuse. Foundations by and large do their work well. They, quoting from the 1965 Treasury Department Report, "play a special and vital role in our society; government service cannot provide a satisfactory substitute"; they "possess important characteristics which modern government necessarily lacks"; they "have also preserved fluidity and provided impetus for change within the structure of American philanthropy"; and they "evoke great intensity of interest and dedication of energy - these values in themselves, justify the tax exemptions and deductions which the law provides for philanthropic activity." The long standing policy of the Congress favoring their existence should not be changed by indirection or by first-step taxation which is simply a punitive beginning-of-the-end. If foundations are taxed out of existence, however slowly, and if private philanthropy founders because of tax policies, it will remain for government to be the sole source of support for all educational, scientific and charitable activities. And, if there is only one doorbell to ring for funds, then those who prefer federalism, variety, flexibility, dispersion of initiative and competition of ideas will too late realize the stultifying burden of a conformed central control of all such support. This would be true, we feel, regardless of the abilities and dedications of those administering such a centralized source.

INVESTMENT INCOME TAX (section 506):

The 7½% tax proposed by this section will, in fact, be borne by the organizations who would have received the funds and not by the foundations. In 1968 for example, applying the 7½% tax to Kresge

Foundation "net investment income" would have meant $544,350 less for us to give away. The tax is discriminatory in that it applies alike to foundations who have not abused the law and to those who have. And, having taxed foundations, would that precedent be used to permit taxation of pension funds and churches? The proposed tax prevents the foundations who have conformed to the law from giving away as much as they could and, at the same time, is not a sufficiently high tax to end the abuses intended to be corrected. To the extent that the tax is a means of providing resources for the Treasury Department to oversee the activities of foundations, its yield at 7½% - estimated as somewhere in the neighborhood of $50 to $75 million - is far too large for such an office. Moreover if the intent of the tax is to provide such funds for such an office it places foundations in the unique situation as being the only entities who are asked to give up money which would otherwise go to charity to provide for their own supervision. The tax moreover conflicts with fundamental congressional policy of over fifty years standing and the revenue effect is minimal for the government but is critical for the persons to whom The Kresge Foundation might give. For example, it would not simply be just a loss of the assumed 1968 tax of $544,350 to potential donees. In view of the fact that The Kresge Foundation makes most of its grants on a challenge basis it seems likely that the raising of perhaps twenty times that amount might fail by reason of our inability to make the grants.

While we see no justification for any tax on foundation net investment income, if it seems necessary to have the foundations provide funds for foundation surveillance, then our tepid preference would be for an "audit" fee (not a "tax") which would be at the rate of 1%. Certainly such a fee would

provide ample means for the establishment of a capably staffed office within the Treasury Department which could provide any supervision which Congress may think is required.

In further criticism of Section 506, there is no justification, in our view, for the inclusion of net long term capital gain within the concept of net investment income. We would have no objection to the inclusion of short term capital gains but the inclusion of long term capital gains, even using a stepped-up basis of stock, would violate equity and could well occasion the making of investment decisions on an unwise basis.

In addition, the deductions allowable from gross investment income seem extraordinarily restricted. We know of no reason why ordinary and necessary expenses should be limited to those of investment advice or property management only. We see no reason why all expenses of the foundation should not be allowed assuming that such expenses are reasonable and necessary to carrying out the exempt purpose of the private foundation and if such expenses are not excessive. This is precisely the formula allowed in the computation of compensation paid to disqualified persons and it should be used to define allowable deductions in arriving at net investment income.

REQUIRED DISTRIBUTION (section 4942):

This section requires us, by the end of the year following the close of our accounting period, to distribute or use the larger of our "minimum investment return" or "adjusted net income" in "qualifying distributions."

Regardless of the fact that The Kresge Foundation will not be subject to the "minimum investment return" distribution provision for taxable years prior to January 1, 1972, this concept presents major investment difficulties to us. Approximately 75% of The Kresge Foundation assets are represented by some 6,057,000 shares of S.S. Kresge Company common stock, (approximately 17½% of all outstanding shares), and, it seems likely that the "adjusted net income" of our Foundation will be under 5% for the foreseeable future if we retain the Kresge stock. Assuming the trustees were to decide to further diversify this investment in an effort to bring up the adjusted net income to equal or exceed the 5% figure it would, according to our best present analysis, require the sale of approximately $150 million of such S. S. Kresge Company common stock and the investment of the proceeds thereof in corporate bonds or stocks yielding at least 7%. It is literally impossible to contemplate the disposition of such an amount of stock over a two-year period of time - even assuming that such a move is the most desirable investment direction we could take. There are important and presently unknown market considerations which apply and in addition it would probably be unwise or unworkable to sell such shares (which would have to be registered with the Securities and Exchange Commission in every instance) in one offering. The point is that application of the "minimum investment return" concept as early as 1972 places an unduly heavy burden on this foundation and might force us into possible premature and unwise investment decisions. In addition, it seems unlikely to us that the curbing or continuation of present inflationary trends will be sufficiently understood prior to January 1, 1972 so as to permit us to adopt, with some degree of sanity, the proper investment decisions.

The portion of the Act having to do with excess business holdings indicates its awareness of the difficulty of disposing of large blocks of stock except over an extended priod of time and it seems to us that the "minimum investment return" portion of tho Act should likewise show this recognition. In our view, in the case of organizations organized before May 27, 1969, section 4942 should, for taxable years beginning before January 1, 1975, (instead of January 1, 1972, as presently proposed) apply without regard to the "minimum investment return" provision. In addition, it is our opinion that the applicable base point percentage of a 5% return is unreal. It would seem to us that a more proper point of beginning might well be 4% or less. All fair applicable market indicators known to us and the yields of other well managed funds, would seem to make the 5% figure too high - especially in the light of present market instability.

In Section 4942 as well as in the investment income tax section, we see no reason why deductions should be limited to simply the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management or maintenance of property. Once again we would suggest that the more proper and fair definition of deduction should be one which allows expenses which are reasonable and necessary.to carrying out the exempt purpose of the private foundation and which are not excessive.

The valuation portion of section 4942 indicates that the fair market value of securities for which market quotations are readily available shall be determined "on a monthly basis." This definition surely needs more precision. The method of determining value on a monthly basis

33-758 O - 69 -- No. 19 -- 18

is not spelled out and should be made clear by statute and not by regulation. Shares of S.S. Kresge Company stock owned by The Kresge Foundation are traded on the New York Stock Exchange but, in view of the large number of shares held by the Foundation, would, for example, the concept of "blockage" apply to any such monthly valuation?

The concept of "set-asides" creates some problems for The Kresge Foundation. The Foundation accepts applications during the first two months of a given year. During this period of time we will receive, on an average, approximately 500-600 applications. Based on prior experience, the total aggregate amount requested in such applications will exceed $100 million. Approximately 95% of our grants are made on a conditional or challenge basis - that is, the successful applicant is told that we will give him so much money if he is able to raise the balance required for the project involved. Following consultation, a time is set by which he must raise such balance of funds. Upon his certification to us that such balance of funds have been raised - our money is paid over. In many cases - especially where the balances required to be raised are large - up to three years may be given to meet the conditions of our grant. All such conditional grants made by us are considered as a charge to income at the time of appropriation. As far as we are concerned the definition of qualifying distribution should be expanded to cover any contribution which we make on a conditional basis which is listed as a charge to income at the time of appropriation. It is impossible for us to tell, under the present wording, whether the so called "set-aside" provisions mean to apply to such conditional grants.

If our present practice of making contributions charged to income at the time of appropriation is disallowed as a "qualifying distribution" and is not considered as "paid", it will probably mean that our challenge grants can be no longer than one year in duration - so as to assure their pay out prior to the end of the year following the year in which the income was earned - and it will mean a general tightening of the time within which conditions must be met. Money raising is a tough business at best and there is no sense in imposing additional unwarranted burdens on the colleges, universities, hospitals, etc. to whom we make grants. Since we make grants largely for construction purposes the amounts to be raised are often considerable and it takes time to raise such funds. In addition, more often than not government funds are involved and, regrettably, the length of time required to process a government grant is great. And, if our challenge grants are not allowable as qualifying distributions we are certain that it would unduly and unnecessarily hamper our grant system if it was necessary to establish to the satisfaction of the secretary or his delegate that the amount to be paid out will be paid out within five years <u>and</u>, in addition, that the project is one which can be better accomplished by such set-aside and by the immediate paying out of funds. The imposition of such a bureaucratic clearance would surely cause us to seriously consider discontinuance of our present carefully considered and liberal challenge conditions.

Apparently the act proposes that, where the distributions during the preceding five year period have exceeded income, the distributable amount for the taxable year should be reduced by an amount equal to such excess. In the wording of the section, however, the five-year prior period is referred to as "the five <u>taxable</u> years immediately preceding the taxable year." This raises the question of whether or not the five years

preceding the effective date of such an act is involved or whether we will have to go five "taxable years" before any excess can be used against distributable amounts. It appears to us that any "excess" available at the time of effect of the Act should be available for use.

SPECULATIVE INVESTMENTS (section 4944):

Under this section foundations may not invest funds so as to "jeopardize" exempt purposes. It seems to us that this provision is not only vague but impossible to understand. Regulations and court cases defining it would take years. In the interim the private foundation would find itself in an almost impossible condition with respect to investments. Obviously there are some extreme situations which would clearly fall under the concept of the section but there is a very large grey area in which greater definition is absolutely required. Or, in the more desirable alternative, the provision should be dropped completely. In its present form, its meaning is not only unclear and its purpose cloudy, but it lends itself to almost endless interpretations.

TAXABLE EXPENDITURES (section 4945):

None of the activities restricted by this section have ever been engaged in by The Kresge Foundation to our knowledge. We have never made individual grants, have never contributed to voter registration drives and have never attempted to influence legislation. We, therefore, cannot say that the section as presently drafted constitutes a restriction on our present program. We are very much concerned, however, about the precedent established by this section. The Kresge Foundation is mainly in the business of making grants for construction purposes, excepting for certain program grants in the Metropolitan Detroit area.

Will the next step be to require that we may only give to certain types of building projects, for example? And then only if they are built in a particular sort of way? It seems to us that this is an extremely delicate area and should be approached with the greatest caution.

SUMMARY:

As far as we are concerned, taxing our income in the time of vastly increasing social and financial complexity would hardly make it easier to perform our assigned task of promoting the well-being of mankind. Lack of funds causes us to decline many meritorious applications as it is. Moreover since many of our challenge grants join federal challenge grants in the same project, it seems a questionable dilution of institutional fund raising to cut our challenge grant by taxing us. It would seem to follow that if we give less because we have less to give, then someone else will have to give more.

This Foundation is in its forty-fifth year and we are glad to share our deeply held belief that we have operated usefully, honorably, legally and openly. Nonetheless, we have no doubt that there are foundation abuses. Regrettably, the correction of man's nature has not proceeded as rapidly as one might wish. In brief response, however, we would say that this foundation has done and can do some things better and quicker than government, some things very nicely in tandem with government and that the derelictions of the very few should not cripple our contributions or stifle our independence.

Respectfully submitted
THE KRESGE FOUNDATION
by William H. Baldwin
President and Trustee

September 8, 1969

THE CONSERVATION FOUNDATION

RESEARCH · EDUCATION

1250 Connecticut Avenue, N. W.
Washington, D. C. 20036
Telephone · 659-2180
Cable Address · CONSERVIT

STATEMENT OF SYDNEY HOWE, PRESIDENT, THE CONSERVATION FOUNDATION TO THE SENATE FINANCE COMMITTEE, ON H.R. 13270, OCTOBER 8, 1969

Mr. Chairman and members of the Committee, The Conservation Foundation appreciates this opportunity to appear before you to present our views on H.R. 13270, specifically on certain provisions of Title I, Subtitle A, dealing with a newly-proposed category of organizations called "private foundations."

The Conservation Foundation conducts research, education, and training programs designed to expand and apply knowledge regarding the earth's resources -- its water, soils, minerals, air, plant and animal life -- and the interrelationships among them. We believe that pollution, blighted surroundings, inadequate open space, and development which degrades landscapes and natural systems -- all intensified by growing population and advancing technology -- represent high priorities for positive conservation programs.

Our activities include environmental studies and surveys, demonstration planning projects to minimize conflict between preservation and development, information services, consulting services to civic groups and educational institutions, and, to a lesser extent, comparable international programs. Our work is financed by grants and gifts from endowed foundations, the Federal government, and other organizations and individuals. The Conservation Foundation does not have an endowment and is not a membership organization within the usual meaning of that term.

The Conservation Foundation is a nonprofit corporation established in 1948 and certified as tax-exempt under Section 501(c)(3) of the Internal Revenue Code. By a ruling of the Internal Revenue Service we are a "publicly supported" organization within the meaning of Section 170(b)(1)(A) of the Code, and therefore our donors can qualify for the additional 10% deduction allowed by that section.

As a so-called "30%" organization we doubt that our own tax status would be altered by H.R. 13270. However, the bill as now written will seriously impair our ability to carry out our tax-exempt purposes. Equally important to us is the probability that several of the provisions of Title I will inhibit or cripple the work of a large number of other conservation groups throughout the country. Our concern about the proposed legislation centers in three areas.

First, Section 506 of Title I of the bill imposing a 7 1/2% tax on the net investment income of every so-called "private foundation" will harm this Foundation and other conservation organizations by reducing the amount of funds available for grants to us and to them from private foundations. We believe that the resulting limitations upon our activities and those of other conservation organizations are not in the public interest. We suggest, in lieu of a tax upon the investment income of private foundations, that a foundation registration fee be imposed. Such fee should be set at a level necessary to finance full enforcement of existing law and any new legislation needed to correct existing abuses, and no higher.

Second, under Section 4942 private foundations, as defined in Section 509, must distribute all income currently to avoid graduated tax sanctions. For the purpose of this mandatory payout requirement, qualifying distributions include distributions to public charities and direct expenditures for charitable purposes, but not distributions to private foundations -- unless the recipients can meet the complicated test specified in Section 4942(j) for an "operating foundation."

We fear that a host of educational, research and civic organizations, large and small, which constitute a major constructive element of our public life, could not qualify as private operating foundations under the present definition. Thus they would be cut down by the inability of their major contributors, which are frequently endowed private foundations, to finance their work. We doubt that any endowed private foundation would continue to make grants to another private foundation if this would subject the donor to tax.

One limited alternative, of course, is simply to amend Section 4295 by broadening the definition of "operating foundations." Such revision, however, would not affect the overwhelmingly complex accounting and legal procedures required throughout the bill for the small private foundations whose value we have noted. Ambiguous provisions on "disqualified" persons (Section 4946) and "termination of private foundation status" (Section 507) are only a few examples of legal intricacies that may eventually cripple small 501(c)(3) organizations -- a result stemming both from restrictions on the organizations themselves and on the new rules for donors. It may well be that if the bill passes, as written, only the large "private foundations" will be able to survive.

Our third area of concern, and perhaps the one that troubles us most, is Section 4945. This section imposes a 100% tax penalty on each "taxable expenditure" by a private foundation. Under subparagraph (c), the term "taxable expenditures" 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 the legislation,

other than through making available the results of nonpartisan analysis or research..."

We believe that subparagraph (1) quoted above is perhaps the most dangerous provision in the bill. It is so broad and general that it places under a cloud

all but the most theoretical or scientific and technical work of many 501(c)(3) organizations.

The most fanciful semantic exercise could never clearly define what is and what is not an "attempt to affect the opinion of the general public or any segment thereof" for the purpose of influencing legislation. Furthermore, the difficulties of defining what is or is not "nonpartisan analysis or research" are even more serious. For, in one sense, every charitable organization is and should be "partisan" in the performance of the charitable duties and objectives for which it was established.

Let us assume for a moment that one private foundation makes a grant to a second private foundation organized by concerned citizens to enable them to study the causes of environmental pollution in their community or state, or to analyze existing attempts to protect the environment from further degradation. Assume that the results of such study are made public -- as one would certainly hope -- and that the findings then become part of the justification for a variety of remedial actions, including new local, state or federal legislation to deal with environmental pollution. Would the Internal Revenue Service, under the provisions of Section 4945(c) quoted above, then be in a position to impose a 100% tax on the expenditures made by the recipient foundation for the study, on the grounds that such study was an illegal attempt to affect public opinion and influence legislation?

This is an incredible spectre, but apparently one we must take your time to contest.

There is another aspect of this matter which causes us real concern. Under another provision of Section 4945, any grant by one private foundation to another is subject to a 100% tax, unless the grantor polices the grant and verifies that it is spent for a proper purpose. In the hypothetical situation outlined above, might not the Internal Revenue Service also seek to assess a 100% tax on the grant made by the donor foundation, on the basis that the donor had failed to properly police the grant and verify that it was spent for a proper purpose?

In light of this policing requirement, we fear that tax counsel to endowed private foundations mightly simply conclude that for several reasons it would be wise to support only 100% "safe" projects. First, there are obvious practical difficulties in supervising grants made to other 501(c)(3) organizations. Second, under Section 4945(b)(5), questions will arise regarding 501(c)(3) "purposes." For example, could some small portion of a private foundation grant support an insubstantial attempt by a publicly-supported organization to influence legislation? Finally, and most conclusively, the cost to private foundations, should they violate these provisions, would be excessive. If private foundations are to be guarantors of the activities of their grantees, tax counsel may be expected to be conservative. Already, we have indications that endowed private foundations may withhold support from publicly-supported organizations if the grant could by any stretch of the imagination be considered an attempt to affect the opinion of the general public.

The practical effect of Section 4945 would be to stifle innovation. Exploration of many public problems would be seriously curtailed. The new and the experimental would be shunned. The role that endowed foundations would play in stimulating public programs would be vastly diminished. Even if IRS regulations

eventually seek to alleviate some of these effects, the inevitable IRS delay may nevertheless cause irreparable damage to 501(c)(3) organizations as they and their donors wrestle with the ambiguities and risks of the bill. The absence of funds during such a period of delay might well force some organizations out of business.

If this spectre should be realized, it would be a tragedy of immense proportions for our nation. Open inquiry and discussion of public issues are central to our way of life. Foundations have financed independent studies which have led to innovations and improvements of benefit to the people of the United States and of the world. They are often the only source of funds for such studies. It is simply beyond comprehension that Congress would now seek to impose prohibitive tax penalties upon this major source of free and open inquiry and discussion.

We are also troubled by the provisions of the second subparagraph quoted above which defines as a taxable expenditure "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."

Many conservation organizations are from time to time asked by members of Congress, as well as by state and local legislative bodies, to comment -- formally or informally -- upon contemplated or pending legislation. For example, our Foundation has, on request, provided information in recent months to members of Congress, state legislatures and administrative agencies on offshore oil exploration, pesticides, highway route selection, mineral leasing, water pollution control, and other environmental subjects. In fact, our present resources permit us to supply only a small portion of the assistance sought on such subjects.

Does Congress intend that private foundations shall no longer finance basic information services for the public? If part of an organization's operating funds is received from private foundations, should the organization refuse to submit a statement to a legislative body, to return a congressional telephone call, to reply to a letter, or to meet personally with "any member or employee of a legislative body," lest the result be prohibitive tax penalties against the organization and/or the foundation?

Throughout the country, many local, state and national organizations are working to conserve the American environment. The more substantial among these are 501(c)(3) organizations whose trained staffs serve educational or scientific needs of literally thousands of unstaffed citizen conservation groups. Much of the support of these staffed organizations is received from endowed foundations, with a large number of small donations coming from the general public. If these organizations are found to be private foundations under Section 509, which seems possible, many of them could not function. At best, their limited resources would be sapped by tax attorney bills and by a morass of clerical work and reporting requirements.

We urge the Committee to consider the problems of handling public information directed toward the solution of environmental problems. In the environmental field, virtually all issues require decisions based on social, economic, scientific and political considerations. The resolution of environmental conservation problems may -- and most often does -- encompass "legislation." We suspect that legislators and their staffs would welcome more information on legislative solutions, because their constituents are demanding better environmental management. Informed natural

resource and environmental specialists employed by 501(c)(3) organizations are often a legislator's only non-governmental source of such information, aside from the delegations of commerce and industry.

Private businesses, of course, may take tax deductions for expenses incurred in connection with legislation directly related to their interests. Congress thus provides tax benefits that encourage business expenditures for public information programs dealing with legislation. At the same time, Section 501(c)(3), as now written, discourages information programs concerned with legislation affecting the broad public interest.

We believe that 501(c)(3) organizations should be permitted to conduct the same kind of information programs that private businesses carry out as normal, tax-deductible activities. While private businesses and their associations could continue to lobby, H.R. 13270 would make private foundations pay a 100% penalty for funding activities which are somehow determined to be attempts to influence public opinion and legislation.

Existing law already prohibits foundations from carrying on or financing propaganda or other efforts to influence legislation if such activities are "substantial" in relation to other activities of the organization. Existing law also prohibits 501(c)(3) organizations from engaging in any activity on behalf of a candidate for public office.

In lieu of the approach taken by H.R. 13270, we believe Congress should hold hearings to explore thoroughly the adequacy of existing legislation on lobbying -- in a positive instead of a punitive framework, and with full consideration of the impact of any new legislation upon <u>all</u> institutions in our society.

We strongly recommend that, <u>at the very least</u>, Section 4945 be revised by (1) deleting the words "or otherwise attempt" in subparagraph (b)(1), in order to limit the scope of this restriction to the carrying out of "propaganda to influence legislation"; (2) deleting in its entirety subparagraph (c), which was quoted in part above and which drastically expands the restrictions of subparagraph (b)(1); and (3) revising subparagraph (f), so that the "expenditure responsibility" imposed upon a donor private foundation making a grant to another foundation would be satisfied by the donee executing and sending to the donor a certificate setting forth the manner in which the grant was spent.

We have touched only a few of the disturbing elements of the bill, but there are many others, such as the new complications and restrictions affecting charitable contributions in Title II. We urge that the Committee re-examine provisions concerning gifts of appreciated property and less than fee interests in real property, in the light of their potential damage to many organizations.

The Conservation Foundation shares the concern of Congress and the public for the need to correct abuses which have been disclosed in the foundation world. We endorse reform which will prevent the misuse of foundations as tax havens and which will prevent manipulation of foundation funds for the personal benefit of donors. The provisions of Title I, Subtitle A, of H.R. 13270 would, however, constitute a radical departure from a public policy which has encouraged private scientific, educational and research efforts in support of public objectives. We feel that many conservation organizations could not continue to serve the public usefully if this bill becomes law as written.

To conclude, we would like to reiterate the recent words of John W. Gardner, former Secretary of Health, Education and Welfare and former president of the Carnegie Corporation. Mr. Gardner wrote in an article in the June 8, 1969, Washington Post:

> "...tax exemption is a means of preserving the strength of the private sector and insuring that our cultural and educational life is not wholly subject to the monolithic dictates of government. It would be quite possible for a nation to insist that government be the sole source of support for all educational, scientific, charitable and perhaps even religious activities -- and in some nations, the government is precisely that. But our policy of tax exemption asserts that it is in the public interest for many varied groups outside of government to be engaged in charitable, religious and educational activities.
>
> The policy is based on the wise conviction that we will be better off if these activities so crucial to the core of our national life are participated in by individuals and groups with a wide range of points of view. We don't believe that Big Government has all the answers; we want a lot of people in the act."

We share Mr. Gardner's views, and we urge Congress not to restrict the pioneering role which foundations play in our society.

-0-

PART B—ADDITIONAL STATEMENTS

SINK

STATEMENT OF SOUTHERN REGIONAL EDUCATION BOARD ON TAX REFORM BILL (H.R. 13270)*

The Southern Regional Education Board (SREB) has a genuine concern regarding some of the provisions of the Tax Reform Bill (H.R. 13270) affecting the treatment of private foundations. Prompted by this concern, the Board desires to make known to the Finance Committee of the United States Senate the Board's views on such provisions.

I. BACKGROUND AND ACTIVITIES OF SREB.

SREB is the operating agency of the nation's first interstate compact for higher education. Created in 1948 at the direction of the Southern Governors' Conference, SREB is a pioneer in regional planning and action and in effective multistate use of higher educational resources.

Fifteen states are now members of the compact: Texas, Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, North Carolina, Maryland, Mississippi, Oklahoma, South Carolina, West Virginia, Tennessee, and Virginia.

The Board has no coercive power over any state or institution. Its success depends entirely upon the interest and cooperation of the states and institutions.

SREB conducts cooperative programs aimed at providing better undergraduate, graduate, professional and technical education for all citizens of the South.

The Board works directly with state governments, academic institutions and other agencies concerned with higher education to:

* Statement of Governor Mills E. Godwin, Jr., of Virginia, retiring chairman, and Governor Buford Ellington, of Tennessee, incoming Chairman of the Board.

(a) do research on the South's problems and needs in higher education;

(b) provide consultant services to states and institutions on problems related to higher education;

(c) find ways of solving these problems through regional cooperation; and

(d) disseminate information on higher education throughout the region.

SREB is a catalyst for innovation in curriculum and instruction; a goalsetter concerned with the major problems of the South and the role higher education must play in solving them; a resource, conducting research, promoting research by colleges and universities, and offering consultation services to institutions, states and agencies; a communicator, disseminating a continuing flow of meaningful news to the general public, the campus community, state government and educational agencies and organizations.

Reflecting the broadening concerns of higher education today, the Board's activities cover a wide spectrum: computer sciences, nursing, agriculture, instructional television, resource development, special education, international studies, institutional research, and mental health training and research.

Basic support for SREB comes from an annual appropriation of $25,000.00 by each participating state. At present, each state also participates in the Board's mental health research and training program and appropriates an additional $8,000.00 annually to support the program. Funds for special projects come from federal agencies, private foundations and other organizations.

Of the Board's budget for 1968-69, state funds comprised 30 percent; grants from private foundations, 30 percent; and federal funds, 40 percent. The "seed money" invested by the states to operate the Board has brought millions of dollars from other sources for programs to improve higher education in the South.

Private foundations have been an extremely important source of support for SREB almost since it was created in 1948. The support from private foundations varies from year to year but the volume and nature of the support is of the utmost importance. In the 1969-70 budget, support from foundations will be in excess of $420,000.00.

The nature of the support of private foundations to organizations such as SREB is of particular significance. Much of this support has been, and is, for innovative and experimental study and programs - programs for which public funds are not readily available. There is attached to this statement an appendix which briefly describes some of the recent or current programs supported from the private sector.

SREB would be seriously harmed - as would the cause of education generally - if any legislation should be passed which limited the incentives for, or had a repressive effect upon, the continuation of the type of support which has been so beneficial to the region served by SREB and to the cause of education generally in our nation. There is indicated below a brief reference to some of the concerns of SREB as to some provisions of H.R. 13270.

33-758 O - 69 -- No. 19 -- 19

II. VIEWS OF SREB ON CERTAIN PROVISIONS OF H.R. 13270.

A. Section 4942(g). Qualifying Distributions Defined.

"1. In General. For purposes of this section, the term qualifying distribution means - (a) any amount paid out to accomplish one or more purposes described in Section 170(c)(2)(b), other than any distribution to (i) an organization controlled (directly or indirectly) by one or more disqualified persons (as defined in section 4946) with respect to the foundation, (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), or (iii) an organization which would be a private foundation if it were a domestic organization . . ." (Emphasis added.)

H.R. 13270 generally requires private foundations to distribute specified amounts each year. Section 4942(g) pertains to the type of contributions which would qualify in determining compliance with distribution requirements.

SREB is of the opinion that its purposes fall within those described in §170(c)(2)(b) and that SREB qualifies as an operating foundation as described in §4942(g)(3). However, aside from the question as to whether or not SREB so qualifies, the provisions of §4942(g) appear unduly restrictive. SREB is a §501(c)(3) organization which is exempt from tax under §501(a). SREB must continue to qualify for such status each year, as do all other §501(c)(3) organizations.

SREB's concern is that there be no question as to the qualification of distributions for the support of the type of pro-

grams which have been, and are being, supported by private foundations. SREB works with and provides assistance to a large number and variety of organizations which are involved in one phase of education or another and which SREB would not want to be harmed by unduly restrictive qualifications for distributions from private foundations. It would seem that any such organization which qualifies, and continues to qualify, as a §501(c)(3) organization should qualify for distributions. If the requirements for qualification as a §501(c)(3) organization need review and possible revision or if the activities of such organizations require greater scrutiny, then this should be undertaken. However, attempts to draw distinctions between such organizations are almost certain to raise doubts about qualifying distributions and may result in serious injury to fine causes in the field of education. SREB would hope that all organizations which continue to merit the beneficial treatment accorded them under §501(c)(3) would qualify as recipients of distributions from private foundations.

B. Section 506. Tax on Private Foundation Investment Income.

"(a) Imposition of Tax.--There is hereby imposed for each taxable year on the net investment income of every private foundation (as defined in section 509) a tax equal to 7 1/2 percent of such income."

The privilege of tax exemption is indeed an important one and must be carefully guarded. Those seeking such status must recognize their obligation of demonstrating, and continuing to demonstrate, eligibility. Exemption from federal income tax has been provided by Congress to encourage individuals and organiza-

tions to provide support for activities which Congress deems beneficial to our society. The wisdom of this policy has been proven beyond question.

Any abuse of tax exempt status should be dealt with in a manner commensurate with the extent of the abuse. However, the tax suggested would apply to all private foundations and could, we fear, have an extremely detrimental effect on the continuation of the benefits which have come from private gifts and voluntary action.

As a recipient of support from private foundations, SREB would be indirectly harmed by the tentatively proposed tax, as would many educational organizations with which SREB is concerned and with which it works. Further, it is feared that one inroad into a tax structure which now reflects, and is a part of, a policy which has resulted in great benefit to many worthy causes would lead to larger and broader inroads. If one type of tax exempt organization loses that status, this creates a genuine threat to other organizations which are the beneficiaries of an overall tax structure grounded on charitable purposes. In addition to income tax exemption, many organizations are the beneficiaries of exemption from ad valorem and other state and local taxes. Eligibility for federal income tax exemption is frequently given considerable weight in passing upon eligibility for exemption from these other types of taxes.

Certainly no one can justifiably condone abuse of tax exempt status. However, such abuses can be eliminated by enforcement of existing provisions of the law or, if not, these provisions may be revised or greater scrutiny provided. The tax imposed

in §506 does not correct abuses; it applies with as heavy a hand to the pure as to the impure; and could undermine, discourage and weaken the type of activity which Congress heretofore has effectively encouraged.

C. Section 4945(b). Taxable Expenditure.

> "For purposes of this section, the term 'taxable expenditure' means any amount paid or incurred by a private foundation (1) to carry out propaganda, or otherwise attempt to influence legislation, (2) to influence the outcome of any public election (including voter registration drives carried on by or for such foundation . . ."

Our concern is with that portion of the above which prohibits any amount paid or incurred to "attempt to influence legislation."

SREB works directly with state governments, federal agencies, educational institutions and other organizations and bodies concerned with education. As before stated, its support comes from states, federal agencies and private foundations. It engages in research, consultation, supervision of demonstration and experimental programs and other activity designed to further its objectives.

For example, SREB provides consultation services to states in the planning and coordination of higher education, including long range planning. Consultation is provided to states, and all types of institutions with respect to academic programs; community service programs for academic credit; the financing of

higher education; improving public information programs at universities and colleges; establishing, expanding and improving undergraduate social welfare curriculums, and in many other areas of education. The very nature of such activities is such that the results thereof could influence legislation in matters pertaining to education.

Subsection 4 of §4945 imposes a 100 percent tax on the private foundation and a 50 percent tax on the foundation's manager for expenditures described in §4945. Subsection 4 of §4945 specifically states that the 100 percent tax is imposed on a private foundation which makes a grant to another organization (other than an organization described in paragraph 1, 2 or 3 of §409(a)), unless the private foundation exercises expenditure responsibility with respect to such grants in accordance with subsection (f). There follows a subsection 5 which also imposes the 100 percent tax on the private foundation and a 50 percent tax on the foundation manager who makes distribution for any purpose other than for a purpose specified in §501(c)(3). This latter reference is to an organization operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes or for the prevention of cruelty to children or animals, and it specifically excludes organizations which carry on propaganda or otherwise attempt to influence legislation.

The present language in §4945(b) might raise questions about the eligibility of SREB for certain types of grants from private foundations. We strongly urge elimination of that portion of the section pertaining to attempts to influence legislation.

III. <u>CONCLUSION</u>.

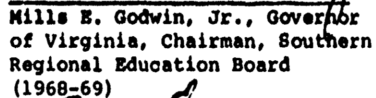
This statement does not purport to reflect a study in depth of H.R. 13270 or an exhaustive reaction to its provisions. It is intended to substantiate SREB's concern as to the following:

(1) That the immense benefit which flows to this country from the charitable impulses of its people not be jeopardized by legislation representing a radical departure from a policy heretofore supported by Congress.

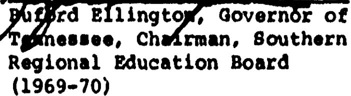
(2) That legislation in the nature of tax reform not be used to remedy whatever abuses there may be under existing laws but that, instead, the existing laws be revised if necessary and enforcement be improved.

(3) That any legislation which is passed not be of so technical a nature as to require the making of fine spun distinctions which may result in irreparable harm to organizations and programs of unquestionable value and desirability.

SOUTHERN REGIONAL EDUCATION BOARD

By: 

Mills E. Godwin, Jr., Governor of Virginia, Chairman, Southern Regional Education Board (1968-69)



Buford Ellington, Governor of Tennessee, Chairman, Southern Regional Education Board (1969-70)

APPENDIX TO STATEMENT OF SOUTHERN REGIONAL EDUCATION BOARD ON TAX REFORM BILL (H.R. 13270)

I. THE INSTITUTE FOR HIGHER EDUCATIONAL OPPORTUNITY.

A relative newcomer created in April 1968, the institute is now active on several fronts. During the year, it completed reports on curriculum changes required to prepare Negro students for new career opportunities, interinstitutional cooperation involving traditionally Negro colleges, and the special dollar needs of those colleges.

In the area of curriculum change, a follow-up project, funded by the grant of a private foundation, is under way, supporting intensive revision efforts at 12 predominantly Negro institutions. A second series of case studies of intercampus cooperation is now being prepared with financial assistance from another private foundation. Publication is expected in early 1970.

Five junior colleges - in Florida, North Carolina and Texas - are working with the Board in a three-year project financed by a private foundation and aimed at determining how public junior colleges can attract more black students and serve them more effectively. Additionally, the institute staff is assisting the State of Florida in a comprehensive examination of post-high school educational opportunities for black students.

II. AGRICULTURAL SCIENCES.

Early this year, SREB's Council on Graduate Education in the Agricultural Sciences completed year-long consideration of ways the predominantly white and Negro land-grant institutions might cooperate to improve academic programs in agriculture. The

Council's report, published in the spring, led to follow-up meetings between the presidents, agriculture deans and extension service directors of land-grant institutions in subregional areas. These meetings will reach all of the SREB states.

A six-month project is now under way to develop a basic course in animal science, which is expected to be a model for schools of agriculture throughout the region. This summer, the Board will sponsor an institute in animal nutrition at the University of Georgia.

III. NURSING EDUCATION.

In cooperation with the 124 institutions in the region which offer degree programs in nursing, SREB's Nursing Education Project this year carried out a variety of programs designed to improve nursing education and reduce the critical shortage of nurses in the South.

Programs included: a seminar series for instructors in medical-surgical nursing in master's degree programs; management training seminars for deans of bachelor's and advanced degree programs, sponsored by Emory University; two regional workshops for faculty members in associate degree programs sponsored by the University of Tennessee and the University of Maryland; and a clinical training project in cancer nursing, directed by the University of Texas M. D. Anderson Hospital and Tumor Institute.

More than 150 deans and directors of Southern college nursing programs attended the semi-annual meetings of the Council on Collegiate Education for Nursing, the main planning body of the Nursing Education Project. At one meeting the prime topic was the federal Regional Medical Programs, and at the other, curriculum development in nursing.

IV. CONTINUING EDUCATION FOR JOURNALIST.

Some four years ago SREB began, with the support of a private foundation, a pilot project in continuing education for journalists. The goal was to provide working newsmen with opportunities to discuss contemporary problems with experts from the academic community, and thus to help the newsmen improve their performance. This January, after three and a half successful years, the project came to a happy conclusion. The original intention was that it should become permanent, independent of SREB, and it is well on its way toward that goal.

The foundation and a new Southern Newspaper Publishers Association Foundation are financing it jointly for a five-year period, during which the foundation's support will decrease and publisher support increase annually. If all goes well, the program will be firmly established and entirely supported by SNPAF six years from now. A development of this kind is particularly gratifying to SREB, which seeks to spur new educational activities that can become self-sustaining.

V. COMPUTER SCIENCE.

SREB's Computer Science Project this year completed a national inventory of the use of computers in higher education and undertook an ambitious two-year experiment with different ways to supply computer facilities to small colleges for instructional purposes. The inventory, financed by the National Science Foundation, is regarded as the most up-to-date and comprehensive collection of data about computer equipment, facilities and use, plus computer science degree programs offered, at some 2,000 universities and colleges nationwide.

Twenty small colleges across the region are participating in the current project, also supported by NSF. Nine are using terminals connected to university or commercial computer time-sharing centers, six have their own small computers, and five are sharing a single computer. Techniques of computer use for instruction, and attitudes of students, faculty and administrators toward such instruction, are being studied and evaluated.

SENATE FINANCE COMMITTEE

Statement of
Dr. Jonas Salk

October 6, 1969

SUMMARY OF PRINCIPAL POINTS

I. This nation's Government and its private foundations are avowedly working together toward the attainment of common public goals. Each of these channels of philanthropy is supported by the people of the United States and each has developed distinctive characteristics. The question presented by the legislation under consideration is whether this dual system should be allowed to continue.

II. Both channels of American philanthropy are subject to shortcomings. Prior to attempting any objective evaluation one must examine the abuses of private foundations and the effect of such abuses upon their stated purposes. This question of abuse must be distinguished from the more basic question of whether our dual system of philanthropic funding should be preserved. Recent history provides innumerable examples of valuable research, initiated and supported by private philanthropy, which otherwise might not have been accomplished.

III. The dualism of foundations and government parallels the dualism found in living systems generally. In each instance, the dualism represents a difference in function and purpose rather than a mere division of labor. Just as the genetic system of living organism is concerned with the future survival of the species, the private sector of philanthropy (represented by foundations) is concerned with the long-range future of mankind; similarly, the somatic system is concerned primarily with the machinery for sustaining life in the same manner that government must deal with the short-range problems of mankind. Foundation endowments provide stable reserves from which exploration and change may be effected.

IV. Regulation and control constitute important functions for every healthy living system, from cells to organisms to human society. Reasonable controls over foundations can provide positive benefits, and will not be damaging. However, unduly severe strictures will limit the usefulness of foundations. Abundant evidence has been presented regarding the positive contribution to our society made by foundations, while the existence of certain abuses has likewise been established. This Committee is charged with the responsibility of distinguishing the necessary and the useful from that which is unduly restrictive.

Like a physician, the Committee must exercise extreme caution and discretion to avoid injuring or killing the patient. Absent such care, this nation might be deprived of a vital, innovative, and independent force for growth and for constructive change.

STATEMENT OF DR. JONAS SALK

My relationship to American foundations is somewhat different from that of the other speakers you have heard thus far. I am not an administrator of a foundation, nor a member of any foundation board, nor have I ever been. Neither do I now hold a position with fund-raising responsibility for any institution. Rather, I come before you as an individual who has been enabled--through the American system of private philanthropy--to work in certain ways, toward certain goals, which would not have been possible had this system not existed.

Therefore, I bring a somewhat different perspective to the questions the Congress now faces. From my vantage point, I would like to examine these questions, and see if it is possible to draw some conclusions.

****

First of all, I see both the government and the foundations as having the same avowed end: that is, they are both intended

to work for the benefit of the people--especially the people of this nation, and ultimately the people of the world--if the full destiny of this country is to be realized. The people of this nation support both the government and foundations. The government of this nation encouraged the growth of foundations through legal statutes, and within this framework foundations have evolved a certain character which we will examine in a moment,

I am, of course, aware that there is concern that foundations may be abusing their privileges, and that they may be "getting out of hand." This concern extends over a broad range of points, from whether or not foundations are accumulating excess wealth in tax-free shelters, to whether or not foundations are unduly influencing legislation, to whether or not foundations are mis-using their tax-exempt status in a variety of other ways, such as operating businesses. So strong is this concern that the very existence of foundations is now being questioned.

Since foundations and the government work for a common purpose--for the benefit of man--one of the basic issues that needs to be resolved is whether two separate channels of

philanthropy--one private, one public--should continue separately, or whether one should be eliminated. Thus, we must first ask ourselves, is the foundation system a disease to be stamped out, or is it a positive benefit to be encouraged?

****

It seems to me that before judgments can be made about the value of foundations--or, the reciprocal questions: can we afford them, or can we afford to do without them--you should have information about how much they cost and how much they give--how much wealth has accumulated in foundations compared to that accumulated by other tax-exempt organizations, and what are the relative amounts spent yearly from taxes and from philanthropic sources. You would also want to know the specifics about how often, and to what extent, foundations have abused their privileges and how often they have not. I imagine you would also want to know specifically, and not merely generally, how often, and to what degree, foundations attempt, or appear to be attempting to influence legislation, how often they have

33-758 O - 69 -- No. 19 -- 20

not, and how this relates to the activity of other tax-exempt organizations which have, as their openly avowed aim, the influencing of legislation.

****

I would remind you that regardless of advantages neither government nor foundations have been exempt from scandal in the past. No system, however well-intentioned, is perfect. And although abuse is certainly an issue, it ought not be confused with the deeper question of whether funding for philanthropic purposes, for health, for education and welfare, should continue to be conducted privately as well as publicly. Is a dichotomy between public and private funding useful?

I believe that it is not only useful but necessary and there is evidence in support of this opinion. There are innumerable examples of philanthropically initiated and supported research that would have been delayed--or would not have been accomplished at all--were it not for the American system of private philanthropy. For example, research that led to the development of polio vaccine was

philanthropically funded. The government became active only when the time came to administer and control a vaccine. Studies that led to the development of vaccines for yellow fever were funded by foundations and the early work that led to the development of vaccines for influenza and measles also were foundation funded.

These are popularly comprehensible examples but an even more impressive record is in the clear fact as noted by George Beadle that "the remarkable twentieth-century flowering of experimental biology would not have been possible without the support of private foundations in key areas and at critical times." Up to 1965 no fewer than thirty Nobel laureates received Rockefeller Foundation fellowships before they won the prize.

****

The dualism of foundations and government has a parallel in the dualism that exists in living systems generally. For example, living organisms possess a genetic mechanism and a somatic mechanism, each separate and yet both interrelated and interdependent. This dualism is not merely a division of labor but rather a difference in function and therefore in purpose. In anthropomorphic terms there is a

difference in emphasis, outlook, responsibility--a difference in attitude and even a difference in the value system applied in making judgments. By and large, the genetic system, which is concerned with heredity, is concerned with the future--with the survival of the species--with generations to come. The somatic system is concerned primarily with the machinery of life, with coping, with staying alive, with the here and now, and also with the preservation of the genetic system. This also describes the way in which foundations and government work together. Foundations can afford to be more concerned with the long range future and government, of necessity, is more concerned with the present and short range future.

As for dualism in this country, our nation was founded on diversity, and one of its great strengths lies in its tolerance of diversity. Few other countries tolerate it. Even fewer encourage it. Dualism precludes monopoly and precludes dictatorship.

****

The foundations can, in a way, be thought of as equivalent to a savings account prudently accumulated for building the future. Foundation funds supplement tax-derived government funds which can be thought of as borrowing from the future for use in the present. Foundations can use the income from their accumulated savings to finance innovative programs continuing over a period of years; the government deals with the more urgent necessities, and with crises not yet forestalled by planning and foresight.

The foundations are in the business of developing foresight. They support, amongst other things, colleges and universities and other institutions of advanced and future-oriented research. Foundations with their endowments provide the stable reserves from which exploration and change can be effected.

****

We need both the stability and the change. Legislation which aims to reduce the life-span of foundations, to limit or discourage the development of new foundations, or to hamper the foundations' ability to influence change will have a

deleterious effect upon those vital functions which operate now for the benefit of the nation and the world.

At the same time that I say this, I also agree that regulation and control are important functions which every healthy living system possesses, from cells to organisms to society. Our society now demands more regulation and control from all its institutions--and this is a healthy demand. Failure of regulation and control, on the cellular level, for example, leads to cancer. Failure of regulation and control in an organ or an individual leads to many kinds of disorder and disease. Something of the same sort is true in institutions.

Just as the public is now demanding more control over its government, so I think it should demand and have more regulation over foundations. Any reasonable regulation will not be damaging. It will be invigorating. I believe most foundations will favor, and will benefit from, a form of better auditing by the IRS, financed through a fee paid by foundations themselves. I think this is necessary and advisable, and can have positive effects. On the other hand, unduly severe strictures--either financial, or in terms of foundation activity in any sphere--will limit the usefulness of the foundations.

Determining what is necessary and useful, from what is unduly severe, is the job of this Committee and of the Congress. It is not an easy job, and I do not envy you the decisions you must make. In this respect, you are the "physicians" to the country who, in a sense, must make decisions on the basis of what may be insufficient evidence. Every physician does this. No physician enjoys it. But there is a maxim from Hippocrates which is appropriate here: 'Above all, do no harm.'

I think you have evidence, indisputable evidence from the past, of the advantages and value of foundations. I think you have indisputable evidence that in many areas, the foundations are supporting programs--such as grants and loans to higher education--which save the government expenditures it might otherwise have to make. I think you have evidence that the foundations have reduced tax burdens that would have arisen if work they supported had not been done. You are currently faced with the equally indisputable evidence of certain abuses and I would urge you, in treating this problem, to be quite certain that you do not maim or kill the patient, and that you do not deprive this country of what has

been, for the past half century, a vital, innovative, independent force for growth and for constructive change in American life, and in the world.

As a source of

useful and reliable information

attached are

Title Pages and Table of Contents

of the book by

Warren Weaver

entitled

U. S. PHILANTHROPIC FOUNDATIONS

310

U.S. Philanthropic Foundations

THEIR HISTORY, STRUCTURE, MANAGEMENT, AND RECORD

BY

WARREN WEAVER

With contributions by

GEORGE M. BEADLE, ARNE TISELIUS,
LEE A. DUBRIDGE, JOSEPH C. HINSEY, GEORGE J. STIGLER,
ERWIN N. GRISWOLD, WHITNEY J. OATES,
BROOKS ATKINSON, ANATOLE CHUJOY, DONALD L. ENGLE,
RICHARD MCLANATHAN, BROCK CHISHOLM, LORD BOYD-ORR,
FREDERICK OSBORN, PHILIP E. MOSELY, GEORGE M. BECKMANN,
FRED M. HECHINGER, FLORA M. RHIND
AND BARRY BINGHAM

HARPER & ROW, PUBLISHERS

NEW YORK, EVANSTON, AND LONDON

311

CONTENTS

INTRODUCTION / *by Milton Katz* vii

PREFACE xiii

PART I. THE HISTORICAL ORIGINS AND THE DIMENSIONS OF MODERN PHILANTHROPY

CHAPTER 1. PRE-CHRISTIAN PHILANTHROPY 3
CHAPTER 2. A THOUSAND YEARS OF ECCLESIASTICAL FOUNDATIONS 9
CHAPTER 3. THE SHIFT TO SECULAR CONTROL 14
CHAPTER 4. EARLY AMERICAN PHILANTHROPIC ORGANIZATIONS 19
CHAPTER 5. KINDS OF FOUNDATIONS 39
CHAPTER 6. THE ARITHMETIC, CHRONOLOGICAL, AND GEOGRAPHIC FACTS ABOUT FOUNDATIONS 57
CHAPTER 7. THE RESOURCES OF FOUNDATIONS AND THEIR SHARE OF PHILANTHROPY 60
CHAPTER 8. REASONS FOR ESTABLISHING FOUNDATIONS 67
CHAPTER 9. LEGAL AND FINANCIAL ASPECTS OF FOUNDATIONS 90
CHAPTER 10. THE STRUCTURE, STAFFING, AND PROCEDURES OF FOUNDATIONS 104
CHAPTER 11. FOUNDATIONS AND INDIVIDUALS 139

CHAPTER 12. FOUNDATIONS AND UNIVERSITIES 151
CHAPTER 13. FOUNDATIONS AND GOVERNMENT 168
CHAPTER 14. FOUNDATIONS AND SOCIETY 198

PART II. JUDGMENTS CONCERNING THE VALUE OF FOUNDATION AID

INTRODUCTION TO PART II / *The Difficulties of Assessment* 223
CHAPTER 15. BIOLOGY / *George W. Beadle* 225
CHAPTER 16. CHEMISTRY AND BIOCHEMISTRY *Arne Tiselius* 241
CHAPTER 17. PHYSICS / *Lee A. DuBridge* 252
CHAPTER 18. MEDICINE / *Joseph C. Hinsey* 260
CHAPTER 19. ECONOMICS / *George J. Stigler* 276
CHAPTER 20. LAW / *Erwin N. Griswold* 287
CHAPTER 21. HUMANITIES / *Whitney J. Oates* 299
CHAPTER 22. THEATRE / *Brooks Atkinson* 310
CHAPTER 23. DANCE / *Anatole Chujoy* 316
CHAPTER 24. MUSIC / *Donald L. Engle* 329
CHAPTER 25. VISUAL ARTS / *Richard McLanathan* 338
CHAPTER 26. WORLD HEALTH / *Brock Chisholm* 346
CHAPTER 27. FOOD / *Lord Boyd-Orr* 353
CHAPTER 28. POPULATION / *Frederick Osborn* 365
CHAPTER 29. INTERNATIONAL AFFAIRS / *Philip E. Mosely* 375
CHAPTER 30. NON-WESTERN STUDIES / *George M. Beckmann* 395
CHAPTER 31. EDUCATION / *Fred M. Hechinger* 410
CHAPTER 32. RACE / *Flora M. Rhind and Barry Bingham* 428
CONCLUDING REMARKS TO PART II / *The Consensus / Warren Weaver* 440
Biographical Notes on Contributors 449
Notes 459
Index 475

Statement of Dr. Malcolm Moos
President, University of Minnesota
for
Hearings on H.R. 13270
Tax Reform Act of 1969

Committee on Finance
United States Senate
Washington, D. C.
~~September 10, 1969~~
October 6, 1969

These comments are offered from the perspective of one who is currently the president of one of the nation's largest public universities and was formerly a program officer of the Ford Foundation.

I should like to limit my attention to those aspects of the proposed Tax Reform Act of 1969 (H.R. 13270) which seem to me to have important and negative implications for public and private higher education, and the vital supportive role that the best of our foundations provide to both. The word "best" is used advisedly; I have no desire to protect those who would mask their profit-making or political or ideological activities by identifying their organizations as educational foundations. On the other hand, I hope to demonstrate that both public and private education in this nation are in need of greater, rather than less, support from the legitimate foundation activities threatened by the proposed reforms.

I should also like to point out that I am personally in favor of major reform in our tax legislation, and I do not know a single responsible member of the higher education community who is not. First of all, as observers and students of the national scene (and taxpayers ourselves), it is clear to us that

inequities and potential for abuse in our current tax structures cripple the morale of taxpayers and raise legitimate questions from them about the degree to which they should be expected to subsidize the opportunism of others. Nothing except broad reform measures, of the scope contemplated by the Congress, can restore the integrity of American tax policy. Second, since the legitimate needs of public higher education in America will require additional tax revenues and since the availability of these additional funds depends on the continuing good faith of taxpayers, the American citizen must not become cynical about the burden of taxes he bears or the uses either of tax revenues or of funds exempted from taxation. Both reason and self-interest argue for major tax reforms.

However, I do take exception to some of the details of the legislation before this committee. In my judgment, they will have unfortunate consequences for universities. I also believe that Congress would not wish those consequences to occur. The health, and possibly the independence and autonomy of many of our institutions can be seriously damaged by the provisions which affect individual and foundation giving to public and private higher education.

- USE OF PRIVATE FUNDS -

Private gifts constitute vital income for the nation's institutions of higher education, both private and public. A state university like the University of Minnesota, of course, is not so dependent on gift income of various kinds for its general operating costs as a private university. I am certain that the private universities can adequately describe both their presently dire financial straits and the damage that reductions in gifts of various kinds would do. For some of them, their very existence would be threatened.

For all of them, the uncertainties add further to the already grave discussions of whether dual private and public systems of higher education sustained in the United States. I need not list the many reasons for the opinion of the higher education community in this country that the nation is best served through widely differing approaches to support organization and instruction in higher education. Any threat to the financial support and therefore to the quality and quantity of private higher education is a threat to all of higher education.

But private income plays an essential and irreplaceable role in public higher education, as well. At the University of Minnesota, for example, the complete budgeted expenditures of private resources totalled about $31 million during the past five years. These expenditures, of course, constituted a small proportion of the total University budget for that period of time, but analysis of those expenditures is revealing. They have an importance far beyond their amounts in dollars and cents.

1. Budget amounts from private sources are increasing substantially in total dollars and also provide an increasing proportion of the University's income. In the year ended June 30, 1969, the University of Minnesota spent $9,254,925 from these sources, up nearly 40 per cent from the previous year. In the year ended June 30, 1969, expenditures from these sources made up 4.5 per cent of the University's total budget, compared with 3.3 per cent four years earlier. Furthermore, the University of Minnesota is not alone in this regard. Efforts to improve investment of university funds and solicit greater support from private sources have paralleled the huge increase in higher education enrollments throughout the nation and the accompanying pressure on public sources of support.

2. Private support has been used for purposes absolutely critical to the excellence and progress of the University of Minnesota -- purposes for which public funds could not be available at the opportune time or could not be available at all. For example, the following efforts undertaken at the University of Minnesota during the past five years could not have been accomplished without substantial or complete funding from these sources:

a. The initiation of the Center for Programmed Learning

b. The initiation of the Department of Family Practice and Community Health in the College of Medical Sciences

c. The Community-University Health Center

d. The Office for Advanced Drama Research

e. Research on problems in law and society

f. The initiation of a program for low income minority students

In short, the University of Minnesota depends on private resources for special efforts that are vital to its development and its relevance to the society of the 1970's, but for which public support is, for one reason or another, unavailable.

3. The capacity of a university to meet the demands of the public is directly tied to the availability of these private funds. Without them and the extra resources they provide, a university is less flexible, less innovative, less dynamic than it must be if it is to be truly excellent and responsive. With them, it can make the moves, undertake the studies, catalyze the change, strengthen the weaknesses, create the new units -- meet the demands that are not susceptible to regular, proportionately increased state and federal appropriations. These are the hard and real demands of a rapidly changing and problem-ridden society which historically has turned to its resources of

public higher education to address itself to these needs. It is ironic that so often it is the support by private gift or foundation that really enables the public university to do what the public demands of it. One important example at the University of Minnesota is the development of a new program in Family Practice and Community Health, which was made possible by a grant given by the Louis W. and Maud Hill Family Foundation. The development of this program was in response to the public demand of Minnesota that our health care delivery system is presently inadequate to meet the demands for health services.

4. Clearly many of the resources of a university that give it special distinction as a community or national resource are the direct result of gifts facilitated by the tax provisions which are under question before this committee. Works of art, collections of private papers, books, and even whole libraries often come into the possession of a university, museum, or other institution as gifts with tax relief implications for the donors. Such gifts then become public resources, where they once were private and unavailable to their communities. They enhance the institution and the community and help the university to serve its historic role of heightening the quality of life in the society through the careful stewardship and cultivation of educational resources.

-WEAKNESS IN THE LEGISLATION-

Under Sections 101 and 201 of the proposed legislation, H.R. 13270, there could be serious disruption of these vital resources.

1. The proposed legislation would make gift planning extremely complicated for individual donors, especially where appreciated property is involved. The tax advantage to the donor, though it fortunately remains a significant one, would be less than under the present law. How much that one fact will affect the volume of private contributions is unclear. But even more important is the

33-758 O - 69 -- No. 19 -- 21

difficulty of estimating how much the tax advantage would be at any one time. In a given situation the planning of a large gift of appreciated property involves so many indefinites and interdependencies that a donor might be persuaded to do nothing at all, especially since the tax advantage is decreased in any case from its present status. While there is definitely a need to place some limitations on deductibility and avoid relieving donors from having any tax obligations at all, it is unfortunate from our standpoint that the proposed changes should compound the effects of limiting deductions by adding a good deal of confusion to the computation.

2. By discouraging large gifts, the proposed regulations would complicate the use of these gifts by the institutions which receive them. Large gifts have a double advantage for an institution like the University of Minnesota, for they cut the proportional costs of fund-raising at the same time that they make it possible for the institution to make better plans for their use. A single gift, if it is large enough, may be dedicated to a single, independent, long-range use, thus providing assurance of future availability of funds for that purpose. The limitation on gifts of appreciated property to 30 per cent in the case of individuals appears certain to reduce the size of gifts.

3. To the extent that these laws and regulations bring a general reduction in private giving to the University of Minnesota or other educational institutions -- or even a reduction in the rate of increase of giving -- the proposed laws will increase the pressure on students and federal and state treasuries for support of higher education. This is a time of significant change in higher education, and of phenomenal growth as well. Throughout the nation, state governments are reaching the limits of their ability to finance public needs and retain the good will of taxpayers at the same time; and the difficulties of federal

financing of public education need no elaboration before this body. The result is that students in public institutions of higher education are being required to provide an escalating share of the costs of that education. At the same time, institutions are struggling to maintain quality instruction in the face of increased numbers and costs, while they are faced with constant and justified demands to provide education that is more relevant to our complex and technical society.

The members of this committee are well aware of the increasing demand for student assistance funds. In the case of loans a nearly unbearable debt burden is placed on students who are not fortunate enough to have their educations financed for them. To the extent that universities are caught between pressure to limit taxation and this anticipated reduction of private financing, the visible remaining source of income is our students. The proposed changes in tax legislation, while they do not affect public institutions as harshly as private institutions, will nevertheless cause a greater hardship for our students.

-FOUNDATIONS-

4. Finally, there is little doubt that the proposed regulations will adversely affect both the fund-raising and fund-distributing capacities of our private foundations. As a matter of fact, that appears to have been at least partly the intention of the House bill.

As I stated earlier, I have no interest in protecting any organization that tries to dignify its political, profit-making, or ideological thrusts through the protections that have been provided to private foundations under our laws. But it is absolutely vital to distinguish those misuses of the law from the legitimate and very valuable support and services provided by our best foundations to American higher education in particular and to the American society in general.

a. First of all, every effect of the proposed tax reforms on private giving is an effect on foundations as well. Like the universities, they receive and manage gifts from individuals, using the proceeds for their own research and support efforts, many of which are carried on in the universities. Their gifts to the universities, in turn, assist those institutions in the same way that private gifts assist them -- by providing support of critical efforts for which funds would otherwise not be available. A qualifying foundation under the proposed law, then, will suffer from the same problems and the universities will suffer the effects of those problems in potentially reduced income.

b. Besides the total value of the support universities receive from our legitimate foundations, there are other important functions they provide as well. In its relationship to a university, a foundation reduces the costs of fund-raising for that university by acting as a sort of broker. To the extent that the proposed law reduces the capacity of the foundations to accept and distribute funds, it will complicate the fund-raising activities of individual institutions, which have in the past had a dependable and flexible intermediary in the private foundation. The impact of these laws would be especially great in the contribution of appreciated properties to foundations.

c. The weakening of the role of foundations in higher education would reduce the contribution foundations make to the improvement of higher education as well. Many private foundations not only act as convenient resources for the collection and distribution of private funds to universities, but also function as coordinators of research and support of specific matters of substance.

A foundation may undertake to study a particular issue or procedure -- for example, the development of university information management systems -- and thus establish itself as a national resource in that field. Through such a

function, the foundation reduces the necessity for overlapping studies in individual universities and increases the possibility that an acceptable common practice can be established. Such efforts are expensive and require resources which are not available in a single institution. The foundation can commit the required funds centrally and coordinate the use of resources -- functions which no individual institution can manage.

In this function, in fact, private foundations provide a desirable alternative resource to the involvement of the federal government in such efforts, since the federal government is the only other institution which can muster the financial resources and operate throughout the nation to make use of resources in individual institutions.

d. For foundations which make these contributions to American higher education, perhaps the most unprecedented and undesirable aspect of the proposed legislation is the 7 1/2 percent tax on investment income of the foundations. The effect of this taxation would be a direct reduction in the amount of funds available to universities through the foundations, thus striking at the support of the vital university efforts outlined above. For foundations involved in legitimate educational efforts, this seems unnecessarily punitive.

The Louis W. and Maud Hill Family Foundation in St. Paul is heavily involved in grants to institutions of higher education, including the University of Minnesota, and has provided information that indicates that the 7 1/2 per cent tax, exclusive of tax on capital gains, would diminish the amounts available annually for grant purposes by at least $177,000. This relatively small foundation supported efforts at the University of Minnesota amounting to more than $600,000 during the fiscal year ending in 1969. If it

should determine that the University of Minnesota must bear the entire brunt of its new tax-paying status, more than one-fourth of the critically-needed funds from this foundation would disappear from the University's budget. However, if it were to distribute the reduction, essential efforts would be curtailed in the institutions to which the Foundation provides grants. There simply would be that much less money available for distribution. And, as the spokesman for the foundation points out, "Of course, all foundations would be subject to the same tax and would have less funds for grant-making purposes." Furthermore, if capital gains income should be taxed in this foundation, the loss to grant-receiving institutions would be approximately doubled. Interestingly enough, this loss to institutions would be a loss to those organizations which the proposed legislation, for the most part, specifically excludes from taxation.

It makes little sense to require taxes to be paid from funds which would have supported cancer research and student assistance programs but not from those which support the self-serving activities of trade associations and other lobbying organizations. The tradition of Congressional treatment of charitable organizations has been to place them in a favored position. If there are deficiencies in the present tax law, I strongly believe that Congressional acumen can resolve them in a manner consistent with the traditions that have fostered support rather than diminished it. It is difficult to see why the Congress should change that emphasis at a time when educational and charitable causes need strengthening.

Finally, as a student of government stretching across a quarter century of teaching at Johns Hopkins, Michigan, and Columbia, I find the sections of the bill that would muzzle groups from making representations before Congress appalling. Such a sweeping restriction would tend to stifle the very breath of

a pluralistic society and in my judgment ought to be eliminated.

-CONCLUSION-

Perhaps the House of Representatives, faced by the praiseworthy pressures for general tax reform, did not give adequate consideration to certain less visible implications of the proposed tax reform bill. The leadership of American higher education, both private and public, hopes these critical issues will receive careful consideration before action is taken in the Senate. Speaking as the president of one of the largest public universities in America who has had experience with private foundations from both perspectives of grant-receiver and foundation officer, it seems to me that the following specific recommendations should be considered by this committee:

1. At the same time that limitations are placed on the deductibility of charitable contributions, including gifts of appreciated property, ways should be found to formulate deductibility so that the complexity of computation does not increase the likelihood of reduced gifts to institutions which need them so badly.

2. In considering the possible reduction in total giving which this proposed law may bring about,further attention should be paid to the public benefits which are achieved by the donation to institutions, libraries, and museums of paintings, books, and collections of valuable papers.

3. In establishing the amount of deductibility of charitable gifts, and therefore assessing the degree to which the federal government should, in effect, encourage such gifts, attention should be given to the public benefits which flow from those gifts -- specific research and educational efforts which make it possible for public as well as private institutions to improve their service to students and the society; the widely accepted viewpoint that the educational

quality of our institutions of higher education and the educational health of the nation both require strong private as well as public efforts in higher education; the relief that these gifts provide to state and federal governments and students, all of whom otherwise bear the burden of supporting a growing and changing higher education system in the Nation; and, therefore, the need to encourage increases rather than decreases in private gifts to higher education.

4. Serious consideration should be given to alternatives to the 7 1/2 per cent tax on foundation investment income and stock ownership limitations by some means which will meet the regulatory necessitities, but not weaken the capacity of these foundations to support vital activities either within the foundations or at the nation's universities. Alternatives are available to cover the costs of investigating and regulating the activities of foundations which would meet the recognized need to maintain constant examination of foundation activities, without penalizing institutions assisted by the foundations or reducing the clear public benefit that legitimate foundation activities now provide.

5. Finally, tax legislation that affects the income of public and private higher education should always be considered in the context of the important question of possible alternatives to the contribution made by foundations to research, instruction, and management of American higher education. Greater dependence on the federal government for financial and management support is the only alternative I can visualize.

Statement by James Day, President

National Educational Television and Radio Center

Before the

Senate Committee on Finance

October 6, 1969

Mr. Chairman and members of the Committee, I am James Day, President of the National Educational Television and Radio Center, known as NET. The purpose of my testimony is to discuss the problems posed for public broadcasting and for NET by the proposed Tax Reform Act of 1969 (H.R. 13270).

We are particularly concerned with the language presently contained in Sections 4945(b)(1), (b)(2) and (c)(1) of the proposed Act, which are designed to restrict the "legislation-influencing" and "election-influencing" activities of "private foundations." As I will discuss later in greater detail, it is our position that, if enacted, these provisions will seriously hamper, if not emasculate, the public affairs broadcasting activities of NET. [See Part III at page 9.] Since we believe that the Treasury proposal of September 30, 1969, does not solve

the problems which we find in Section 4945, * we propose the following addition to Section 4945:

> "(g) PUBLIC BROADCASTING -
> Subsections (b)(1) and (b)(2) shall not apply to amounts paid or incurred for the production or distribution of public affairs programs which are broadcast over noncommercial educational broadcast stations as defined in Section 397(7) of the Communications Act of 1934, as amended (81 Stat. 368; 47 U.S.C. 397(7))."

We are also vitally concerned with the classification, under the proposed Act, of a foundation such as NET. Unless NET qualifies as a non-private foundation or as a private operating foundation as defined in Section 4942(j)(3), grants to NET will not be "qualifying distributions" under Section 4942 and, hence, foundation managers will undoubtedly discontinue all grants to NET. This will have the immediate effect of cutting off funding for the production of almost all national programs for public broadcasting, a public service that Congress has repeatedly sought to strengthen. [See Part IV at page 30.]

---

* Because the "substantial" test of existing law (Section 501 (c)(3) of the Internal Revenue Code of 1954) is eliminated by Section 4945, it is critically important that that section be both clear and limited as to the activities which it covers. We believe that the Treasury's language is not sufficiently clear. While the Treasury states that its proposal to amend Section 4945(c) would limit it to existing law, this is not entirely clear from the proposal's language. Moreover, without the "substantial" test, even the language of existing law is not sufficiently explicit. Finally, the Treasury proposal does not amend the language of Section 4945(b)(2).

We believe that it is crucial that both of these problems be solved in order to insure the continued functioning of NET, public broadcasting's major program source, and also the continued viability of the entire non-commercial educational television and radio system. The testimony of Mr. Macy, President of the Corporation for Public Broadcasting, and Mr. Harley, President of the National Association of Educational Broadcasters, explore the problems caused by the proposed Tax Reform Act to the other major elements in the public broadcasting system. NET endorses both of these statements.

I. <u>OPERATIONS OF NET</u>.

NET is an Illinois non-profit corporation, incorporated in 1952, organized and operated exclusively for scientific, educational and charitable purposes. NET's primary purpose is to "promote the advancement of educational television and radio for the general welfare." In furtherance of this purpose, NET acquires and supplies programs to its 166 affiliated stations. In addition, NET provides essential advisory services for these stations which they could not otherwise individually afford. NET's sole function is to provide programs and services to its affiliated educational television stations.

Neither NET, nor its affiliated stations, may accept commercial sponsorship. NET is therefore completely dependent on such financial support as it receives from the United States Government and private foundations, the small amounts it receives from the general public and the small amounts in fees it receives from its affiliated stations. Since 1963, NET has received unrestricted annual grants of approximately $6 million from the Ford Foundation. NET also received funds from other sources. This year, for example, we received approximately $1.8 million from the Corporation for Public Broadcasting. All of our funds are spent annually.

NET is a prime source of educational television programming intended for the general public. Nearly 50% of such programs are provided by NET. NET currently provides at least

five weekly hours of original programming to its affiliated stations.

The programs supplied by NET constitute an important alternative to those offered by the major national commercial networks -- ABC, CBS and NBC. Half of NET's schedule consists of public affairs programs such as news programs, documentaries, panel discussions, political debates, and interviews. The programs consider important current issues in foreign policy, politics, and government as well as other social and economic questions. "NET Journal," for example, is a thought-provoking weekly hour-long series that examines crucial domestic and international issues such as poverty, prejudice, problems of public and private education, the balance of world power, the Supreme Court and world hunger. NET programs deal in depth with events that commercial networks do not fully cover as well as other news items that may not otherwise be broadcast to the public. The balance of NET's schedule consists of programs of primarily cultural interest -- dealing with the arts, drama, history, humanity and science -- and children's programming. Some of these cultural programs may deal with public issues and in this sense are public affairs programs. Various national and international awards have been made to NET for its programs. For example, NET was awarded Emmy and Peabody Awards this year for two of its series.

Under Section 399 of the Communications Act of 1934, 47 U.S.C. § 399, the public noncommercial broadcasting stations affiliated with NET may not "engage in editorializing" and may not "support or oppose any candidate for political office." Further, Section 315 of the Communications Act, 47 U.S.C. § 315, and the Federal Communications Commission's fairness doctrine * require that these stations give reply time to opposing political candidates and for competing views on controversial public issues. NET insures that its programming complies with these requirements and with the recently adopted personal attack rules, requiring that individuals or groups which are personally attacked be afforded time to reply, 47 C.F.R. § 73.679. It does not offer programming that might be held to constitute political or legislative editorializing, and its programs are produced with strict adherence to objectivity and balance.

* Report on Editorializing by Broadcast Licensees, 13 FCC 1246 (1949); 47 U.S.C. § 315.

II. CURRENT TAX STATUS OF NET.

At present, NET qualifies as an educational organization exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1954. Qualification as a Section 501(c)(3) organization has other, equally important, tax benefits to NET. Other private foundations can contribute funds to NET without fear of losing their own 501(c)(3) tax exempt status. Individuals contributing to NET can deduct the amount of such contributions up to 20% of adjusted gross income under Section 170 of the Internal Revenue Code of 1954.

NET must, to retain its Section 501(c)(3) status, insure that "no substantial part" of its activities consists of "carrying on propaganda, or otherwise attempting to influence legislation," and it cannot, even to an insubstantial degree, "participate in, or intervene in . . . any political campaign on behalf of any candidate for public office." Despite the ambiguity of the terms "attempting to influence legislation" and "substantial" and the lack of consistency in their interpretation by the Internal Revenue Service and the courts, we are certain that NET can continue under present law to present balanced public affairs programming dealing with topics that are the subject of current or potential legislation without jeopardizing its Section 501(c)(3) status. Further, we are

confident that NET will continue to present balanced coverage of candidates and election issues without being held to have "intervened" in an election on behalf of a candidate.

III. PROBLEMS POSED BY SECTION 4945.

1. Effect of Proposed Sections 4945(b)(1), (b)(2) and (c)(1) on NET.

a. Proposed Changes from Present Law.

H.R. 13270 proposes to amend the Internal Revenue Code by adding a new Section 4945(a) which would impose a 100% tax on "taxable expenditures" by a "private foundation" and a 50% tax on foundation "managers" -- including officers and directors -- who approve such an expenditure. (In some cases a 100% tax would also be imposed on a foundation manager.) For reasons I will discuss later, NET would be held to constitute a "private foundation" subject to Section 4945. The consequence of this is that NET -- and the foundations which support NET -- are subject to the penalty tax if they make "taxable expenditures."

"Taxable expenditures" are defined by Section 4945(b) to include any amounts paid:

> "(1) to carry out propaganda, or otherwise to attempt to influence legislation, or
>
> "(2) to influence the outcome of any public election. . . ."

Section 4945(c) states that Section 4945(b)(1) expressly includes:

33-758 O - 69 -- No. 19 -- 22

> "(1) any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof . . . ."

The proposed law does not contain the "substantial" test which presently allows a certain amount of direct or indirect lobbying on legislation to be carried on by an exempt organization without punitive consequences.

The coverage of Sections 4945(b)(1), (b)(2) and (c)(1) is very difficult to determine. Section 4945(b)(1), defining a "taxable expenditure", merely repeats the "attempt to influence legislation" language of present law (Section 501(c)(3)). As such, standing alone, it seems to cover only those "legislation-influencing" activities now covered by Section 501(c)(3). Ambiguity arises, however, because of the new language in sub-section (c)(1), which expressly includes in those activities covered by sub-section (b)(1) "any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof. . . ." Section 4945(b)(2) also differs from present law by defining as a "taxable expenditure" any amount incurred "to influence the outcome of any public election". Both 4945(c)(1) and 4945(b)(2) seem to expand the scope of definitions in prior law of what will be considered "legislation-influencing" and

"election-influencing" activities that certain 501(c)(3) organizations may not undertake in the following ways:

(i) Restrictions on "Legislation-Influencing" Activities:

Subsection (c)(1) seems designed at least in part to clarify existing law by accepting the Treasury view that "grassroots" lobbying -- urging the public to contact legislators -- on particular legislation or legislative proposals is included within the present definition of "attempting to influence legislation" in Section 501(c)(3). See Treas. Reg. § 1.501(c)(3) - 1(c)(3)(ii). It may also be designed to cover editorializing (*i.e.*, taking an organizational position) on legislation, which the Treasury also interprets as falling within this phrase in Section 501(c)(3) *Ibid*. The language can, however, be interpreted to cover much more, and to restrict the educational activities of organizations defined as "private foundations" even though these efforts are factual and balanced. These efforts usually are carried on for the very purpose of "affecting public opinion", if only to affect the public by making it aware of the issues.

Certainly NET's public affairs documentaries, panel discussions, interviews, and in-depth news programs have

this purpose, even though they are balanced presentations, satisfying the FCC's fairness and personal attack doctrines and the statutory prohibitions against editorializing by non-commercial broadcasters. Thus under the broadest possible interpretation of this statute, if NET presented a balanced program or series of programs on a current topic such as the ABM controversy, the draft, or the Vietnam War, it could conceivably be held to be "affecting public opinion" on present or possible future legislation dealing with these issues.

(ii) Restrictions on "Election-Influencing" Activities:

Subsection (b)(2) also seems to go beyond present law by excluding another large segment of NET's activities that might technically be held to "influence the outcome" of an election. Just as even balanced educational reporting of legislative issues will inevitably "affect" public opinion, any balanced educational broadcasts dealing with election issues should have at least some minimal influence upon the "outcome" of that election. Again the very purpose of such broadcasts, which are subject to the equal time requirements of Section 315 of the Communication Act, 47 U.S.C. § 315, is to attempt to give the public the full facts and all viewpoints so as to stimulate thought and

discussion of the issues among the electorate. If these programs were not successful in helping to create informed voters, there would be no reason for their existence.

b. The Proposed Changes Would Severely Curtail NET's Public Affairs Programs.

If Section 4945 is enacted without clarifying amendments, NET would be confronted with essentially two choices: (1) it could forfeit its tax exempt status or (2) it could cease to make "taxable expenditures". If NET were to adopt the first alternative, it would have to cease business entirely since approximately 75% of its current support is from "private foundations" which could no longer make qualifying contributions to NET.

Under the second alternative NET's "managers" -- including its officers and directors -- faced with the spectre of heavy personal as well as institutional penalties for a mistaken interpretation of the language of the section, will be reluctant to undertake public affairs programming on issues that have any remote link with current or potential legislation. NET might also have increasing difficulty in persuading highly qualified men to serve as trustees and officers in the face of such great potential liability. Further, even if NET and its managers were willing to risk the statutory penalties,

NET would be forced to adopt a programming policy foregoing public affairs broadcasts in order to continue to get financial support from other private foundations. Prudent foundation managers would not make grants to NET if there were any possibility that they might ultimately be used for public affairs programming coming within the "taxable expenditures" definition of Section 4945.

2. Reasons Why Section 4945 Should Be Redrafted To Exempt Public Broadcasting.

a. None of the Alleged Abuses Giving Rise to Section 4945 Is In Any Way Related to NET.

None of the Congressional concerns which led to the provisions of Section 4945 of H.R. 13270 in any way relates to the activities of NET or public broadcasting. There has been no testimony before the House committee or this committee concerning any alleged improper activities by NET or any entity engaged in the field of public broadcasting. Moreover, none of the alleged abuses which led to Section 4945 relates to the activities of NET or public broadcasting.

The impetus for the expanded definition of "legislation-influencing" activities in Section 4945(b)(1) and (c)(1) is somewhat obscure. The House Committee on Ways and Means, after extensive hearings, noted in its report transmitting

H.R. 13270 that "in recent years, private foundations had been moving increasingly into political and legislative activities". H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, 32 (1969) (hereinafter referred to as "House Committee Report"). There is, however, nothing in the report that clearly indicates exactly what the committee meant by "legislative activities". It is clear that it wanted to stop foundations from direct lobbying and "grass-roots" campaigns to urge the public to contact legislators, alleged abuses considered in its hearings, but whether anything beyond this was contemplated is uncertain.

Examples of "political activities" the committee wanted to curtail under Section 4945(b)(2) were more clearly stated in the report. The committee definitely wanted to stop voter registration campaigns in limited geographical areas that were designed to favor the registration of voters who would support certain candidates. It also wanted to prevent private foundations from spending their funds to "publicize the views, personalities and activities of certain candidates" and "to subsidize preparation of materials furthering specific political viewpoints." House Committee Report, pp. 32-33. None of these activities is or has been, carried on by NET or any other element of the public broadcasting system. Although both NET and other public

broadcasters do present balanced coverage of elections, such activity, as before, was not the concern of the House committee.

b. Restricting Public Broadcasting Activities Would Be Contrary to the Public Interest and Congressional Policy.

More fundamentally, we strongly believe that it would not serve the public interest to restrict programming for the public broadcasting system. Public broadcasting supplies an important alternative source of public affairs programming in the United States States. At present local non-commercial stations, lacking the technical and monetary resources, are not heavily engaged in program production. Educational stations rely strongly on NET to supply the public affairs programming that they must present to satisfy the conditions of their broadcast licenses* and to serve the interest of their viewing audiences. NET programming thus contributes substantially to the strength of non-commercial television and the diversity of programming that Congress and the FCC have sought to foster.

---

* The Communications Act requires that all broadcasting stations, as part of their obligation to operate in the "public interest", 47 U.S.C. §§ 307(a), 309(a), "afford reasonable opportunity for the discussion of conflicting views on issues of public importance". 47 U.S.C. § 315(a); see Red Lion Broadcasting Co. v. FCC, 395 U.S. 367, 392-95 (1969).

It is clear from past legislation that Congress desires to promote a strong and viable system of public television. The Educational Television Facilities Act of 1962, Pub. L. No. 87-447, 76 Stat. 64, authorized thirty-two million dollars over a five-year period for the construction of various facilities for educational television stations. Moreover, the Public Broadcast Act of 1967 (47 U.S.C. § 390, et. seq., as amended) continued this program and gave a further Congressional mandate in support of public broadcasting which, Congress contemplated, would create programs "not only. . .supplementary to, but competitive with commercial broadcasting services", and programs which will be "responsive to the interests of people" and "an expression of diversity and excellence". S. Rep. No. 222, 90th Cong., 1st Sess. 6 (1967); 47 U.S.C. § 396(a)(4).

To this end, the Federal Communication Commission has reserved 623 station channels for educational television and, in addition, petitions may be made to the FCC for additional reservations. These stations are being licensed only to non-profit education organizations upon a showing that the proposed stations will be used "primarily to serve the educational needs of the community; for the advancement of educational programs; and to furnish a nonprofit and noncommercial television broadcast service". 47 C.F.R. § 73.621(a).

Not only has Congress demonstrated in the past its intent to strengthen noncommercial educational broadcasting in general, but has also indicated that it feels that the presentation of vigorous public affairs programming is one of the most important contributions that educational broadcasting can make. The legislative history of the Public Broadcasting Act of 1967 emphasized that Congress expected noncommercial educational stations to be leaders in this area. The report of the Senate Commerce Committee stated:

> "Particularly in the area of public affairs your committee feels that noncommercial broadcasting is uniquely fitted to offer in-depth coverage and analysis which will lead to a better informed and enlightened public." S. Rep. No. 222, 90th Cong., 1st Sess. 7 (1967).

And the House Committee on Interstate and Foreign Commerce observed:

> "Considerable testimony was heard that no noncommercial educational station editorializes.
>
> "Out of abundance of caution, the bill provides that 'no noncommercial educational broadcasting station may engage in editorializing or may support or oppose any candidate for political office.' It should be emphasized that this section is not intended to preclude balanced, fair and objective presentations of controversial issues by noncommercial stations." H.R. Rep. No. 572, 90th Cong., 1st Sess. 20 (1967).

Thus, ironically, if Section 4945 is enacted as presently drafted, the portion of public broadcasting that was intended to be its strongest point, will become in fact its weakest link.

3. There Are Serious Doubts That Sections 4945(b)(1), (b)(2) and (c)(1) of H.R. 13270 Are Constitutional.

Not only do we believe that the adverse effect upon the public broadcast system by §§ 4945(b)(1), (b)(2) and (c)(1) is unintended and unwarranted, but it is also our view that the potential breadth of the present language of those sections raises serious constitutional issues.

a. Assuming That the Section 4945 Restricts Balanced Discussion of Public Issues by NET, It May Be Unconstitutional.

Discussion and debate of public issues is at the heart of the First Amendment. The Supreme Court has noted that "speech concerning public affairs is more than self-expression; it is the essence of self-government". Garrison v. Louisiana, 379 U.S. 64, 74-75 (1964). The primary purpose of the First Amendment is to protect our "profound national commitment to the principle that debate on public issues should be uninhibited, robust, and wide-open . . . ." New York Times Co. v. Sullivan, 376 U.S. 254, 270

(1964). "Suppression of the right of the press to praise or criticize governmental agents and to clamor and contend for or against change. . .muzzles one of the very agencies the Framers of our Constitution thoughtfully and deliberately selected to improve our society and keep it free." Mills v. Alabama, 384 U.S. 214, 218-19 (1966).

Discussion of public issues by broadcasters has been specifically held by the Supreme Court to enjoy the protections of the First Amendment. In Red Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969), the Court stated at 390:

> ". . .the people as a whole retain their interest in free speech by radio and their collective right to have the medium function consistently with the ends and purposes of the First Amendment. . . .It is the purpose of the First Amendment to preserve an uninhibited marketplace of ideas in which truth will ultimately prevail. . . ."

The Court in Red Lion warned that the right of the public to access to social and political ideas through the broadcast media "may not constitutionally be abridged. . .by Congress". 395 U.S. at 390.

Such discussion and debate of public issues can be infringed not only by direct prohibitions, but also by the taxing power. The Supreme Court has said, "[p]lainly a community may not suppress, or the state tax, the dissemination of views because they are unpopular, annoying or

distasteful". Murdock v. Pennsylvania, 319 U.S. 105, 116 (1943). The Court has held that a State cannot tax newspapers more heavily than other institutions, because this would reduce "the circulation of information to which the public is entitled". Grosjean v. American Press Co., 297 U.S. 233, 250 (1936). The Court has also concluded that a State cannot penalize expression by denial of a tax exemption or deduction. Speiser v. Randall, 357 U.S. 513 (1958). Speiser clearly rejected the argument that "because a tax exemption is a 'privilege' or 'bounty', its denial may not infringe speech" (357 U.S. at 518) and held that the State could not deny an otherwise available property tax exemption to an individual who had refused to sign a statement on his tax return stating that he did not advocate the overthrow of the Government by force or violence. In a companion case, the Court held that an exemption could not be withheld from a church that refused to sign a similar oath, indicating that denial of a tax benefit to an organization like NET raises the same constitutional issues as denial of a deduction to an individual. First Unitarian Church of Los Angeles v. County of Los Angeles, 357 U.S. 545 (1958).

If the State had denied an exemption to the taxpayers in the Speiser and First Unitarian Church cases because they refused to sign statements agreeing not to

engage in any discussion of public issues, it is difficult to believe that the result would have been different. The statute, we suggest, would have been equally unconstitutional, particularly if -- as is the case here* -- deductions were granted to some organizations and denied to others.

If we are correct in this conclusion, it would seem to follow that Section 4945 as presently drafted faces serious, if not unsurmountable, constitutional obstacles since it restricts organizational discussion of public issues. Unlike present law, Section 4945 cannot be justified on the ground that it is limited to the "lobbying" or "electioneering" activities. Cases like Cammarano v. United States, 358 U.S. 498 (1959), United States v. Harriss, 347 U.S. 612 (1954) and United Public Workers v. Mitchell, 330 U.S. 75 (1947) -- sustaining restrictions on such activities -- do nothing to support the broader restrictions of Section 4945.

In Cammarano v. United States, supra, it was held

---

* Section 4945 does not apply to tax exempt organizations, like churches and colleges, that do not constitute "private foundations". Section 4945 would, through use of a support test, in effect, make, a value judgment that expression of ideas on public issues held by less than a certain number of contributors are less beneficial than those that are broadly held. Such discriminatory attempts to suppress minority viewpoints are, however, exactly what the First Amendment forbids.

that Congress can deny a tax deduction as an "ordinary and necessary business expense" to a business for sums expended "to promote or defeat legislation" as a legitimate means of preventing the public subsidizing of lobbying. United States v. Harris, supra, upheld other non-tax restrictions on lobbying, such as the disclosure and reporting requirements for lobbyists in the Federal Anti-Lobbying Act, 2 U.S.C. §§ 261-70. Neither the Cammarano nor Harriss opinions, however, suggested that similar restrictions could be placed on discussion of public issues not within the categories of direct lobbying or overt appeals to the public to contact legislators. The Court in Harriss, in fact, implied that a restriction that went further than this, and attempted to cover a broader class of technically "legislation-influencing" activity, would be invalid under the First Amendment. 347 U.S. at 625-26. And the Court in Cammarano clearly indicated that its holding there was not meant to undercut its holding in Speiser that tax legislation cannot reach broadly to suppress discussion of public issues. 357 U.S. at 513.

Both Harriss and Cammarano sustained restrictions on the basis that Congress had a legitimate role in passing legislation to help maintain the integrity of the legislative process, in one case to protect it from distortions caused by tax advantages given to the lobbying activities

of special interest groups, and in the other to allow Congress and the public to know exactly who is funding lobbying activities. Balanced educational presentation of public issues does not, however, undermine the integrity of the legislative process. Rather, it assists in preserving that process, by ensuring that the public is aware of legislation and the facts behind issues that may become the subject of legislation.

In United Public Workers v. Mitchell, supra, the Court, in sustaining Hatch Act limitations on partisan participation in political campaigns by federal employees, held that Congress may place reasonable restrictions upon participation in the electoral process. But the Court specifically noted that nonpartisan expression of views on public issues was not prohibited by the Act, implying that if it were, the Act would have been held unconstitutional. 330 U.S. at 100. And in Mills v. Alabama, supra, the Supreme Court specifically held that a state could not supress the discussion of controversial issues -- in that case last-minute editorials -- on the ground that this was necessary to prevent the electorate from being unduly swayed in a public election.

The fact that Section 4945 covers some activities which Congress can constitutionally regulate does not, of

course, save it from constitutional attack. The constitutional doctrine of the "less restrictive alternative" requires that Congress, when it legislates in the area of speech, regulate only up to the minimum extent necessary to restrict the evil it wishes to control, with the least possible diminution of protected rights. United States v. Robel, 389 U.S. 258 (1967); NAACP v. Button, 371 U.S. 415 (1963).

b. Even If Section 4945 Is Not Meant To Cover NET's Public Affairs Programs, It May Be Void For Vagueness.

Assuming that Congress cannot constitutionally tax the balanced, educational presentation of discussions on public issues, it is also constitutionally irrelevant that Congress may not have intended to penalize such presentations in its proposed enactment of Section 4945. The language of the statute is now drafted "in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application". Connally v. General Construction Co., 269 U.S. 385, 391 (1926). It can be read to restrict large areas of discussion protected by the First Amendment.

Under existing case authority the vagueness and overbreadth of the statute are alone sufficient to raise serious questions as to its validity. The Supreme Court

33-758 O - 69 -- No. 19 -- 23

has held that strict standards of definiteness must be met by statutes having "a potentially inhibiting effect on speech". Smith v. California, 361 U.S. 147, 151 (1959). See also NAACP v. Button, supra, at 432-33, 438 (1963). In the area of free speech vague statutes are unconstitutional if they seriously inhibit discussion by forcing individuals to "steer far wider of the unlawful zone" (Speiser v. Randall, supra, at 526) and restrict "their conduct to that which is unquestionably safe" (Baggett v. Bullitt, 377 U.S. 360, 372 (1964)).

The principle that laws must give clear warning is particularly relevant when the offense is to be prescribed by regulation rather than by statute (United States v. McDermott, 131 F.2d 313, 316 (7th Cir. 1942), cert. denied, 318 U.S. 765 (1943)) or when the statute is subject to administrative enforcement which can result in discrimination against minority or unpopular views (Cox v. Louisiana, 379 U.S. 536, 556-58 (1965)).

We suggest that, because of its vague terms, Section 4945, as presently drafted, will unquestionably inhibit protected speech, and is therefore likely to be held unconstitutional.

One lower court has indicated that the "attempting to influence legislation" language already contained in

Section 501(c)(3) might be held unconstitutionally vague if it were not limited more specifically by regulation and judicial decision to direct or "grassroots" lobbying, noting:

> "In one sense, nearly every effort made by individuals or organizations in the public interest and for the betterment of government necessarily, has as an indirect result at least, some influence on legislation."

Seasongood v. Commissioner, 227 F.2d 907, 911 (6th Cir. 1955).

If the meaning of this language is still open to question, after decades of Treasury and court attempts at interpretation, the potentially even broader language of Subsections 4945(b)(1), (b)(2) and (c)(1) cannot possibly give sufficient guidance to those affected to enable them to regulate their conduct in the public affairs discussion area so as to avoid its sanctions. If this bill is enacted with its present ambiguities, foundation officers will be forced to protect themselves by restricting their educational activities. This is particularly so because extremely broad administrative discretion will necessarily have to be lodged with the Internal Revenue Service for its interpretation and enforcement, and foundation managers cannot predict how this discretion will be exercised.

Even assuming that the Treasury might at some future date issue limiting regulations or rulings that would give sufficient guidance to the interpretation of Section 4945, or that future court decisions might narrow its coverage, the delay in obtaining such standards would cause irreparable harm to educational broadcasting. NET would be forced to discontinue public affairs broadcasting in the interim, probably losing the services of many of its professionals who specialize in this area. Once private foundations, which have only limited resources, move out of the non-commercial broadcasting area and into other charitable or educational activities, it will be difficult to get them to return, even on the hopeful assumption of future regulatory or judicial clarification. Once foundations have entered other fields of philanthropy, there will be a natural tendency for them to remain there, since they have created funding expectations in those fields and will wish to follow through on initial efforts they have supported.

Thus, we believe, if Congress does not intend Subsections 4945(b)(1), (b)(2) and (c)(1) to apply to balanced presentations of public issues, it can not assume that these sections will be saved from unconstitutionality by narrowing regulations or judicial interpretations. This

Committee should take positive steps to clarify the bill to insure that it does not inhibit discussion of public issues, particularly public affairs programming of the kind NET supplies to its affiliates.

* * *

In summary, in view of the unintended and substantial adverse effects that Section 4945 would have for public broadcasting and NET, the strong Congressional policy to support public broadcasting (including its public affairs programs) and the substantial doubts as to the constitutionality of the section as now written, we suggest that this committee should revise Section 4945 to exempt public broadcasting's public affairs programs, using the suggested language set forth earlier in my statement.

IV. CLASSIFICATION PROBLEMS.

1. NET Should Be a Section 170(b)(1)(B) Organization.

As indicated above, it is crucial that Section 4945 be amended as proposed. In addition, it is also crucial that NET be classified as a non-private foundation or a private operating foundation to avoid the ultimate demise of NET, non-commercial educational broadcasting stations' prime source of programming. (Even if NET were to qualify as a non-private foundation or an operating private foundation under proposed Section 509(a), it would still be adversely affected by the Act, insofar as private sources of funds may be eliminated unless the amendment to Section 4945 suggested above is adopted.)

Under proposed Section 509, a Section 501(c)(3) organization such as NET will be treated as a private foundation unless it comes within one of a series of specified exceptions. As currently funded NET will not come within any of the specified exceptions.

The current re-examination of the tax bill affords Congress an opportunity to help reach the goals set by Congress for public broadcasting by classifying NET as a non-private foundation.

To best carry out Congress's general intent of establishing a viable non-commercial educational broadcast system which has a broad base of public support that will complement funding from the Government, Congress may use

this opportunity to give the public a tax incentive for support of this system.

By the inclusion of NET and the other elements of the country's non-commercial educational broadcast system within the 30 percent category [Section 170(b)(1)(B) organizations] NET would have the following beneficial results.

First, by classifying NET as a Section 170(b)(1)(B) organization and thus a non-private foundation under Section 509(a)(1), it will be released from the provisions of the Act which create significant problems for the non-commercial educational broadcast system. For example, it would solve the problem of whether grants to NET will be "qualifying distributions" under Section 4942 of the Act. And it will eliminate the possibility that the working arrangements between NET and the other elements of the non-commercial educational broadcast system will fall under Section 4941 - the "self-dealing" provision.

Second, by including the elements of the non-commercial broadcast system within the list of organizations described in Section 170(b)(1)(B), the system will be on an equal footing with schools and colleges, churches and other similar organizations designed to promote the general welfare. Most of the local stations already fit into this group and since all of the local stations and the other elements of the system

are all working for the same end and carrying on in many instances the same functions, there is every reason to treat all of the elements of the system as qualifying for the charitable deduction prescribed in Section 170(b)(1)(B). To do this, Section 170(b)(1)(B) should be amended by adding a new subsection 170(b)(1)(B)(vii) which would read:

> "An organization which is a non-commercial educational broadcast station as defined in Section 397 (7) of the Communications Act of 1934, as amended (81 Stat. 368; 47 U.S.C. 307 (7)) or an organization referred to in Subsection (c)(2) which is operated exclusively for the production or distribution of programs which are broadcast over such non-commercial educational broadcast stations."

In the alternative this language could serve as a separate exception to Section 509.

2. Operating Foundation Status

Adoption of the proposed amendment to Section 4945 is crucial to NET's continued ability to produce programming for educational broadcasting. However, even with this adoption, if NET is not included within the category of Section 170(b)(1)(B) organizations, it must qualify as an operating foundation in over to survive. Under proposed Section 4942(j)(3)(A) and (B), a private foundation is not an operating foundation unless --

(1) substantially all [at least 85 percent]* of the foundation's income is expended directly for the active

---

* See House Committee Report, pp. 42-43.

conduct of its tax exempt activities [the "income expenditure test"];

(2) either,

(i) substantially more than half [at least 65 percent]* of the assets of the foundation are "devoted directly" to the foundation's tax exempt activities [the "asset test"] or

(ii) substantially all [at least 85 percent]* of the foundation's "support" (other than gross investment income) "normally" comes from five or more exempt organizations or from the general public and no more than 25 percent of the foundation's support comes from any one exempt organization [the "support test"].

The crucial question is whether NET can satisfy the requirements of either of the additional tests -- the asset test or the support test. The latter test -- the support alternative -- was described in the House Committee Report as follows:

> "The . . . [support] alternative has been added because it has come to the attention of

---

* <u>Ibid</u>.

> your committee that a number of charitable foundations are regularly used by many private foundations to funnel charitable contributions into certain areas. The operating foundations, in such circumstances, have developed an expertise which permits them to make effective use of the money through grant programs or otherwise." House Committee Report, p. 26.
>
> "The support alternative is intended to focus primarily upon special-purpose foundations, such as learned societies, associations of libraries and organizations which have developed an expertise in certain substantive areas and which provide for the independent granting of funds and direction of research in those specialized substantive areas." House Committee Report, p. 42.

NET would appear to fit the Committee's picture of a special-purpose, funnel, expert foundation. It cannot, however, qualify under the support alternative since the bulk of its revenues comes in the form of grants, albeit unrestricted, from fewer than five foundations.

It may be, however, that NET satisfies the requirements of the asset alternative set forth in (B)(i) of Section 4942(j)(3) above. NET's furniture, equipment and supplies are presumably "devoted directly" to its tax exempt activities. At any given time, however, its assets in the form of cash (or short-term securities) for operating purposes are likely to be substantially greater than any physical assets. Such assets are, in one sense, as "devoted directly" to the tax exempt activities as are the typewriters and paper supplies. Such an interpretation would be consistent with the apparent purpose of the Act to impose special tax burdens

on foundations which invest substantial portions of their support revenues and thus appreciably delay the charitable benefit resulting from such revenues and contributions. However, according to the House Committee Report, p. 42, the asset alternative was intended to "apply particularly" to organizations such as museums, Callaway Gardens (a horticultural and recreational area), Colonial Williamsburg and Jackson Hole, each of which has substantial fixed assets which are related directly to and physically used directly for their tax exempt purposes.

Therefore, in the absence of any change in this respect in the subsequent legislative history, it is possible that cash and short-term securities will be held not to be assets "devoted directly" to an institution's charitable purposes for purposes of Section 4942(j)(3)(B)(i) even though they are spent annually in furtherance of the organization's exempt purpose. If the asset alternative is interpreted in this manner, NET will not be treated as an operating foundation. If NET does not qualify as an operating foundation, private foundations will cease supporting NET.

Since, under the Act, a private non-operating foundation is subject to a tax on the failure to distribute income, such a foundation will be likely to make only "qualifying distributions" to avoid the tax imposed by Section 4942.

One can assume, therefore, that the major consequence of failure to qualify as an operating foundation will be that NET will lose all of its foundation support.

We do not believe that Congress intended that the cash assets (possibly invested in short-term securities) to be expended during the year -- and which are, in fact, expended during the year or succeeding year -- should be deemed to be assets not "devoted directly" to charitable purposes. If read in this fashion, an anomalous situation is created whereby a grant-making foundation is entitled to make "qualifying distributions" directly for charitable purposes during the course of two years but may not utilize a specialized grant-making foundation to make a payment for the same charitable purposes within the same period of time.

Accordingly, we suggest that language be inserted in the committee report to make it clear that where contributions are made by a private foundation to a second private foundation to be expended directly for charitable purposes by the latter within the taxable year or succeeding taxable year, of the payee foundation, the expenditure by the latter will satisfy the "assets" test under Section 4942(j)(3)(B)(i).

Indeed, consistent with the long-established Congressional interest to foster and aid the development of a strong non-commercial educational broadcast system,

the committee report should make it clear that NET will qualify as an "operating foundation".

SUMMARY OF THE PRINCIPLE POINTS
INCLUDED IN THE STATEMENT OF
DR. CHARLES L. McCLASKEY
PRESIDENT OF THE NATIONAL ASSOCIATION
OF FOUNDATIONS, INC.

1. Tax on investment income: This tax is self-defeating; it will in a short time reduce the net aggregate of foundation income now passing to charity so low that private charity can exist only if subsidized by the Government, or by higher taxes. It is "robbing Peter to pay Paul."

2. Prohibitions on self-dealing: Not opposed in principle; matter greatly exaggerated; widespread abuse does not now and has never existed. Of the 4,335 audits by IRS of private foundations (1964-67) only 82, less than 2%, warranted recommendation for revocation of tax exemption. We maintain this matter can be best handled by private foundations through self-regulation under the Association's Code of Ethics.

4. Stock ownership limitation: This provision is unconstitutional on two grounds; (1) It is an ex post facto law passage of which is forbidden by Article 1, Section 9, Clause 3, and (2) It purports to take property, "without due process of law" in violation of the (v) Article of Amendment of the Constitution of the United States. It cannot apply to existing private foundations and it is of highly doubtful legality if applied to private foundations created after its passage. Congress cannot do by indirection - such as a requirement for tax exemption - that which it has no legal authority to do directly. This provision which voices an imaginary fear of transactions between foundations and corporations goes back into legislative history many hundreds of years as it is akin to the Statute of Mortmain whose fears have long been proven unfounded and we had thought forgotten.

6. Other limitations: We quote an article, entitled, "ARE TAX WRITERS VIOLATING LAW?", written by David Lawrence, which appeared in the Evening Star, Washington, D.C., August 28, 1969.

8. Change of status: As a penalty for relinquishing its tax exempt status this provision imposes upon a private foundation a tax equal to the aggregate tax benefits granted through tax exemption from December 31, 1912. It rejects all tax exemption legally granted for the last 57 years. This provision is ex post facto and forbidden by Article 1, Section 9, Clause 3, of the Constitution of the United States. If this type of proposal were enacted then all citizens would lose their protection under the law and, of course, their confidence in the stability of their Government.

Comments: Mention of adverse propaganda about private foundations; the extent of the havoc from the passage of the Tax Reform Act of 1969 (H.R. 13270) in the field of private philanthropy; and that the worth and charitable deeds of private foundations are great national assets that must be preserved not destroyed.

WRITTEN STATEMENT OF
DR. CHARLES L. McCLASKEY
PRESIDENT OF THE NATIONAL ASSOCIATION
OF FOUNDATIONS, INC.
201 NORTH WASHINGTON STREET
ALEXANDRIA, VIRGINIA

PRESENTED AS TESTIMONY AT A
PUBLIC HEARING
OF
COMMITTEE ON FINANCE
UNITED STATES SENATE

RELATIVE TO CERTAIN PROVISIONS OF THE
TAX REFORM ACT OF 1969, H.R. 13270
AS THEY RELATE TO PRIVATE FOUNDATIONS

33-758 O - 69 -- No. 19 -- 24

THE NATIONAL ASSOCIATION OF FOUNDATIONS
A PERPETUAL NON-PROFIT CORPORATION • INCORPORATED IN 1957

201 NORTH WASHINGTON STREET, ROOM 206
P.O. BOX 1203
ALEXANDRIA, VIRGINIA 22313
TELEPHONE: 548-6400 AREA CODE 703

September 3, 1969

Honorable Russell B. Long,
Chairman, Committee on Finance,
United States Senate
Washington, D. C.

Dear Mr. Chairman:

There are respectfully submitted the statement of The National Association of Foundations, Inc., with a summary of its principle points, setting forth the Association's views and opposition to specific provisions of the Tax Reform Act of 1969 as they relate to private foundations.

STATEMENT

1. Tax on investment income (sec. 101 (a) of the bill and new sec. 506 of the code).

   This tax is self-defeating. It will contribute little to the public welfare but there is the strong probability that it will eventually increase the tax burden of the average taxpayer. This tax would be totally unlike any other. This anomaly, where the collection of a tax is not a benefit but a detriment, to the public interest arises from the fact that all of the private foundations' net income now goes toward philanthropy, thus, the levying of a tax would decrease the amount passing to charity. Even if the tax were earmarked for return to charity it would be reduced by heavy collection and administrative costs. The revenue increases are estimated at $65 million the first year, $85 million in the fifth year and $100 million by the tenth year. If these vast sums are withdrawn yearly from the support of private charity it will only be a short time until these services will degenerate to a point where there will be a widespread public demand for a Government subsidy which in turn will increase the tax burden of the average taxpayer. To levy this tax upon the assumption that it will benefit the public is a cruel delusion. If the 7-1/2 percent tax rate is raised which it most likely will be the day of account will come sooner. This tax would be a classic example of the folly "robbing Peter to pay Paul." We oppose the enactment of this proposed tax into law.

- - -

2. Prohibitions on self-dealing (sec. 101 (b) of the bill and new sec. 4941 of the code).

Prohibitions on self-dealing are not opposed in principle. Our position is that this matter of self-dealing has been greatly exaggerated, that widespread abuse does not now exist and has never existed. The audit experience of the Internal Revenue Service shows during fiscal years 1964-67, 4,335 audits of private foundations were made and only 82 (less than 2%) warranted recommendation for revocation of tax exemption. Former Commissioner of Internal Revenue Cohen testifying on November 16, 1967 before Subcommittee Number 1, Select Committee on Small Business, U. S. House of Representatives, said, "I do not intend to suggest that all or even a large percentage of the exempt organizations require surveillance. We believe our audit experience indicates rather conclusively that a great majority of the exempt organizations, including private foundations, are complying with the requirements of the tax laws."

We believe that the situation can best be managed by private foundations voluntary self-government under the Association's Code of Ethics, which is as follows:

CODE OF ETHICS

Preamble

The National Association of Foundations, Inc., in order to inspire public confidence, affirm the fairness of the self-assessment tax process and to indorse the basic principle of promoting private philanthropy through tax-exemption, does proclaim ethical standards of conduct for foundations as follows:

1) Be ever mindful that they are organized for philanthropy and not for private gain.

2) Recognize that they hold a public trust.

3) Realize that tax-exemption imposes special obligations to operate solely in the public interest.

4) Never permit a foundation to be used for the self-service or private interests of its donors, trustees, directors, officers or employees.

5) The foundations recognize the need to make distributions annually commensurate with their incomes and consistent with their respective charters.

6) To make investments as a prudent man would in a fiduciary capacity.

7) Willingly furnish required information when requested by duly constituted local, State and Federal authorities.

c The National Association of Foundations, Inc. 1963

4. Stock ownership limitation (sec. 101 (b) of the bill and new sec. 4943 of the code).

Our opposition to this provision is based upon the fact that we consider it to be unconstitutional on two grounds, to wit:

First: It is an _Ex post facto_ law whose enactment is prohibited by Article I, Section 9, Clause 3, of the Constitution of the United States, which states, "No Bill of Attainer or ex post facto Law shall be passed."

The term "ex post facto" is defined as "Done or made after a thing but retroacting upon it; retrospective; as, an _ex post facto_ law is any law enacted with a retrospective effect."

It is clear and beyond the scope of doubt or argument that the mandatory stock divestment requirements and sanctions of this provision are _ex post facto_, because in 1969 they would declare stock ownership acquired PRIOR thereto illegal and impose sanctions for continued ownership. If this type of legislation were not prohibited by the Constitution no one could feel in 1970 secure in the title and ownership of property acquired in 1969. It is of no significance that this provision is proposed in connection with the requirements of a tax exemption, because an ex post facto law is unconstitutional no matter what the objective may be. Certainly, Congress would not employ an unconstitutional means to enforce a requirement for tax exemption.

It is evident that this provision of the bill can be applied only prospectively, that is to those private foundations formed after its enactment; there is in our opinion, serious questions as to the validity of the provision against private foundations created after its enactment.

We contend the provision is unconstitutional.

Second: It deprives private foundations of property "without due process of law" in violation of the (v) Article of Amendment of the Constitution of the United States.

The mandatory language of a statute is not "due process of law" within the meaning of the term as used in the Constitutional Article of Amendment.

The reasons given for the necessity of this provision are both suppositive as to facts as they are unrealistic. The presumable conflicts of interest between business and foundations simply does not happen. It is a remote potential not a fact. Insofar as concerns alleged unfair competition foundations have to pay an unrelated business tax the same as owners of business have to pay an income tax.

Aside from being unconstitutional this provision is open to another fatal objection. Congress cannot do indirectly what it cannot do directly. Certainly it could not pass a law limiting citizens' ownership of corporate stock to an arbitrary percentage, therefore, it cannot lawfully limit foundations' ownership of corporate stock to an arbitrary percentage, as a condition precedent to the allowance of a tax exemption. Requirements for the allowance of a tax exemption must be constitutional, prospective and reasonable.

This provision which voices an imaginary fear of transactions between foundations and corporations goes back into legislative history many hundreds of years as it is akin to the Statute of Mortmain, whose fears have long been proven unfounded and we had thought forgotten.

6. Other limitations (sec 101 (b) of the bill and new sec. 4945 of the code).

Our views regarding this provision are best expressed in an article by David Lawrence, which appeared in the Evening Star, Washington, D.C., Thursday, August 28, 1969 as follows:

"ARE TAX WRITERS VIOLATING LAW?"

"Perhaps the persons who drafted the tax bill which passed the House of Representatives recently and now is pending in the Senate didn't realize that some of the restrictions to be placed on the operators of private foundations might be declared unconstitutional.

"The House bill says that such organizations will lose a part of their tax exemption if they engage in any activities 'to carry out propaganda, or otherwise attempt to influence legislation' or 'to influence the outcome of any public election, including voter registration drives carried on by or for such foundation.'

"The bill specifies that 'any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof', as well as any effort to influence legislation by lobbying, would result in a tax equal to 100 percent of the amounts spent for such activities. Also a 50 percent tax on the amounts expended improperly would be levied on the management of the foundation as a penalty."

"But the Supreme Court of the United States rules 20 years ago that a labor union - which, of course, is tax exempt - cannot be prohibited from "expressing views on candidates or proposed measures." ****.

"The Supreme Court held that if the Corrupt Practices Act 'were construed to prohibit the publication by corporations and unions in the regular course of conducting their affairs, of periodicals advising their members, stockholders or customers of danger or advantage to their interests, the gravest doubt would arise in our minds as to its constitutionality."

"The high court in another case has also ruled that the tax weapon itself cannot be used as a penalty to restrict freedom of the press or freedom of speech. Private foundations, it will be contended, therefore, have just as much right under the Constitution as any other group to set forth their views on politics or subjects of public concern. Hence, a dimunition of their tax exemption because they have expressed opinions on public questions will certainly be challenged before the Supreme Court."****

"The specific question that arises today, however, is whether there can be discrimination in a tax law against one group while another is permitted to carry on the same kind of activities. Will labor unions retain their tax-exempt status as they engage, directly or indirectly, in politics or propaganda on public affairs?"

"Certainly, the Senate is confronted with some important precedents by the Supreme Court which makes it difficult to tell any private educational or charitable foundation that it will be penalized when utilizing its right of expression on public affairs."

8. Change of status (sec. 101 (a) of the bill and new secs. 507, 508, and 509 (b) of the code).

On page 39 of the Report of the Committee on Ways and Means, House of Representatives to accompany H. R. 13270, a Bill to Reform the Income Tax Laws, there are astounding statements, to wit: "*** your Committee has determined that organizations should not receive substantial and continuing tax benefits in exchange for the promise of their contributions to society, and then avoid the carrying out of these responsibilities. Accordingly, the bill provides that an organization which was a private foundation *** for its last taxable year ending before May 27, 1969, may not escape its obligations by relinquishing its exempt status unless it repays to the Government the aggregate tax benefits (with interest) that have resulted from its exempt status. *** The tax benefits to be repaid in such a case are all of the increases in income, estate, and gift taxes which would have been imposed upon the organization and all substantial contributors if the organization had been liable for income tax and if its contributors had not received deductions for contributions to the organization.*** For purposes of computing the amount of the aggregate tax benefits, all benefits available to the private foundation for taxable years beginning after December 31, 1912, and all tax benefits on contributions made to the foundation after February 28, 1913, are included. In addition, interest on all such benefits shall be added to the amount of the benefits computed, in the case of each benefit, from the first date on which the added tax would have been due if the benefit had not been available."

It is unbelievable that the bill contains a provision which provides for the denial of all legal tax exemptions which have been granted to a private foundation for 57 years before its passage, and holds the private foundation liable for all tax forgiven or exempted during that period, purely as a punitive measure against the private foundation for relinquishing its exempt status.

If this type of legislation is permitted all citizens lose the protection of law and, of course, confidence in the stability of Government.

Because it disturbs and reacts upon by total denial conditions which have existed with the full sanction of law for the last 57 years, this provision of the bill is clearly ex post facto and its enactment into law is prohibited by Article 1, Section 9, Clause 3, of the Constitution, which reads:

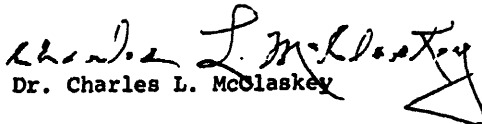
"No ** ex post facto Law shall be passed."

******

Comments: Since early in 1962 there have appeared articles in the public press which, although based 98% on mere assumption of fact, they, nevertheless, have prejudiced the general public against private foundations and have created "a distorted public image" of them. This propaganda seems to be reflected to some extent by the language and passage of the Tax Reform Act of 1969 (H.R. 13270). This is unfortunate for the general welfare. The worth and deeds of them are too much of a national asset to be destroyed. The real beneficiaries of the havoc this bill would do in the field of private philanthropy are the millions of young, old and infirm, sick and helpless treated by our hospitals, the students in our colleges and universities, innumerable research projects in medicine, science, health, education and the support of religion and social welfare. The more than a billion of dollars given annually by private foundations to support the philanthropy of the nation must be preserved not destroyed.

******

Respectfully yours,



Dr. Charles L. McClaskey

WRITTEN STATEMENT IN LIEU OF ORAL TESTIMONY

TO THE

FINANCE COMMITTEE OF THE UNITED STATES SENATE

ON BEHALF OF

THE WEATHERHEAD FOUNDATION

AND

THE NATIONAL CITY BANK OF CLEVELAND,

AS TRUSTEE UNDER THE WILL OF

ALBERT J. WEATHERHEAD, JR.,

WITH RESPECT TO CODE SECTION 4942

(Private Foundations - Taxes on

Failure to Distribute Income)

Submitted by

Robert B. Nelson, Esq.
Jones, Day, Cockley & Reavis
1750 Union Commerce Building
Cleveland, Ohio 44115

September 3, 1969

Area Code 216 Telephone 621-5800

SUMMARY

Proposed Code Sections 4942 and 4947 in the 1969 Tax Reform Bill impose a 100% tax on private foundation and non-exempt charitable trust income (or "minimum investment return") except to the extent the income is promptly disposed of in "qualifying distributions". In order to prevent avoidance of this tax, distributions to any "private foundation which is not an operating foundation" and to certain other charitable groups are not recognized as qualifying distributions--but this rule is applicable even though such distributee promptly makes a distribution which would have been a "qualifying distribution" if it had been made directly by the original charitable trust (or private foundation). Since this result is manifestly not intended, this statement suggests technical amendments to Section 4942 which would avoid this result.

TYPICAL FACT PATTERN: PRIVATE CHARITABLE FOUNDATION AS BENEFICIARY OF CHARITABLE TRUST

The National City Bank of Cleveland is Trustee of a large testamentary trust for the benefit of The Weatherhead Foundation, a tax exempt charitable foundation incorporated in Ohio. The Charitable Trust assets are to be held in perpetuity and the trust income is payable to the Foundation as earned. The Foundation treats all receipts from the Charitable Trust as income, and distributes all of its income (including the Charitable Trust income) on a current basis. All of the Foundation's distributions are "qualifying distributions" within the statutory concept.

At the present time the Foundation is a grant making and not an operating foundation; four out of five Members of the Foundation, and three out of four Trustees of the Foundation, are members of the decedent's family.

This typical fact pattern is the result of a desire to separate investment decisions from responsibility for attainment of charitable objectives, and is repeated with numerous other private foundations.

THE PROBLEM CREATED BY THE PRESENT PROVISIONS OF SECTION 4942

Since there is no real question in this typical fact pattern of unreasonable accumulations of income intended for charity, we assume that there is no intention to tax the Charitable Trust income under proposed Sections 4942 and 4947. Nonetheless, because of the limiting definition of "qualifying distribution" contained in proposed Section 4942(g), it appears that the tax may apply. We propose a simple solution by in effect treating the Foundation's distributions as though made by the Trust.

If these sections are enacted failing to "credit" the Charitable Trust with "qualifying distributions" made by its beneficiary, the Charitable Trust and the Foundation (and others similarly situated) would eventually be taxed out of existence. Such a confiscation of assets would raise Constitutional questions and would not serve to further any announced or legitimate objective of tax reform.

PROPOSED SOLUTION

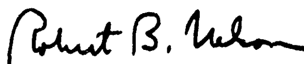
The solution which we propose to this technical problem is a modification of Section 4942(g) pursuant to which any non-exempt trust

subject to Section 4942 or other private foundation would receive credit for any "qualifying distribution" made in a timely manner by a charitable beneficiary of the trust or foundation. Specifically, we propose that Section 4942(g) be amended by adding the following paragraph (3) thereto:

"(3) QUALIFYING DISTRIBUTIONS BY BENEFICIARY -

If a recipient of a distribution which (i) is made by the foundation to accomplish one or more of the purposes described in Section 170(c)(2)(B), but (ii) is not a qualifying distribution, pays out or sets aside any part or all of such distribution in a manner such that such payment or setting aside by the recipient would have been a 'qualifying distribution' under paragraph (1) or paragraph (2) if made at that time directly by the foundation, then to the extent that such distribution by the foundation is so paid out or set aside by the recipient it shall be treated as a qualifying distribution by the foundation."

Respectfully submitted,



Robert B. Nelson
On behalf of:
The Weatherhead Foundation and
The National City Bank of Cleveland, Trustee

TESTIMONY OF

C. MAXWELL STANLEY, MUSCATINE, IOWA

Re H.R. 13270 As It Affects Private Foundations

Submitted to the SENATE FINANCE COMMITTEE

September 9, 1969

I am the President, a member of the Board of Directors, and a co-founder of The Stanley Foundation. I am a professional engineer and businessman, currently President of Stanley Consultants, Inc., International Consultants in Engineering, Architecture, Planning, and Management, and Chairman of the Board of HON INDUSTRIES Inc., a manufacturer of office furniture and materials handling equipment.

The Stanley Foundation was established in December, 1956. From inception its Board of Directors has been my wife, Elizabeth M. Stanley; my son, David M. Stanley, a lawyer and member of the Senate of the State of Iowa; my son, Richard H. Stanley, an executive vice president of Stanley Consultants; and my daughter, Jane M. Buckles, a university professor and housewife.

The resources of The Stanley Foundation consist almost entirely of common stock of HON INDUSTRIES Inc. which I have contributed to it over the years. In addition, I have made limited cash contributions and we have received cash contributions from others to help finance specific projects. The Stanley Foundation was granted exemption from tax under Section 501(c)(3) on May 22, 1959.

The Stanley Foundation has limited its activities to those consistent with the intent of Section 501(c)(3). It has distributed annually more than its adjusted net income as defined in H.R. 13270 and has carefully avoided self-dealing and other unethical practices restricted in H.R. 13270.

I support the prohibitions against self-dealing (Section 4941); the required distribution of income (Section 4942); the requirements for proving exempt status and taxing foundations which have evaded the law (Sections 507 and 508); and most of the limitations on use of assets and on activities (Sections 4944 and 4954). They are necessary and needed reforms and Congress should enact them.

I offer comments in six other areas of the proposed legislation: (1) the general philosophy of H.R. 13270 as it affects private foundations, (2) discriminatory legislation in favor of particular foundations in Section 6684, (3) the tax on net investment income of all foundations in Section 506, (4) the particular restriction concerning travel expenses of certain governmental officials in Section 4941, (5) the arbitrary percentage tests concerning stock ownership limitations in Section 4943, and (6) unclear legislative intent in Section 4945.

33-758 O - 69 -- No. 19 -- 25

1. General Philosophy. One thrust of the portion of H.R. 13270 directed to foundations is that the costs of government should be borne by those able to pay, including foundations. A second thrust is that private foundations must use their funds for the purposes intended and avoid self-dealing, accumulating funds, using funds for political action, and other purposes incompatible with the basic purposes for which tax exemption is granted.

The second thrust should be demanded and assured of all foundations that seek and are granted tax exceptions. Legislation should prohibit abuses of the tax exempt privilege and insure that all funds are for charitable purposes broadly defined.

If such practice is assured, the taxation of foundations to bear costs of government is contrary to the public interest and would reduce the social benefits the nation derives from legitimate foundations operating in the fields of charity and philanthropy. The ability to pay concept is clearly inappropriate when directed towards taxation of funds that will be used charitably. As the capacity of foundations to perform such functions is reduced, the deficiency will inevitably be assumed by the public through taxation to support various governmental agencies. I oppose the concept of taxation of foundations that perform ethically and legitimately the functions which warrant tax exemption.

I strongly support adequate sanctions against inappropriate conduct on the part of the foundations and the deprivation of their tax exemption in the case of uncorrected violations. Such sanctions should apply to all foundations, not just those included in an arbitrary definition of "private foundations."

2. Discriminatory Legislation. Section 101(K) of the proposed bill is entitled "Effective Dates" and contains two tightly drawn exemptions designed for two specific foundations from the ownership limitation provisions of Section 4943. The exemption for each of these is evidently based on a belief that these foundations have not been guilty of kinds of action against which legislation is directed, have operated in a manner consistent with the rest of the proposed legislation, and would be adversely affected by sale of their holdings.

This may be true. But it also is true of The Stanley Foundation and, I am sure, of many others. Such specific exemptions indicate only effective political lobbying on the behalf of the affected organizations. They do not indicate an attempt to conscientiously deal with the problems corrective legislation has on foundations which have been operating in the manner intended of them.

These provisions are patently inequitable and grossly unfair to the numerous other foundations, including The Stanley Foundation, that have and intend to function in an ethical and legitimate manner.

If Congress desires to resort to exemptions to serve specific foundations, I would be pleased to submit one that would fit The Stanley Foundation.

3. Tax on Investment Income. The proposed tax on investment income of all private foundations is bad tax law. Tax laws should encourage legitimate charity and philanthropy. Encouragement should go to all foundations, not just those who through the arbitrary formula avoid classification as "private foundations." Any tax, whether 1 percent or 7-1/2 percent, limits the capability of truly charitable foundations. Moreover, it invites the natural upward progression of tax to bear the costs of government.

4. Expenses of Government Officials. For purposes of the taxes on self-dealing, certain government officials are included in "disqualified persons," who cannot deal with foundations except to receive nonexcessive payment of compensation and expenses for services and expenses which are reasonable and necessary to carry out the exempt purposes of the private foundation. In addition, in the case of government officials, no compensation can be paid and the only expenses which can be reimbursed are traveling expenses from a point in the United States to another point in the United States.

If it is considered necessary to prevent even reasonable compensation to government officials for actual services, reimbursement for actual travel expenses ought not to be limited to travel between points in the United States. The activities of The Stanley Foundation over the past several years have included Conferences on the United Nations of the Next Decade, involving scholars and officials from all over the world. It is sometimes necessary and desirable to hold these conferences outside of the United States. No compensation is paid to these participants, but their actual expenses are reimbursed. Expenditures otherwise reasonable and necessary should not be limited geographically.

5. Stock Ownership Limitations. The control shareholding limitations in Section 4943 are not realistic when they must be applied from the smallest to the largest of corporations. The proposed legislation permits only 20 percent of the voting stock of a corporation to be held by a foundation and "disqualified" persons connected with it. Much less than 20 percent of the voting stock will control large, very widely held corporations. Much more than 20 percent is necessary to control smaller corporations, less widely held. The legislation should recognize this fact with holding limitations geared to the size and nature of the corporations involved.

In the case of The Stanley Foundation and its holdings of common stock of HON INDUSTRIES Inc., 20 percent is far below the amount required for control and no other individual or group has a holding adequate for control.

6. Unclear Legislative Intent. Section 4945 taxing certain expenditures of private foundations is excellent in its intent. No foundation should engage in any form of political action or propaganda. Legislation designed to prohibit and limit such activity should be encouraged. However, certain of the chosen legislative language is unfortunately broad and unclear and on final drafting should be clarified before final enactment.

For instance, Section 4945(c) includes as taxable expenditures subject to the sanctions of that section: ". . . any attempt to influence legislation through an attempt to effect the opinion of the general public or any segment thereof, and . . . 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 formation of the legislation, other than through making available the results of nonpartisan analysis or research."

The Committee report indicates this section is meant to "preclude(s) only direct attempts to persuade members of legislative bodies or government employees to take particular positions on specific legislative issues and does not extend to discussions of broad policy problems and issues with such members or employees." This is not directly apparent from the legislative language and it is not clear to what extent a foundation's reports, discussions, and other functions can be published and stay within the meaning of "making available the results of nonpartisan analysis or research."

HINDRY & MEYER
ATTORNEYS AT LAW
2301 FIRST NATIONAL BANK BUILDING
621 SEVENTEENTH STREET
DENVER, COLORADO 80202
CABLE ADDRESS: HEMLAW
TELEPHONE (303) 292-9000

HAYES R. HINDRY (1962)
MILTON E. MEYER, JR.
C. HENRY ROATH
KERWIN H. FULTON
CHARLES F. BREGA
ARNOLD C. WEGHER
WILLIAM M. SIMS
JAY L. GUECK
JOHN P. KREISHEIMER
ROBERT D. SHOWALTER
JOHN J. HANLON
JOSEPH F. COLANTUONO
FRED A. ALBI
JOHN T. GRACE
LOREN L. HALL
PETER C. MAXFIELD
RICHARD B. VONWALD

September 3, 1969

Committee on Finance
United States Senate
Washington, D. C.

Gentlemen:

These comments are directed to the provisions relating to PRIVATE FOUNDATIONS as dealt with in H.R. 13270 and are submitted pursuant to the following telegram:

> "DUE TO LARGE NUMBER OF WITNESSES WHO WISH TO TESTIFY ON TAX REFORM AND SHORT AMOUNT OF TIME AVAILABLE FOR HEARING IT IS IMPOSSIBLE TO SCHEDULE ALL WITNESSES THAT THE COMMITTEE WOULD LIKE TO HEAR. I REGRET THEREFORE THAT IT WILL NOT BE POSSIBLE TO SCHEDULE YOU FOR ORAL PRESENTATION BEFORE THE COMMITTEE. HOWEVER, THE CHAIRMAN HAS INSTRUCTED ME TO ADVISE YOU THAT IF YOU SUBMIT 50 COPIES OF YOUR WRITTEN STATEMENT TO THE COMMITTEE NOT LATER THAN FRIDAY, SEPTEMBER 5, 1969 IT WILL BE PRINTED IN THE RECORD AND BE GIVEN SAME CONSIDERATION AS THOUGH DELIVERED ORALLY.
>
> TOM VAIL, CHIEF COUNSEL, SENATE FINANCE COMMITTEE"

The undersigned is a partner in a Denver law firm that serves as general counsel for a half-dozen private foundations ranging in size of assets from a few thousand dollars to two and one-half million dollars.

We take exception to the H.R. 13270 treatment of Private Foundations (Title I - Tax Exempt Organizations, Subtitle A - Private Foundations) and urge that the Senate repudiate or substantially revise this portion of the Tax Reform Act of 1969.

A. In General:

1. It is apparent from the record that few members of the House of Representatives had an opportunity to be aware of the contents of this complicated bill, much less to give consideration to the details of any of its numerous provisions, such as those dealing with Private Foundations, prior to passage on August 7. In effect, they were compelled to vote for or against "reform" without personal awareness of the contents of this House bill (House Report 91-413; floor debate reported in Congressional Record of August 6 and 7).

2. Private Foundations, through action or non-action of all former Congresses since the advent of the federal income tax, have been given a special preferred status within the taxing laws. Now, suddenly, we have a Congress which seems to feel it has a mandate to punish private foundations, their benefactors and their managers. As to Private Foundations, H.R. 13270 is not "reform," but "eradication"! For example:

a. Where will Private Foundations henceforth find their officers, directors and trustees when persons holding such offices will be personally subject to successive layers of punitive taxes and penalties for acts that might have been incurred in good faith with no possibility of personal benefit?

b. Where will Private Foundations look for future financial support when the persons and organizations historically responsible for their creation and support are substantially prohibited from dealing with them or making further contributions to them because of novel concepts of "self-dealing" or "excess business holdings"?

c. A Private Foundation that runs afoul of the new rules will not merely lose its exemption (which would still leave it in a position, nevertheless, to carry out its "charitable" objectives), but will be subjected to 100 percent confiscation of all its assets.

3. It would seem that the limits of the interest of the citizens of the United States (and hence that of their elected representatives) in the regulation of tax exempt organizations would be to deny the exemption from taxation to any organization that does not conform to the national policies deemed to justify tax exemption. The rationale of H.R. 13270 is that denying tax exemption has been ineffective (see generally "Summary Tax Reform Bill of 1969" prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance) and that only punitive confiscation of the assets of a Private Foundation and/or those of its "managers" and "self-dealers" will suffice.

4. It would appear that the draftsmen of H.R. 13270, utilizing the alleged "sins" of a few Private Foundations as justification, have made a political decision that all "charity" henceforth will be the exclusive province of government. If the motivation were merely the correcting of "abuses," it would be hard to conceive of a more notable example of "overkill."

B. In Particular:

1. Tax on Investment Income. This would seem the least objectionable of the "reform" provisions regarding Private Foundations so long as the rate of tax is not excessive. Implicit in Title I of H.R. 13270 seems to be the admission that revenue agents and their superiors are insufficiently motivated to enforce existing law relating to Private Foundations where the only "goal" is the possible loss of the organization's tax-exempt status; hence, the preoccupation with new and massive "taxes." Perhaps a 7 1/2 percent tax on investment income will defray the cost of policing the balance of the existing law and render unnecessary the more punitive provisions of the Act. The risk here is that the 7 1/2 percent rate is probably just the opening wedge to total elimination of the tax-exempt concept in due course.

2. Self-Dealing. The abandonment of any concept of whether the Private Foundation or the interests of "charity" are injured in any so-called "self-dealing"

transaction seems extremely punitive. Literally, if a "disqualified" person purchased 1000 shares of General Motors stock from a Private Foundation at twice the undisputed market at the time of purchase, the "disqualified person" would apparently be subjected to an "initial tax" of 5 percent on the inflated price paid and an "additional tax" of 200 percent of the "amount involved" if the transaction is not or can not be "corrected" within the time specified. In addition, the officers and trustees or directors of the Private Foundation are subjected to personal taxes of 2 1/2 percent and 50 percent (limited to $10,000 for each tax) if they participated in the transaction.

This approach (and other approaches of Title I of H.R. 13270) suggests a total lack of confidence by the House of Representatives in the ability of the judiciary to distinguish situations which abuse the tax-exempt privilege and those which do not.

3. Excess Business Holdings. The typical small Private Foundation (as well as some of the large) has been created by a successful businessman or his corporation. He has been prompted to create a foundation by (1) a desire to share his success with the less fortunate; (2) a desire to protect his business or family from the ravages of other aspects of taxation; or (3) some combination of (1) and (2). So long as the interests of charity are not defeated or threatened by the inclusion of an interest in a related business in the portfolio of a Private Foundation (a matter the judiciary can determine under existing legal concepts), there would seem to be no compelling reason to adopt the harsh prohibitions of H.R. 13270.

Enactment of the "Excess Business Holdings" concept will certainly have a limiting effect on charitable donations and bequests from donors whose estates are substantially one-asset estates. The proposed period for disposing of such existing interests or those subsequently acquired by bequest will not solve problems where the business interest is truly closely-held and there is no third-party market except at a financial sacrifice.

One minor technical point: Apparently the draftsmen of H.R. 13270 are not aware that a substantial number of estates are transmitted at death today by revocable living trusts instead of by wills in order to avoid the disadvantages of probate. The provision dealing with the disposition of business interests acquired from a decedent under a dispositive instrument executed prior to July 28, 1969, etc., refers only to a "will" and ignores the possible use of a revocable trust. This is a further example of the difficulties that exist when Congress tries to be too explicit and leaves nothing to common-sense interpretation by the Courts.

4. Distributions of Income. Existing law, if enforced, would seem adequate to deal with unreasonable failure of a Private Foundation to distribute its income for charitable purposes. The proposal of H.R. 13270 would preempt investment decisions of foundation managers and force investment (at this time) in high yield debt-securities instead of equities, thereby foreclosing portfolio growth. Administration of the proposed provision, with attendant annual valuation problems, would seem very burdensome.

5. Taxable Expenditures. Although existing law should be adequate, the concepts of H.R. 13270 in this area do not appear entirely unreasonable.

6. Investments Which Jeopardize Charitable Purpose. The "second-guessing" opportunities of this provision strike the undersigned as frightening! Any foundation investment that goes sour could, apparently, involve the foundation and its "managers" in painful argument and the peril of expensive non-persuasion. Although borrowed from existing Section 504 (a) (3), the scope of the new proposed law is vastly broader, affecting all investments. The penalties are such that (referring to A.2.a. above), what prudent individual will hereafter be willing to serve as an officer, director or trustee of a Private Foundation?

The answer of H.R. 13270 to the evil that a "charitable purpose" may be "jeopardized" appears cynical in the extreme - confiscate the offending investment on behalf of the government! How does "charity" benefit from that solution?

7. Termination of Private Foundation Status. One may also ask how charity benefits from the total or near total confiscation of a foundation's assets on voluntary or involuntary termination of its tax-exempt status as presently proposed. Is this further evidence that the draftsmen of H.R. 13270 are not really concerned about the role of private, as opposed to public, charity?

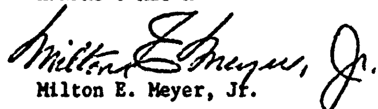
8. Penalties for Late Filing of Reports. It is a foregone conclusion that the reporting requirements of Private Foundations under H.R. 13270 will be significantly enlarged and complicated. Not only will the expenses of satisfying such requirements doubtless be burdensome, but the possible $10 per day fine on "managers" for late filing will be one more reason for a prudent man declining the office with thanks.

C. Summary:

There are, in addition to those discussed, many other provisions and details of Title I of H.R. 13270 that appear alien to long-standing concepts of the role of private charitable giving through Private Foundations. Whatever the abuses that have crept into the operation of some Private Foundations, it is respectfully submitted that they can be dealt with by effective administration of existing laws. The proposed new legislative remedy for the "problems" appears to fall short of distinguishing between the baby and the used bath water and, hopefully, will be repudiated by the Senate in its current deliberations.

Very truly yours,

HINDRY & MEYER



Milton E. Meyer, Jr.

JOSEPH G. ENGEL
COUNSELLOR AT LAW
31 PARKER ROAD
(CORNER OF WESTMINSTER AVENUE)
ELIZABETH, N. J. 07208

TELEPHONES
ELIZABETH 4-5526
ELIZABETH 4-5537
AREA CODE 201

NEW YORK OFFICE
310 MADISON AVENUE
NEW YORK, N. Y. 10017
(212) 867-6363

H. R. 13270

SUMMARY OF STATEMENT

of

JOSEPH G. ENGEL, President
of N. R. Leavitt Foundation

1. INTRODUCTION: Remove treatment of foundations in this revenue raising bill; the subject is not and cannot be adequately treated in this fashion.

2. 7½% TAX: No tax, whether based on a foundation's income or asset value is justified; the cost of auditing foundations should be through a fee basis, similar to that system used by many states in auditing banks.

3. LIMITATION OF 20% OWNERSHIP: This provision should not operate retroactively; you cannot destroy what was legal when previously done by a ten year wipe-out program. At the very most, existing situations should have twenty-five years to adjust; the timing and method should be the responsibility of the foundations.

4. The 5% or any other annual minimum pay-out of income very possibly will destroy private foundations. No percentage should be invoked. The present law has adequate standards for annual pay-out.

Dated: September 5th, 1969.

JOSEPH G. ENGEL
COUNSELLOR AT LAW
31 PARKER ROAD
(CORNER OF WESTMINSTER AVENUE)
ELIZABETH, N.J. 07208

TELEPHONES
ELIZABETH 4-6526
ELIZABETH 4-6537
AREA CODE 201

NEW YORK OFFICE
310 MADISON AVENUE
NEW YORK, N.Y. 10017
(212) 687-6363

September 5th, 1969.

Senate Finance Committee
2227 New Senate Office Building
Washington D. C. 20510

Gentlemen:

I am President of the N. R. Leavitt Foundation located in Elizabeth, New Jersey. I am also its legal counsel. I have represented foundations since 1951. I have also been a member of the American Bar Association Committee on Exempt Organizations for some years.

The more study I give to H. R. 13270 since it was passed by the House in August on only two days' consideration after it was reported out of Committee, the more I realize its complexity and the serious consequences that can ensue from the acceptance of the provisions relating to foundations. By foundations, I mean the three categories contemplated by H. R. 13270; namely Private, Private Operating, and Public. Accordingly, I am strongly in accord with the attached August 6th, 1969, editorial of the "New York Times" that urges the removal of this subject from a revenue raising bill so that it may be given proper consideration by your Committee and the Senate. Obviously, the members of the House of Representatives could not have given these provisions or the whole bill careful and adequate consideration in two days' debate. A very serious problem exists if our Supreme legislative bodies will pass such important legislation as embodied in H. R. 13270 without adequate consideration in the House and without opportunity being given to qualified interested parties to appear before your Committee to present oral testimony and answer questions of members of your Committee.

7½% TAX

No income tax or tax based upon the value of assets should be imposed on any foundation. A tax, whether at the rate of 7½% on income or at any other rate, means that the federal government rather than foundations should administer the funds represented by these taxes. This policy is incompatible with the very basic philosophy of charity which is to administer to the wants of mankind and to relieve the government of some of these burdens. This tax means competition and usurpation by government of the function of private charity which has existed, I would like to believe, as long as mankind has been on the face of this earth. In addition, such administration by government is more costly. Studies have shown the foundation costs are almost nominal.

If this attempted tax is rather a desire to help defray the cost of administering the law, then an equitable system of charging the cost against foundations should be adopted. After many years as an attorney connected with foundations, I most heartily believe in the value of audits. These audits prevent abuse and instruct the uninitiated. If Congress had provided adequate funds to the Treasury Department to carry out these audits over the past years, I believe that the abuses found by Congressman Patman and erroneous acts of foundations could have been discovered and terminated under the existing law.

I recommend the adoption of a charge being made against a foundation when the audit is made. This would be similar to the system used for many years by the banking departments of many states in their audit of state banks; see the attached report of The American Bankers Association and the August 25th, 1969 letter of Central Home Trust Company of Elizabeth, N. J.

DIVESTITURE OF MORE THAN 20% INTERESTS

Many persons have made substantial gifts to foundations of more than 20% of the stock of a corporation

either during their lifetime of upon death. These gifts have been made in reliance upon the law permitting such gifts and the retention of these securities by the foundations. I am not going to discuss the gradual sell off of such foundations' holdings, but rather the extreme inequity of this proposal itself and the unwarranted harshness of the penalties for failure to comply with the divestiture reliance. Any law as drastic as this should act only upon future gifts. The actions heretofore taken in good faith and in reliance upon the law should be excepted from any divestiture proposals. The breach of faith involved here is similar to the breach rising from the attempt to tax the interest on previously purchased tax-exempt bonds of various states, counties and municipalities. The existing income tax exemption was intended to be an inducement for these purchases and was so relied upon by the purchaser. A change of the law breaches these pacts. The law at best, should be prospective only.

If the retention of holdings in excess of 20% is harmful to a foundation, the present law is well-equipped to remedy the evil. The decisions of the Courts clearly require that foundations be operated for their stated purposes. The statutes provide penalties for doing otherwise. Therefore, any harmful holding may be reduced or eliminated under the existing law. Each case can be judged on its own facts and no arbitrary percentage need be fixed. The parties involved are adequately protected by the right to appeal to the Court from any controversy in this respect.

At the very most, a period of 25 years from the effective date of this law, should be given to permit divestiture without a maximum percentage of holdings being fixed by law and without any method or timetable being built into this period. The foundation will be responsible for any evil effects flowing from its failure to divest improper holdings. Twenty-five years is proper because it represents approximately a generation under today's rules of longevity and will provide adequate notice to the parties.

5% MINIMUM ANNUAL DISTRIBUTIONS

Careful consideration of allowing any government to fix 5% or any greater or lesser figure as the minimum yardstick for pay out by foundations of income or a combination of income and some capital, if the income is below the established figure, reveals that such establishments of a figure will, in all likelihood, ultimately be fatal to the lives of foundations.

Studies show that in times of growth the dividend yields on sound stocks seldom, if ever, reach 5% or 6%. Unusual growth companies, like IBM, Xerox, Dow Chemical, Avon Products and others pay out much less than 5% because they retain so much to meet the growth needs of our country and foregin countries. Historically, the yields on United States Government Bonds have been as low as 1-7/8% and now, in the case of Treasury Bills, have reached historic highs by exceeding 7%. Therefore, there is no assurance that a combination of stocks and bonds can produce a yield sufficient to meet whatever may be the government established minimum distribution figure. This, therefore, means that capital assets must be sold. Such sale will reduce the income-producing ability of the foundations and cause further sale of capital assets, ultimately exhausting a foundation's total capital.

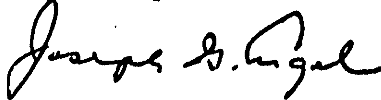
The argument that a foundation can afford to sell some of its stock because it has had appreciation in value overlooks the fact that virtually all the market appreciation in value contains elements of inflation. In order to sustain charitable activities, it is very obvious that larger grants must be made by foundations to give them the same true purchasing power that they had in previous years.

If a foundation could conceivably produce the minimum required distribution income by the purchase of interest-bearing securities, this method would also

ultimately result in the exhaustion of the foundations' assets because there would be no equity ownership to meet elements of growth and inflation. This honorable Committee might be interested in knowing that after World War I foundations in Germany were wiped out when the government required that they invest only in governmental bonds. Everybody knows of the inflation that followed World War I and can very well understand that the German government kept printing more and more bonds which were worth less and less. The result was that the foundations were ultimately wiped out because they were forced into the holding of worthless bonds.

The law of foundations and the rule of the prudent investment of trust funds prohibits the holding of non-income producing assets where this would render the foundations unable to carry out its stated purposes. Adequate remedies can be found readily in the existing law to prevent this. There could be no justification for adopting any required percentage of return. The simple requirement that foundations should distribute all their income is sufficient. In my 18 years as counsel to foundations, I have always advised this procedure to be followed each year without deviation.

Respectfully submitted,



Preserving the Foundations

The House Ways and Means Committee's shotgun approach to the tax-free foundations would buy reform at a very high social cost. It proposes a genuine—and wholly desirable—crackdown on the self-dealing manipulations of foundations that are operated as vehicles for tax avoidance. But great harm would come from the new tax and other restrictions the bill would impose upon the bona fide philanthropic foundations which enrich American life with ideas and innovative social programs.

A leading case in point is the 7.5 per cent tax that would be levied on the investment income—dividends, interest, rent, royalties and capital gains—realized by foundations. The levy is not sufficiently stiff to discourage the tax-dodgers, but it would put a dent in the useful activities of worthier foundations. About two-thirds of their income now goes in the form of gifts to private universities and local charities. Hence, what the Treasury realized in additional revenues—probably not more than $65 million in the first year—would soon be offset by demands for new or expanded Federal programs in the same fields.

Although the foundations tax is described by the committee as a "user fee" to defray the costs of more vigorous policing, no machinery is proposed or funds earmarked for that purpose. A preferable alternative would be a much lower special registration fee for foundations, the proceeds of which would support a special supervisory office in the Treasury Department. With effective supervision of the foundations, dollars destined for philanthropy would actually get where they are supposed to go.

There has been a softening of some of the very harsh restrictions that the committee originally proposed to prevent foundations from engaging in political activities. The Southern Regional Council is specifically cited in the committee report as a foundation that may continue to finance voter registration drives.

But a number of ambiguous and potentially restrictive provisions remain in the bill.

The whole title dealing with tax-exempt organizations should be sent back for redrafting. Its passage by Congress would inhibit creative philanthropic activities, an essential ingredient of a pluralistic society.

STATE BANKING LAW REVISION

Selected Legislative Issues

Edited by
Carter H. Golembe

THE AMERICAN BANKERS ASSOCIATION
90 PARK AVENUE, NEW YORK, N.Y. 10016

33-758 O - 69 -- No. 19 -- 26

Copyright © 1967
THE AMERICAN BANKERS ASSOCIATION
New York, N.Y. 10016

FINANCING STATE BANKING DEPARTMENTS

An adequate budget is a prerequisite to a state banking department that measures up to all the requirements inherent in good bank supervision. Accordingly, methods of financing the banking department are among the important topics that arise whenever substantial banking code revisions are under consideration.

Background

The development of substantive bank supervision was one of the notable features of New York's Safety Fund law, which was passed in 1829 to provide for the insurance of bank obligations. Prior to that time, rudimentary bank supervision included generally inadequate condition reports and sporadic, ineffective bank examinations. Departing from traditional supervision, the New York law contained four significant provisions, which were eventually incorporated into the laws of other states: (1) regular and frequent examinations; (2) bank examiners employed on full-time basis; (3) full access to bank records; (4) cost of supervision paid directly or indirectly by the banks supervised. These provisions also became part of the National Currency Act of 1863 and the National Bank Act of 1864.

While these four tenets of bank supervision have been universally accepted, performance has not always been uniform and, as a matter of fact, the fourth, which is the most relevant to this section, has been subject to great variation. Although the banking departments of all 50 states collect examination and other fees and the banks they supervise pay all or a portion of the costs involved in running the department, the diversity in methods of financing banking departments and the application of examination fees and other charges is extremely wide. For example, some departments are financed independently of the state's budget, have sole control over the funds they collect, and are fully self-sustaining. In other

Copyright © 198[illegible] The American Bankers Association

cases, the fees collected are deposited into the general fund of the state, with complete loss of control by the banking department. The budgets of such departments may have little or no relationship to the amount collected.

There are many variations within these two extremes. The banking department of at least one state operates on a legislative appropriation from the general fund and at the end of the year collects enough money from the banks to reimburse the state for the funds advanced. Some departments collect annual assessments from all state banks regardless of the number of times each one is examined. Some states assess examination fees only, while others charge for processing applications for charters, branches, conversions, and mergers.

While the lack of uniformity in the various state statutes would seem to indicate otherwise, most supervisors and bankers and some other observers generally agree that banking departments should be financed entirely by the bank supervised.

Existing Statutes

In view of differences between the system of fees for national banks and those for most state banks, it will be helpful to begin by describing Federal law and the regulations issued thereunder.

Federal Law

The National Bank Act provides that "The expense of examination herein provided for shall be assessed by the Comptroller of the Currency upon national banks in proportion to their assets or resources. The annual rate of such assessment shall be the same for all national banks, except that banks examined more frequently than twice in one calendar year shall in addition be assessed the expense of these additional examinations."

The current regulations issued by the Comptroller under the foregoing statutory provision can be summarized as follows:

> The semiannual rate is a basic assessment of $100 plus $.04 per $1,000 of total assets. (This fee is assessed to coincide, in effect, with the semi-

annual call reports, regardless of whether or not one examination each two years is waived.)

The assessment rate for investigations of applications for new branches or changes in location of branches is $100 a day for the examiner-in-charge and $50 a day for each additional examiner plus expenses of each examiner. The same daily rates apply to examinations of affiliates and trust departments and investigations of applications for trust powers.

A filing fee of $2,000 is assessed for investigating and processing each application for a merger.

A filing fee of $1,500 is assessed for investigating and processing each application to organize a new national bank. This includes conversions.

The Federal Reserve Act provides for examinations of member banks by the appropriate Federal reserve bank for that district. While the expenses of such examinations may, in the discretion of the Board of Governors, be assessed against the banks examined, it is not the practice to make such charges.

The Federal Deposit Insurance Act authorizes the Corporation to examine insured banks but it does not provide for examination fees.

State Law

As mentioned earlier, the statutes of all states provide for assessments to be paid by the banks under the supervision of the banking departments. For the most part, these assessments take the form of examination fees, but some states also charge for investigating and processing applications for charters, mergers, conversions, office relocations, and branches.

Several methods are used to establish, collect, and dispose of funds needed to operate banking departments. A summary review should be of interest to a law revision committee.

Application of fees. The statutes of 18 states provide for fees to be levied on all state banks without regard to the number of examinations per bank per year. Another 25 states assess fees for each examination, and any bank not examined during the year pays no fee. The remaining 7 states provide for a combination of the two methods in that they assess all state banks annually (or semiannually) and, in addition, collect fees for each examination.

Copyright © 1966 The American Bankers Association

Discretionary or fixed fees. Several states do not specify by law a detailed schedule of examination fees and other charges that may be levied on state banks. Generally, these states provide that the commissioner, at his discretion, shall set rates that are the same for all banks and that will result in sufficient income to make the department self-supporting. This is similar to the authority of the Comptroller of the Currency.

The remaining states provide a statutory rate for charging fees, which is applied in three different ways: (1) The rate can be changed only by changing the law; (2) the statutory rate is a maximum, with the commissioner authorized to set a lower rate if expenses of the department justify such action; (3) the statutory rate is a minimum, with the commissioner authorized to increase the rate, if necessary, to cover the expenses of the department.

Disposition of receipts. In 18 states all receipts of the banking department go into a special fund, out of which all operating expenses of the department are paid. This is similar to the method under which the Comptroller of the Currency operates. In a few of these states whenever the banking department fund exceeds a certain amount, usually $100,000, the excess is paid into the general fund of the state. Thus, the banking departments of most of those states have first call on funds derived from fees and other charges, but for a few others legislative appropriations are still required. The banking departments of the other 32 states operate on legislative appropriations. In some cases the funds collected by the department must equal or exceed the appropriation, while in others the appropriation appears to have little relationship to the amount collected. Some departments collect the fees and make monthly deposits to the general fund, while others do not collect fees since they are paid directly to the state treasury by the banks.

Basis and amount of fees. Examination fees are usually based on total resources. However, in one state they are based on total deposits and in three states, on total capital (two of which also

collect fees based on resources.) A number of states charge all banks a flat fee or one based on total resources and an additional fee to cover the cost of each examination.

Information on the basis for charging examination fees and the current rate of assessment is provided in Appendix A. A list of the states having a special banking department fund is given in Appendix B.

Policy Considerations

In considering the revision of the section of a banking code dealing with the financial aspects of a state banking department, the basic concern should be the answer to the question, What are the attributes of a well-financed banking department? Doubtless, everyone will agree that the overriding consideration is to provide enough money for an adequate budget. But what is an adequate budget? If a state desires a modern and effective department, fully capable of supervising a strong and dynamic state banking system, it must attract and retain a staff of highly qualified examiners. Of equal importance is that the competence of state examiners should compare favorably with the capabilities of those examining national banks. Thus, the most important requirement of an adequate budget is to provide for a salary scale, fringe benefits, and travel allowances at least equal to those of the Federal bank examiners. There are several views concerning the most favorable means of accomplishing this.

Department Self-supporting

The principle that state banking departments should be financed from examination fees and other charges lies deep in the banking history of this country. It was incorporated into the state banking laws which antedated the National Bank Act and which served as models for establishing the procedures to be used by the Office of the Comptroller of the Currency. Hence, it seems appropriate to examine the financial arrangements of that Office.

The Comptroller of the Currency reported total income of

Copyright © 1968 The American Bankers Association

$22.4 million for the calendar year 1966.[1] Expenses were $19.8 million, leaving an excess of income over expenses of $2.6 million. These figures provide a classic illustration of a fully self-supporting bank supervisory agency. All funds collected by the Comptroller are retained in a special fund used solely for financing the operations of the office without congressional appropriation. The report also shows that total assets in this fund on December 31, 1966, were over $13.6 million, of which more than nine-tenths consisted of investments. Investment income for the year was $628,000.

Arguments against self-supporting departments. Despite the almost universal belief that state banking departments should be financed by assessments of one form or another paid by the banks supervised, there are theoretical reasons why some, and perhaps all, of the funds needed should come from the general revenues of the state.

First, it can logically be argued that banks are supervised for the benefit of the general public—not for the benefit of the banks—and, therefore, the public should pay the expenses of banking departments.

Second, bank supervision should not be considered an extraneous activity of the state but rather an integral part of governmental services and duties. As such, it seems reasonable that the cost of the banking department should be met in the same way as most other functions of state government.

Third, some observers suggest that a banking department should be independent of the banks supervised; and that such independence is endangered when the banks provide the funds needed to run the department. As the argument goes, unless a department is fully independent, it is less likely to be objective in its supervisory activities and may be more responsive to bank interests than to the public interest. From this it is reasoned that

[1] *Statistical Supplement to the 1966 Annual Report*, Comptroller of the Currency, U. S. Government Printing Office, Washington, D. C., pp. 17–20. Also see Appendix C.

banking departments should rely primarily on legislative appropriations derived from the general funds of the states.

Arguments for self-supporting departments. The basic argument most often advanced as justification for self-supporting banking departments is that this financing is and has been such a prevalent practice that it has become a part of the banking tradition. Furthermore, there have been few, if any, instances in which a state banking department has been remiss because it was financed solely from fees paid by the banks. Moreover, it is often noted that in order to obviate the possibility of undue influence, state statutes generally specify that examination fees and other assessments must be levied impartially upon all banks. Since the payments are mandatory and not voluntary contributions, it is argued that it is virtually inconceivable that they could have any adverse effect upon the quality or impartiality of supervision.

One argument against paying for bank supervision from general taxation stems from the fact that states are already having great difficulty finding sufficient sources of revenue. Elimination of examination fees and other assessments paid by banks would intensify this problem. Moreover, since banks are accustomed to paying examination fees and other assessments and are generally willing to pay whatever is necessary to provide for an adequate budget, it seems reasonable to continue such an arrangement. A self-sustaining banking department is no less a part of state government than one financed by the general revenues of the state since it is generally subject to civil service rules and regulations and the commissioner is almost always responsible to an appropriate state official.

Probably the most forceful argument is that if the expenses of operating a state banking department are not paid by the banks supervised, there is the possibility that some states would shift the entire burden of bank supervision to the Federal agencies, thereby abrogating all responsibility for the creation of a dynamic state banking system.

Copyright © 1968 The American Bankers Association

Section 13

Finally, while there is no doubt that the primary purpose of bank supervision is to protect the general public, nevertheless banks and bank stockholders also receive substantial benefits from good supervision. Such supervision contributes to a stable banking system, promotes public confidence, and provides a favorable environment in which a sound bank can operate. Moreover, an examination made by competent examiners can be very valuable to management. An examiner who has experience with many types of banks and banking problems can often point out likely sources of trouble not fully recognized by management, with the result that the banker takes timely action to correct the situation. Chartering unnecessary banks and authorizing new branches not needed by the public can be extremely harmful to existing institutions. Thus, banks and bank stockholders have fully as much to gain from good supervision as the general public and, as a result, can and should be expected to pay examination fees and other charges to secure adequate supervision.

Special Fund for Banking Department

Closely related to the question of making the banking department self-supporting is the problem of how the funds should be treated. As mentioned earlier, the two methods in use are to have a special banking department fund, into which all receipts of the department are paid and which is automatically appropriated for the use of the department, or to have all receipts of the banking department credited to the general fund with the department operating on a budget appropriated by the legislature.

Many of the arguments both for and against creating a special fund for the banking department are the same as those advanced when discussing self-supporting departments. One of the arguments against retaining the receipts of the department in a special fund is that such a practice is at variance with political science theory. Departments so financed, it is maintained, can escape legislative control and operate outside the main structure of government. Without legislative scrutiny during the budgetary process, the

departments may not operate in the best interests of the public. Furthermore, it is held that to require banking departments to operate on legislative appropriations does not preclude them from being self-supporting. New York, for example, operates on legislative appropriations and at the end of the year assesses the banks for enough to reimburse the state treasury for the funds advanced.

On the other hand, these arguments ignore the authority of the Governor and the legislature to oversee the operations of the department and the power of the legislature to change the structure and authority of the department. Furthermore, other areas of government, both Federal and state, are frequently given funds to make them self-supporting. For example, in situations somewhat similar to that of the Comptroller's Office, both the FDIC and the Federal Reserve System have their own funds and neither is dependent upon congressional appropriations. Also, many other state agencies, such as fish and game departments and highway departments, frequently are given special funds into which certain receipts are credited and out of which their operations are financed. It is probably worth noting at this point that the use of special funds for specific purposes is an increasing phenomenon at the state and Federal level. This is closely allied to the "user charge" concept. Thus, those benefiting from a specialized service pay for it.

The arguments for a special fund for banking departments center around the need for adequate budgets. In those cases where the budget is inadequate, unless some method is provided whereby all of the money collected by the department is made available to it, there is little or no incentive for organized banking to advocate increased fees. Giving the banking department a special fund may be the best method to make sure that all fees will be used to strengthen the department. The merit of this argument is clearly shown by the fact that all but two of the supervisors of the 18 states which operate from special department funds reported that their budgets were adequate, but only 11 of the other 32 states so reported.[3]

[3]*A Profile of State-Chartered Banking*, National Association of Supervisors of State Banks, Washington, D. C., pp. 23–24. Also see Appendix B.

Copyright © 1968 The American Bankers Association

Section 13

Desirable Features of Fees

Although a state banking department may be fully self-supporting, with an adequate budget, and with a satisfactory method of handling receipts, another element in the department's overall financing picture should be examined—the nature of the fees and assessments being collected.

Among the criteria for determining the adequacy of fees and the methods in which they are levied are the following: the benefits received by a bank, the cost of an examination, the ability of a bank to pay, ease of understanding and computing, and flexibility to adjust income with changes in the workload.

There are various ways in which these standards can be mutually reconciled to bring about a suitable system of fees and assessments acceptable to all banks. To illustrate, if the principal reason for charging fees is that all banks are benefited, it follows that all banks should be required to support the banking department. The basic charge can be either the same dollar assessment on all banks regardless of size or one that is based on some indication of size, such as total resources. The latter may be preferable if the concept that size measures both the degree of benefits received and the ability to pay is adopted.

Another arrangement to be considered is that fees should be partially related to the cost of the examinations. When coupled with the above-mentioned concept, this suggests an examination fee consisting of two parts—one, a standard amount for all banks; the other, a levy based upon total resources. It also suggests that a bank should pay for the cost of any examination in addition to those ordinarily made, including those made for applications relating to charters, mergers, establishing branches, or moving bank offices. In substance, this arrangement provides that all banks share in the administrative costs of running the department and at the same time each bank pays for the costs of the services rendered to it.

In adopting a fee schedule, consideration should be given to making it as simple and easy as possible to administer. While it

might be argued that a bank with most of its assets in Government bonds is more easily examined and, therefore, should pay a smaller fee than one with a large proportion of loans, if an attempt is made to provide for every possibility the fee schedule would become unmanageable. Moreover, in situations where the bank pays the costs of examination, the bank that is more difficult to examine will automatically pay more.

Finally, the schedule of fees should contain a mechanism for increasing fees when the expenses of operating the banking department increase. This requirement could be adequately satisfied through a system of reasonable assessments based on total resources of each bank, but, in addition, it may be prudent to vest the supervisory authority with discretionary power to adjust the fee schedule.

Fixed or discretionary fees. This raises the question as to how these fees are to be put into effect. Should they be set by statute or should the banking department be given broad authority to establish such fees as in its judgment are deemed necessary and equitable? As pointed out earlier under the heading "Statutory Provisions," both methods are found among the various states. A third method in use by several states combines the two by giving the department authority to set fees within prescribed limits.

There are good reasons for authorizing the banking department to establish a fee system without any statutory limitations. Discretionary authority provides flexibility since the rate of assessment can readily be varied from year to year to meet changing needs and is more likely to assure a self-supporting banking department with an adequate budget.

Research Suggestions

No articles or books on the financing of State banking departments have been brought to the attention of the editors. The best sources of information are the banking commissioners, probably

Copyright © 1968 The American Bankers Association

CENTRAL HOME TRUST
Company OF ELIZABETH, N. J.

ELIZABETH, N. J. 07207

WILLIAM E. SHACKLETON
PRESIDENT

August 25, 1969

Joseph G. Engel, Esq.
31 Parker Road
Elizabeth, N. J. 07208

Dear Joe:

In accordance with your verbal request this morning regarding assessments made by the New Jersey Banking Department for conducting examination of State Banks the following information was received from the New Jersey Department of Banking and Insurance - the Department assesses Banks examined as follows:-

1. Man days at salary of each examiner.
2. Travel and other expenses of examiners incurred in connection with the examination of a State Bank.
3. An overhead charge for administrative operations of the Department.
4. Fringe benefits as incurred in connection with the employment of examiners.

I hope this satisfies the point of your inquiry.

Sincerely,

Bill

THE MOODY FOUNDATION
GALVESTON, TEXAS 77550

ROBERT E. BAKER
EXECUTIVE ADMINISTRATOR

September 4, 1969

Mr. Tom Vail, Chief Counsel
Senate Finance Committee
2227 New Senate Office Building
Washington, D. C.

Dear Mr. Vail:

The Moody Foundation requested permission to have a representative appear at the public hearing on H.R. 13270 but due to the great number of people desiring to appear you advised that it would not be possible for The Moody Foundation to be heard. You further advised that a written statement would be given consideration. In response to that suggestion, The Moody Foundation is presenting the comments in the following paragraphs regarding H.R. 13270, which we respectfully request you to consider. Numbers relate to similarly numbered sections of H.R. 13270.

Section 506. TAX ON PRIVATE FOUNDATION INVESTMENT INCOME

A tax on the net investment income of a foundation is in reality a reduction in the amount available to the eventual recipient of that income. The Moody Foundation can see no reason to reduce the amount of dollars available to the grantees of this Foundation.

Section 4941. TAXES ON SELF-DEALING

Since there are occasions when benefits would accrue to foundations from certain transactions which would be construed as "Self-dealing" under the language of the suggested statute, relief from this prohibition should be made available where approval for a covered transaction is obtained from the Attorney General of the State in which the foundation operates and permission is granted by a court of general jurisdiction of that state. For instance, there are properties which, because of sentimental attachments, will bring a higher price from a donor or trustee, and no useful purpose is served by prohibiting such a transaction, if safeguards for its review are utilized.

Created for the perpetual benefit of Texans by William Lewis Moody, Jr. and wife, Libbie Shearn Moody

Section 4942. TAXES ON FAILURE TO DISTRIBUTE INCOME

These provisions would create a severe hardship to The Moody Foundation since the principal assets of The Moody Foundation consist of insurance company common stock and ranch land, neither of which provides income equal to five (5) percent of the fair market value of those investments.

Alternatives are suggested as follows:

(a) That all income, irrespective of the percentage of such income, be distributed by the end of the year following the year in which the income is earned with no requirement to earn a specified percentage; or,

(b) A period of five years be allowed in which to make accumulated distributions of income if such income is fixed at a required percentage. This would afford the foundation the time to dispose of assets in a business-like manner in order to create the availability of the specified percentage in cash or its equivalent. The requirement to sell assets within a one-year period in order to meet the required percentage would frequently cause the sale of assets at a highly discounted value. Or,

(c) Provide for the specified percentage on a gradually increasing basis; for instance, the first year require a one (1) percent distribution with a gradual increase to the final required percentage. This would afford the Foundation time to rearrange or sell portions of its assets to obtain the required percentage of income.

Section 4943. TAXES ON EXCESS BUSINESS HOLDINGS.

If legislation requiring disposition of control (as defined in proposed statute) is finally felt necessary, we would point out that it would be difficult and perhaps impossible to arrive at the twenty (20) percent level of ownership of the principal asset of The Moody Foundation within a five-year period. This is because the one asset involved representing eighty (80) percent or more of the value of the Foundation, has a potential market value of such a large amount (several hundred million dollars) that it would take a great deal of time to negotiate the sale of this single substantial asset. This asset consists of common stock in

American National Insurance Company, an unlisted stock. In addition, there is a restriction under an existing Trust which implies that portions of this stock can never be sold. Litigation is in process in an attempt to remove this restriction but there is opposition to such removal by interested parties. The time involved in settling this litigation and in handling the negotiations relevant to sale of the stock owned and controlled by this Foundation down to a level of twenty (20) percent would require a minimum of ten years to conclude the entire transaction.

The requirement to reduce control to less than fifty (50) percent within five years would be detrimental to the over-all transaction because the ability to sell a control position is precisely the advantage that would help to create the highest possible value for this asset. Eliminating fifty (50) percent control within a five-year period would tend to cause a serious reduction in the price the Foundation could obtain for its most important asset. H.R. 13270 attempts to give relief to problems such as those outlined above. However, a strict interpretation of the relief provision which might be helpful to The Moody Foundation problem might not give the relief required. The relief provision referred to is quoted below.

(D) Any period prescribed in subparagraph (A), (B), or (C) for the disposition of excess business holdings shall be suspended during the pendency of any judicial proceeding by the private foundation which is necessary to reform its governing instrument to allow disposition of such holdings." The above wording should be expanded to not only refer to the "governing instrument" but to both the governing instrument and any other trust or other instruments which might restrict disposition of such holdings. In the case of The Moody Foundation, a trust is involved which is not the "governing instrument" of the Foundation but this trust contains a provision construed by certain interested parties to be a prohibition against disposition of American National Insurance Company stock. Judicial proceedings are under way to attempt to interpret provisions of that trust in such a way that the holdings can be sold.

Adoption of a fixed 10-year period to reduce "control" would seem to be the simplest and most understandable method of accomplishing the purposes of these provisions.

Thank you for your consideration of these comments.

Very truly yours,

THE MOODY FOUNDATION

BY: Paul R. Haas

Paul R. Haas, Chairman
Board of Trustees

PRH:de

33-758 O - 69 -- No. 19 -- 27

Statement submitted by
Julius A. Rippel, President
Fannie E. Rippel Foundation

to the

Committee on Finance
United States Senate

in connection with the
Hearings on H. R. 13270, the Tax Reform Act of 1969

September 4, 1969

Statement submitted by
Julius A. Rippel, President
Fannie E. Rippel Foundation
September 4, 1969

The views concerning H.R. 13270 which I present to your Committee are my personal views. They result from sixteen years of active service as president of a foundation which is legally restricted to assisting institutions giving care and relief to aged women; erecting, equipping, maintaining and aiding hospitals; and assisting institutions engaged in treatment of or research in heart disease and cancer.

I believe previous Congresses have acted wisely and entirely for the public good in granting exemption from taxes to many charitable and philanthropic non-profit organizations, including foundations. Those which violate the clear letter of the laws applying to them should be dealt with quickly and firmly. I strongly oppose those who do this willfully and knowingly. They constitute a very small minority, and it should be recognized that often they do many other things which are proper and constructively add to the public welfare and benefit. Nevertheless, they do harm to all tax-exempt, non-profit charitable groups. At their worst, they not only violate the rules and regulations which they work under and which aid them, but they tend to diminish the confidence of our people and our legislators in the general structure of philanthropy and charity.

This is tragic because, of all nations on this earth, the United States of America has been most greatly benefited by the money, time and effort given by huge numbers of its people, in small amounts and in very large amounts, to create the finest structure of charity that has ever existed. The various Congresses have long helped in major ways to make this possible. This nation is the envy of countless people in many other countries because of its advanced system of private charity and philanthropy. Any weakening of our structure of philanthropy,

whether by legislation, public attitude or decreasing the effort or resources of philanthropy would be harmful for our people.

I have no interest in "covering up" any weaknesses or laxities. I do want the strengths and benefits kept openly in view. I do not seek any delay for its own sake, because the time for clarification is overdue. Nevertheless, I am greatly concerned to have whatever now needs to be done accomplished on the most constructive and encouraging basis possible.

The main purpose of my presentation of views concerning H.R. 13270, now before your Committee, is to request that you remove Title I in its entirety from the Bill you report to the Senate and that the current reconsideration of provisions concerning tax-exempt, non-profit organizations, including foundations, be made a separate and independent matter for further study and analysis by your Committee.

This is a serious and urgent request. It is made primarily for the benefit of the general public, or the "public interest", which private foundations and most non-profit organizations are in existence to serve, whether they be big or little in size and operation. In a second sense, it is also made for the benefit of the federal government itself in relation to its own obligation to serve the public interest and to be concerned with the overall welfare and benefit of the American people. The government needs every possible assistance from the "private sector". To restrain or discourage such assistance could be disastrous at a time when more is needed.

Title I is not genuinely tax-reform legislation - even though, for the first time, the House Bill would levy a tax on the income of private foundations. Title I is related to taxation and to tax exemptions; but it is, nevertheless, a complicated, and complicating, set

of regulations and sanctions concerned with the routine operation of foundations, and some provisions are so unclear or uncertain that it would be unfair to enact them into law. The other "taxes" mentioned are actually fines and penalties rather than taxes in a normal sense.

The proposed legislation is too basic in its nature, too fundamental and important to the life and welfare of our nation and too involved in the daily work of the non-profit organizations themselves for it to be finally determined as part of the process of constructing a tax reform bill mainly for profit business and individual persons. There has been pressure to get a major tax bill passed quickly. The matters contained in Title I should not be involved with this pressure and speed, nor decided under these conditions. They need more time and less pressure for their consideration and discussion. They need extensive and adequate opportunity for all non-profit organizations, small and large, to present their views - and, perhaps, of more importance, to discuss the reasons, the background and the operating experience which produce their views. They need this opportunity not only prior to the writing of a specific bill on this subject, but also after the proposed text of such a bill is completed.

Moreover, one important independent group is studying this subject of under what conditions federal tax exemption should be granted to non-profit organizations truly serving our people. A final rewriting of legislation should have the benefit of views of this independent study group. I do not plead for less consideration of the contents of Title I. I plead for a wider and complete consideration, not only of this title, but also of the entire specialized subject.

The House procedure gave no chance for testimony after the Tax Reform Bill's language was available. Most non-profit organizations

have not been able to give adequate study to the House Bill. Many could not get a copy until very recently, and normal vacation schedules and prior commitments have restricted the opportunity for study and conferences with professional advisors. Even now, relatively few smaller organizations and not all larger ones are prepared to give their considered views, nor would they have a chance to do so under the prevailing tight time schedule. Information in the press gives only the "highlights" and nothing on some of the most important provisions. These need wide attention and discussion - within the organizations affected, between them and their professional advisors, and by them with members of the Senate. To pass a bill without this chance risks creating continued uncertainty and misunderstanding and also wasting the time, effort and money of non-profit organizations and of the agencies of government involved in these matters. The net unfavorable results will fall ultimately upon the people who make up the "public interest". A poor bill, an inadequate bill, an antagonistic bill would be harmful and wasteful.

Urgent need exists to simplify and clarify the statutes concerning the bases upon which non-profit organizations are granted exemption from federal taxes. That should be the limit of federal legislation. The federal government does not incorporate or provide for the creating of these organizations. That is a state government function. The federal statutes are necessary and of great importance - but they should deal with the basic federal problems, the basis upon which non-profit organizations are granted federal tax exemption. Those many citizens who are subject to the provisions of the statutes need to have them written in clear, comprehensible language.

The motive of federal legislation should be to assure this. It ought to provide logical penalties for violating clear provisions of the statutes - but it should not penalize the entire non-profit organization system for the punished or unpunished violations of the few. I have a strong impression that statutes to do clearly and constructively what is needed might best make a fresh start and not necessarily base new legislation on the words and structure of previous statutes.

If such a separate and independent approach were made to reconsidering the statutes' provisions concerning private foundations, I would anticipate the following provisions might be included:

1. No self-dealing, and a clear provision that, once a foundation is in existence, it is to be operated solely as an independent entity devoted to and concentrating on its charitable and philanthropic purposes;
2. A reasonable and constructive provision for minimum annual grant appropriations which would not only prevent a foundation appropriating only a very small amount of grants annually because its capital fund holds securities which pay little or no income, but also which would not force other foundations, which do strive successfully against changing financial conditions to secure adequate income production, to invade their principal against their best independent judgment or the provisions of their charters;
3. No actual accumulation of income not appropriated for grants, but not to eliminate the right to hold in reserve funds which have been appropriated in

firm grants and which await payment until the grantees have met the terms or requirements of the grant to assure actual carrying out of the grants' projects;

4. Possibly, no grants directly to individual persons instead of to established non-profit organizations which might provide support to various qualified persons chosen by them for specified projects and purposes; but this is a very controversial subject;
5. No grants for plainly political purposes or activity;
6. No partisan grants for the purpose of trying to restructure the social fabric; and possibly no such grants, not even "non-partisan" ones; but this would be very difficult to interpret and to supervise;
7. A prohibition on outright "propaganda" by foundations, but with clear protection of their right to express their considered views and opinions on matters which involve their work and their activities and the interests of their grantees - even to legislative committees and individual legislators and other government officials;
8. No general tax levy on foundation income or corpus, but instead a registration or similar fee to support an adequate foundation auditing and supervision section of a branch of the federal government.

My experience and the observations gained from my foundation activity lead me to the firm conviction that no other feasible social or political vehicle exists to produce the benefits which American foundations and other non-profit organizations in the aggregate provide

for our people. Any tax levied on the income of the foundation I currently serve will be a tax upon the medical institutions it supports - and at a time when they require greater support, not less. I can think of no reason or justification to tax income of foundations unless the Congress is prepared to decrease the total sum available to operating non-profit organizations which foundations support. That is what such a tax would accomplish. The tax in reality would be a tax on those organizations. This would only punish the grantees of foundations. Moreover, whenever the subject of such taxes is thought of, more attention should be given to the fact that foundation expenditures, including their grants, promptly enter the taxable spending stream and become subject to federal and local taxes very quickly. Foundation income is expended, and it is not tax-sterile. It produces its share of tax revenue.

Many foundations often directly participate with or supplement and complement the work of various agencies of the federal government. Senator Lister Hill and others in government have long pleaded for greater support from the private sector to match the increasing need for appropriations and activity of the federal structure in areas of medical and health care in which many foundations and other tax-exempt organizations concentrate. The recent White House Report on Health Care Needs strongly stated the same essential need for support from the private sector. The Treasury Department's Report on Private Foundations urged greater effort, time and concentration by foundations on their charitable and philanthropic purposes. Every such organization has a limit on these resources, as well as on their money resources. These resources should not be wasted by hobbling them with unclear, threatening or unconstructive regulations. This would be a

grave disservice to the welfare of countless individual persons served or aided by these organizations. In a very real sense, the federal government and non-profit organizations are partners in serving the public interest, and I think the White House Report squarely recognizes this. We all need this relationship to expand and to become more meaningful. New legislation should result from the joint thinking and effort of both the Congress and tax-exempt organizations. Both groups have basic responsibility for the public benefit. The most constructive exercise of these responsibilities is urgently needed at this time.

I have no interest in any delay in this matter concerning foundations. On the contrary, I urge that what I have proposed be carried out as quickly as practically possible. Thus, I plead with your Committee to take the course which promises the greatest probability of providing constructive, effective and valuable new legislation concerning foundations and other non-profit organizations. I believe that course is to consider and decide these matters separately and independently of the controversial and complex problem of overall tax reform legislation - and to set this in motion promptly.

In the meantime, a concise action to provide an immediate registration or similar fee could be enacted to promptly support an adequate federal audit and supervision program for foundations and, possibly, for other tax-exempt organizations.

9/4/69

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Tax Reform Bill Proposals affecting Private Foundations: Report on H.R. 13270 as passed by House of Representatives

by

Special Committee on Exempt Organizations

SUMMARY

A. The Committee respectfully suggests that legislation at this time be limited to the problems of self-dealing, and public accountability, and that any broader legislation be deferred until after the Peterson Commission has reported.

B. With respect to the provisions of H.R. 13270, the Committee recommends that:

1. The investment income tax should be reduced and the proceeds earmarked for administration of the private foundation rules; and deductions should be clearly provided for depreciation, interest, casualty losses and other expenses.

2. "Bargain sales" to foundations should be permitted as an exception to the self-dealing rules.

3. Broader deductions should be permitted for the minimum distribution requirement; "private operating foundations" should also include foundations which, although primarily supported by only one or two foundations, expend their grants promptly and directly for exempt purposes.

4. If divestment of controlling interests in business enterprise is to be required, longer and more flexible divestment schedules should apply; and redemptions of stock by the controlled business enterprise should be permitted by relaxation of the accumulated earnings tax rules.

5. Existing rules on legislative activity should be retained; otherwise, clarifying amendments are required; and "expenditure responsibility" should be clarified.

6. The penalty for speculative investments seems unworkable and unnecessary.

7. The disclosure provisions are sound.

8. The sanctions over 100% (self dealers and foundations) and over 50% (managers) should be reduced; abatement of the tax where payment is made to the foundation should be allowed; and rules regarding

the burden of proof should be adopted.

9. Technical amendments are necessary for §§ 507-509.

DISCUSSION

A. The Committee believes that the provisions of H.R. 13270 relating to private foundations are unnecessarily severe and complex, and that they are inconsistent with our traditional concepts of private philanthropy. It is respectfully suggested that legislation be confined at this time to the problems of self-dealing and public accountability, and that further action might appropriately be deferred until the Peterson Commission can render a report. The substantive provisions and sanctions provided in H.R. 13270 represent a complex and heretofore untried code. They should be subjected to intense study before enactment.

B. The Committee's specific recommendations and comments on the provisions of H.R. 13270 are as follows:

1. Tax on Investment Income

The Committee believes that the 7.5 percent tax on private foundation investment income to be levied by § 506 is inconsistent with the tax exemption embodied in § 501(a). While the complex code governing private foundation activities that H.R. 13290 proposes would require increased audit

and administrative outlays by the Internal Revenue Service, the 7.5 percent tax is not earmarked for administration of the foundation rules and, indeed, the House Report concedes that the tax is only "in part a user fee." H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. (hereafter "H. Rep. (Part 1)"), p. 19. Thus, the tax is as much a revenue raising measure as the taxes levied by § 1 (individuals) and § 11 (corporations). Enactment of the tax would be a significant step toward eliminating private charity; the next step is an extension to all charitable, educational and even religious organizations; the principle, once established, invites state and local governments to adopt such taxes, and all levels of government will find it easy to raise the tax rate a few percentage points at a time.

With respect to the language of § 506, the deductions that are to be allowed in computing "net investment income" should be clarified. As presently drafted, § 506(a)(3) allows "all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income." This language is substantially identical to that of § 212, which allows individuals to deduct expenses that would be

deductible under § 162 but for the lack of a trade or business. Thus, § 506 may be interpreted as permitting only similar deductions. As a result, private foundations would be denied allocable deductions for interest, state and local taxes, depreciation, casualty losses and other outlays ordinarily deductible by individuals and corporations. Indeed, the House Report recognizes the deficiency in the language by expressly stating that depreciation is to be deductible. H. Rep. (Part 2), p. 2. A committee report is not an adequate substitute and the Committee recommends that the provision be rewritten to allow all deductions allowable to a corporation computing its tax under § 11 with specific omissions and additions. Compare the pattern adopted for computing unrelated business income. Code § 512(a) and (b).

2. Self-Dealing

The Committee concurs in the substantive rules adopted to prohibit self-dealing (§ 4941(d)), except for the failure to sanction "bargain sales" of property. Without such an exemption, private foundations may be deprived of a significant source of support, and indeed, this principle should be retained for all charitable gifts. Compare H. Rep. (Part 1), pp. 53-56. The general allocation of basis proposal should, of course, be applied.

As to sanctions, the Committee endorses the principle of penalizing the wrong-doer rather than the charity,

33-758 O - 69 -- No. 19 -- 28

but it has serious reservations about the severity and extent of what is proposed. See Part 8, <u>infra</u>, p. 12.

3. <u>Minimum Income Distribution</u>

The Committee believes that § 4942 should be clarified to insure that the minimum distribution requirement is applied to the amount of income which a private foundation actually has available for distribution without drawing upon capital. At present "adjusted net income" is computed after the allowance only of (§ 4942(f)(3)(A)) "all the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income." This language may be interpreted to permit only § 212 deductions and, indeed, the House Report finds it necessary to make a clarifying comment about depreciation. (H. Rep. (Part 2), p. 11). As in the case of the 7.5 percent tax (Part 1, <u>supra</u>), Section 4942(f)(3) should be amended to permit all deductions allowable to corporations computing their tax under § 11 with specific omissions and additions. Compare Code § 512(a) and (b).

We also urge that an additional category be added to the definition of "private operating foundations", gifts to which are treated as qualifying distributions for the purpose of the minimum distribution. In order to prevent foundations from distributing funds to each other, § 4942(j)(3)(B)

requires a "private operating foundation" to derive its support from five or more private foundations. H. Rep. (Part 1), p.26. Even if this concern is warranted, the Committee is afraid that the broad support requirement will result in (a) the denial of all support to fledgling foundations with an untried idea (e.g., educational television) and (b) evasion of the provision through a pattern of reciprocal grants among foundations. The House's concern and the need for "risk" funding can both be satisfied by waiving the broad support requirement for a private foundation which undertakes prompt and direct expenditure for exempt purposes of its foundation grants. Compare the organizations qualified for the unlimited charitable deduction under § 170(g)(3), and for gifts of appreciated property under § 201(c) of the bill.

4. Business Ownership Limitation

The Committee believes that control of a business by a foundation is not less in the public interest than, say, control by a great university. In any event, it believes that the 2, 5 and 10 year disposition schedule provided by § 4943(c)(4) for existing holdings is unworkable. The exceptions provided for one or two specific cases simply illustrate the fact. Bill § 101(k)(4),(5). Present business holdings vary from publicly traded to closely held corporate stock. In some instances, the limitation may be satisfied by

a quick sale by the foundation or principal donor. In other instances, the only market will be the donor or the corporation itself, and considerable planning and expense will be required to extricate the stock without swamping the market and thus injuring both the foundation's capital and the business. Consequently, the disposition schedule should afford considerable flexibility. A minimum period of 10 years should be provided, with provision for extension by the Commissioner upon a showing of hardship. Contrary to the House Report, market fluctuation should be recognized as a basis for such a showing. In addition, corporations should be allowed to accumulate funds necessary to redeem stock held by foundations free of the accumulated earnings tax.

Consistent with what has been said above, it is believed that a minimum period of 10 years, in addition to a reasonable period of estate administration, should be made available for disposition of excess business holdings acquired by will, and the 10 year period be applied in the case of gifts as well. Under the proposed rules, the conglomerates are likely to gain and charity to suffer. It is noted that under section 4943(c)(5), the 2, 5, 10 year period would apply to bequests under wills executed before July 29, 1969. Otherwise a straight 5 year period applies to gifts and bequests under section 4943(c)(6). The latter provision also seems to contemplate that a redemption from a non-disqualified

person can result in an excess holding subject to 5 year divestiture.

5. Taxable Expenditures

The Committee agrees with the objective of preventing foundation participation in political campaigns. However, it believes that present law regarding legislative activity is preferable to the new proposal. The existing limitation in § 501(c)(3) has been in effect for many years and has been interpreted by numerous judicial and administrative rulings. See St. Louis Union Trust v. United States, 374 F.2d 427 (8th Cir. 1967); and Treas. Regs. § 1.501(c)(3)-1(c)(3). The principal problems in this area have been the weakness of the one sanction -- loss of exemption -- and lack of enforcement. These problems will be substantially eliminated by the multi-level sanction system of § 4945(a) and the expanded audit that will be financed by the net investment income tax. Consequently, the Committee believes that the first sentence in § 4945(c) should be eliminated,* and the second sentence, which exempts from tax activities relating to the foundation's own status, should be redrafted as an exception to subsection (b)(1), which defines as taxable expenditures amounts paid "to carry out propaganda, or otherwise attempts to influence legislation."

* That sentence reads:

(c) CERTAIN ACTIVITIES EXPRESSLY INCLUDED WITHIN SUBSECTION (b)(1).--For purposes of subsection (b)(1), the term 'taxable expenditures' includes (but is not limited to)--

If § 4945(c) is retained, it is suggested (a) that §4945(c) be amended to state that "For the purposes of subsection (b)(1), the term 'taxable expenditures' means --"; (b) that subsection (c)(2) be amended to read "any attempt to influence specific legislation through private communication with (except at the request of) any member or employee of a legislative body, or with any other public official who may participate in the formulation of the legislation"; and (c) that the list of permissible activities in subsection (c) be amended to include "making available the results of non-partisan analysis or research or furnishing technical assistance."

With respect to "expenditure responsibility," the Committee endorses the detailed reporting provisions of § 4945(f), but believes that the requirement of "see[ing] that the grant is spent solely for the purpose for which

---

* (Footnote continued)

"(1) any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof, and

"(2) any attempt to influence legislation through private communication with any member or employee of a legislative body, or with any other person who may participate in the formulation of the legislation, other than through making available the results of non-partisan analysis or research.

made" is unworkable. Private foundations cannot be made absolute insurers of their grantees' performance; not only are there reasonable limits on the amount of charitable funds that are to be consumed in administration, but private foundations should not be liable for a tax because of embezzlement or theft. Detailed reporting and interviews are the only effective measures.

6. Use of Foundation Assets

Section 4944 levies a 100 percent excise on a foundation -- and a 50 percent excise on a participating manager -- which invests its funds "in such a manner as to jeopardize the carrying out of any of its exempt purposes." No definition is attempted either in the bill or the House Report. While a similar provision exists in § 504(a)(3), there has been no administrative (Treas. Regs. 1.504-1) and little judicial (Samuel Friedland Foundation v. United States, 144 F. Supp. 74 (N.J. 1956)) development of it. The need to discourage foundation investment in losing businesses, which may have prompted this provision (Treasury Department Report on Private Foundations (G.P.O. 1965), p. 35), will be fulfilled by the limitation on business holdings. Moreover, state enforcement authorities have a responsibility in this area. See generally Cary & Bright, The Law and the Lore of Endowment Funds (Ford Foundation 1969), pp. 56-65. In sum, the provision seems unworkable and, in fact, unnecessary.

7. Disclosure and Publicity

The Committee concurs in the amendments to §§ 6033 and 6652 insofar as they are made applicable to private foundations.

8. Sanctions

Viewed collectively, the sanction system proposed is a highly flexible innovation, but in some respects it is erratic. In summary, the following sanctions are provided:

Level I

(a) Federal

	Foundation Tax			Manager Tax		
Activity	Initial	Add.	Limit	Initial	Add.	Limit
Self-dealing*	5%	200%		2.5%	50%	$10,000
Minimum distribution	15%	100%				
Business holdings	5%	200%				
Taxable expenditure	100%			50%		
Speculative investment	100%			50%		
Reporting	$10/day		$5,000	$10/day		$ 5,000

* The self-dealer, rather than the foundation, is liable for the 5% and 200% excises.

(b) State

Enforcement of charter provisions against self-dealing, etc., required by § 508(g).

Level II

Section 6684 provides a 100% penalty for repeated or "both willful and flagrant" violations by "any person" of §§ 4941-4945, relating to self-dealing, minimum income distribution, excess business holdings, speculative investments, and political and legislative activity.

Level III

Section 508(e) provides for loss of exemption and requires the turnover of foundation assets to the Government or to other charities for either "willful repeated acts" or "a willful and flagrant act" giving rise to liability under §§ 4941-4945, relating to self-dealing, minimum income distribution, excess business holdings, speculative investments, and political and legislative activity.

The first level is questionable in several respects. First, since protecting the revenue against abuse of exempt status, rather than raising revenue, is the object, the self-dealing excises applicable to the disqualified person and the foundation manager should be abated upon payment of an equivalent amount to the foundation.

Second, the manager taxes raise several problems. Foundation trustees and directors, for the most part, render uncompensated and part-time service, believing that they are performing a public service. The potential liability which

they will risk as the result of the bill will lead to substantial resignations and require foundations to compensate their managers for the risk and work involved.

To minimize this danger, and yet insure manager responsibility, several steps are appropriate: (1) Maximum limitations should be adopted for all of the manager excises, such as those presently provided for the self-dealing excise and the reporting penalty. §§ 4941(c)(2), 6652(d)(2). (2) Consideration should be given to reducing the 50 percent excise applicable under the taxable expenditure (political campaign and legislative activity, and expenditure responsibility) and speculative investment rules. The amount of these excises is in stark contrast to the only 2.5 percent initial manager tax applicable to the equally condemned self-dealing situation and to the absence of any manager levy for excess business holdings and minimum distribution situations. In addition, these excises are applicable to "knowing" violations of the foundation rules and thus may lessen the incentive for managers to give detailed attention to foundation activities. The solution would be to adopt an excise for negligence or for intentional disregard of the foundation rules. Compare § 6653(a) (5% addition to tax for negligence). (3) If the 50 percent manager excises are retained, then the penalty and the act are the equivalent of fraud and the Government should have the burden of proving such acts. Compare § 6653(b)

(50% fraud addition to tax) and § 7454(a) the burden of proving fraud is on the Government).

Third, no excise should exceed 100 percent. The 200 percent "additional" self-dealing and business ownership levies are excessive. Payment to the Government of the amount uncorrected satisfies the need to protect the revenue and is sufficient to negate the possibility that some may view payment of the tax as a "cost" of the transaction. The additional penalty has no place in a civil statute.

9. Foundations Defined; Termination of Status

The Committee suggests that consideration be given to changing the "substantially more than half of the assets" test for operating foundations to the test of "a substantial part". A foundation that has a "substantial part" of its assets devoted to the active charitable activity, and spends substantially all of its income each year directly for the conduct of such activity, would appear to be a legitimate "operating" foundation; and it does not appear that it should be disqualified merely because it has a substantial investment portfolio representing more than 35% of the value of its total assets. The 65% rule for "substantially more than half" suggested in the House Report could in any event create confusion for a foundation whose investment portfolio may be above the line one year and below the line in another.

The committee suggests a technical amendment to clarify the qualifications for broadly supported organizations covered by § 509(a)(2). It is not clear whether contributions which exceed 1 percent of a foundation's support may be taken into account in any respect. Accordingly, § 509(a)(2)(A)(ii) should read -- "not including the portion of such receipts from any person * * * which are in excess of 1 percent." Similar treatment is presently provided for publicly supported charities for the purposes of the unlimited charitable deduction. Treas. Regs. § 170-2(b)(5)(iii)(b). Apparently capital gains are not to be included for purposes of determining normal "support", but it is suggested that the proposed statutory language of section 509(a)(c)(A) and (B) be clarified in this regard.

Section 508 contains several relatively unrelated provisions and it is suggested that they be redistributed as follows:

Subsections (a), (b) and (c), which require § 501 (c)(3) organizations to register with the Commissioner and presumes them to be private foundations until a contrary showing is made, is applicable to all charitable organizations. Accordingly, it should be placed in Part I as a new § 504.

Subsections (d) and (e) deal with termination of private foundation status and should be joined to Section 507.

Subsection (g), which denies §501(c)(3) treatment to private foundations which do not have charter provisions incorporating the rules regarding self-dealing, income distribution, business holdings, speculative investment, and political and legislative activities, should be added to §509, which defines private foundations.

The Committee suggests that the operation and distribution rules for abatement of the tax on termination of foundation status be made parallel. Under § 507(e), the tax may be abated either by distribution to a § 170(b)(1)(B) organization or by operation for 5 years as either a § 170(b)(1)(B) organization, a broadly supported foundation (§ 509(a)(2)), or a satellite of one of the foregoing (509(a)(3)). Broadly based organizations are similar, but not identical, to § 170(b)(1)(B) organizations and distribution to one should occasion abatement. Charitable trusts should be entitled to abatement upon distribution to such foundations also. Compare §§ 4947(b)(5).

In allowing the Commissioner discretion to abate the termination tax, the statute provides no standard for withholding abatement. Either a standard should be added or the word "shall" should be substituted for "may" in the second line of § 509(e).

STATEMENT ON THE TAX REFORM ACT OF 1969

H.R. 13270

Submitted to the Committee on Finance, United States Senate

By

Landrum Bolling, President of Earlham College, Richmond, Indiana

Submitted on Behalf of

<u>The Associated Colleges of the Midwest</u>

Beloit	Cornell	Macalester
Carleton	Grinnell	Monmouth
Coe	Knox	Ripon
Colorado	Lawrence	St. Olaf

and

<u>The Great Lakes Colleges Association</u>

Albion	Earlham	Oberlin
Antioch	Hope	Ohio Wesleyan
Denison	Kalamazoo	Wabash
DePauw	Kenyon	Wooster

October 3, 1969

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.

33-758 O - 69 -- No. 19 -- 29

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 excercise 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 additons.

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 Ph. D in biology at Stanford University.
2. Candidate for Ph. 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.

TAX REFORM BILL OF 1969

Private Foundations - Sec. 4943

Taxes on Excess Business Holdings

This memorandum is submitted on behalf of The Stackpole-Hall Foundation, St. Marys, Pennsylvania.

The proposed Section 101(b) of the Tax Reform Bill of 1969 would amend the Internal Revenue Code by adding Sections 4941-4947 dealing with controls, restrictions and penalties with respect to private foundations. Sec. 4943, which is the subject of the memorandum, in essence imposes penalties on holdings of stock by the private foundation where the amount of voting stock of any corporation held by the foundation and all "disqualified persons" exceeds 20%. "Disqualified persons" are related persons, such as substantial contributors, members of the foundation, 20% plus voting stockholders in the corporation, members of the family of such persons, etc. Relief from the penalty taxes may be obtained by the foundation's divesting itself of its stock holdings within a 10-year relief period, which also may require the reduction in the stock holdings of the disqualified persons to a less than 50% voting stock position. The provisions have an effective date of taxable years beginning after December 31, 1969.

It is submitted that the provisions of the proposed Sec. 4943 are undesirable and unnecessary for the reasons set forth as follows.

1. The provisions are punitive and inequitable, and have an aspect of entrapment. The Federal tax law and the administration of it by the Internal Revenue Service and the courts has authorized and encouraged the creation of private foundations and the holding by said foundations of stock of related corporations. As a consequence, thousands of such family or private foundations have been created and for many years have served an important charitable function. The tax law to date has, accordingly, induced the creation by taxpayers in good faith of a major financial and economic structure. To now adopt a complete reversal of the tax rules and require the dismantling of this structure, with the attendant economic risks and disruptions involved, would seem to be a clearly inequitable action.

2. The provisions are contrary to the economic policy of protecting the independence of small business. Elsewhere governmental policy is to restrict and limit economic "bigness", the growth of conglomerates and the

acquisition of the small independent business corporation by the giants. The effect of the provisions of Sec. 4943, if enacted, would be to the direct contrary, by reason of the sale and divestiture of the corporate stock and ownership control required to avoid the penalty tax.

3. The reforms proposed apart from Sec. 4943 are in themselves sufficient to achieve adequate controlling and policing of private foundations, which is the objective, and make the provisions of Sec. 4943 unnecessary. Sections 4941, 4942, 4944 and 4945 impose taxes and penalties on self-dealing between the foundation and related persons, on failure of the foundation to distribute its income with regularity, on improper investments incompatible with the charitable purpose and on expenditure of funds for improper purposes. If these provisions were to be enacted, private foundations conducting their affairs so as to avoid the application of such penalty provisions would be "clean" foundations operating in a completely acceptable manner.

4. The provisions of Sec. 4943 entail risk of serious economic consequences to persons other than the private foundation and its related persons. As has been indicated above, the requirements for disposal of stock and ownership control in many cases could involve serious economic

results to the persons involved. In addition, many of the private foundations affected are major community institutions, especially in the small community and non-urban areas. The economy and welfare of the area are frequently tied in to a major degree with the activities of the foundation and also with the corporate enterprise involved. If the tax law requires sale of the business to outside interests, a clear risk exists in all such cases of the business leaving the area with the obvious highly prejudicial economic results. Sec. 4943 could in many situations have exactly this effect.

5. Sec. 4943 requires disposal of stock by the foundation when no purpose is served. Under the proposed provisions, if the foundation has no voting stock of the corporation but merely non-voting, it still must sell the stock if more than 20% of the voting stock is owned by disqualified persons outside the foundation. The relation of this to improper use of foundations has not been demonstrated. This provision of the Section should be removed as irrelevant and superfluous.

6. The provisions should at a minimum carry a "gradfather clause". To suddenly change the rules at this date after authorizing and encouraging good-faith taxpayers

to create private foundations is legislating of the most dubious and inequitable nature.

The Stackpole-Hall Foundation was created November 9, 1951 as a Pennsylvania trust by the Stackpole and Hall families of St. Marys and Ridgway, Elk County, Pennsylvania. The Stackpole Carbon Company was organized in 1906 by the same families(Mr. Harry C. Stackpole and his father-in-law Senator J.K.P. Hall) and has been controlled by them from organization to date. The Company's main office and plants are in Elk County, and it is the largest business enterprise in said County, employing 3,523 persons at date of this memorandum. The population of Elk County is approximately 35,000. The Company is also the largest independent in the carbon products industry.

Stackpole Carbon Company's stock is unlisted, untraded and closely held by the Stackpole and Hall families, plus a few employees and unrelated persons. The Company is constantly being importuned by national companies to be acquired, but the policy of the owners is to remain independent and continue to operate as such for the benefit of the Company's owners and employees and the surrounding community.

The Stackpole-Hall Foundation has become a major and vital institution in the area and provides a source of

funds for community needs not otherwise available. It has distributed all its net income annually since inception, plus substantial amounts of principal. Distributions for 1966, 1967 and 1968 were respectively $252,400, $322,159 and $310,840. Total distributions since organization of the Foundation are $3,522,209, divided between charitable organizations (hospitals, Boy Scouts, YMCA, United Fund, library, etc.) $1,981,721, educational organizations (schools, colleges, educational funds) $601,610 and religrious (churches, convents) $969,575. 88% of the total since organization has gone to area organizations, which is typical of the annual pattern. The contributions to the Foundation have been made by the Stackpole and Hall families and the Company.

The Foundation has been operated with meticulous adherence to the most conservative interpretation of the exempt organizations provisions of the tax law. There has been no dealing between the Foundation and the Company or any individuals or for their benefit in any way. The Foundation holds no voting stock of the Company, but a substantial amount of non-voting common and preferred, which as indicated is without a market.

The Stackpole-Hall Foundation is typical of many private foundations serving a most important function with

adherence to the tax laws under which they were organized in good faith. It is submitted that to impose the proposed provisions of Sec. 4943 on the Foundation and its beneficiaries and the Company's stockholders is inequitable, unnecessary and unwise. The revenue and fair and honest dealing will be adequately protected without such provisions in the tax law.

Richard F. Barrett
30 Federal Street
Boston, Massachusetts 02110

September 29, 1969

-- 7 --

STATEMENT OF
WALTER P. REUTHER, PRESIDENT, UNITED AUTOMOBILE,
AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)
BEFORE THE SENATE COMMITTEE ON FINANCE
October 3, 1969

My name is Walter P. Reuther. I am President of the United Automobile, Aerospace, and Agricultural Implement Workers of America, representing approximately 1,800,000 members. I present these views on tax reform proposals on behalf of the UAW.

Among UAW members and among the American people at large, there is today a surging demand for reform of the tax system. Over the years, inequities and injustices have multiplied and compounded, so that countless citizens in the low and moderate income brackets bear a disproportionate share of taxation, while higher bracket taxpayers have their tax burdens reduced and even eliminated by loopholes in the law.

Increasingly, low and moderate income taxpayers have become acutely aware of tax injustice. Today, that awareness has resulted in firm demands that Congress restore justice to the system. A tax revolt is truly in progress.

The burden of federal taxation which the average taxpayer bears is made more onerous by the additional weight of state and local taxes. These taxes are sharply regressive, hitting those with lower income proportionately much harder than the

Table 1

When All Taxes Are Counted: Who Gets Hit, How Much

Income Group	Average Annual Family Income a/	Average Total Taxes Paid b/	Taxes as Percentage of Income	Average Income After Taxes a/
Under $3,000	$ 1,659	$ 564	34%	$ 1,095
$ 3,000-$ 5,000	3,939	1,221	31	2,718
$ 5,000-$ 7,000	6,000	1,980	33	4,020
$ 7,000-$10,000	8,578	2,745	32	5,833
$ 10,000-$15,000	12,387	3,840	31	8,547
$ 15,000-$25,000	20,232	5,665	28	14,567
$ 25,000 and over	51,879	14,526	28	37,353

a/ Calculated from other data in table.

b/ Includes federal and state income taxes; Social Security payroll taxes; sales, property, and all other taxes.

Basic data: U. S. Departments of Commerce, Labor, Treasury and Health, Education and Welfare; Federal Housing Administration; Tax Foundation and other private sources

SOURCE: U. S. News & World Report

rich. The extent to which federal, state, and local taxes combined (including business taxes which are passed on to consumers in the form of prices) bear more heavily on those who can least afford to pay is detailed on Table 1. This table was prepared by the economic unit of U. S. NEWS AND WORLD REPORT, and appeared in that magazine on December 9, 1968.

The average family receiving less than $3,000 in annual income has to pay 34% of its income in federal, state, and local taxes. The percentage falls to 28% for the average family receiving $25,000 and over. (We have added data on average family income before and after taxes calculated from the figures provided by U. S. NEWS AND WORLD REPORT.) The unjust sharing of the tax load would undoubtedly be even more apparent if the figures were broken down to give separate averages for families with very large incomes.

Recently, members of Ford Local 600 in Detroit, one of the largest local unions in the UAW, with a membership of about 50,000, collected thousands of names of other workers, housewives, and retirees on a petition seeking tax reform, addressed to the Hon. Wilbur Mills, Chairman of the House Ways and Means Committee. These men and women are angry at the injustice and inequity they see in our present tax system. They are petitioning you, as Members of Congress, to do something about it. They are going to get angrier unless Congress acts to assure that the tax burden is shared more equitably based upon

33-758 O - 69 -- No. 19 -- 30

the sound and democratic principle of ability to pay.

In our opinion, that should be the first and overriding principle of any tax system--the achievement of justice and equity based upon the principle of ability to pay. It requires that at one end of the scale, there should be no net taxation of incomes which fall below the poverty line; at the other end of the scale, there should be no opportunity for wealthy individuals or corporations to escape taxation at equitable rates on all or part of their income; and in-between, there should be a reasonable progression of effective tax rates, so that a higher percentage of large incomes is taken than of small.

A second principle is that taxation should be of a nature which interferes as little as possible with the natrual processes of the economy, except to the extent that such interference is a matter of deliberately planned public policy to meet national goals and objectives. Sound tax policy should avoid the situations in which a tax provision enacted for one purpose has a secondary, unintended consequence of distorting the economy by making attractive, through tax avoidance, a form of economic activity which, without such special treatment, might be found uneconomic. We are thinking in particular of some of the provisions regarding taxation of capital gains, and the effects of tax exemption on the interest of state and local government bonds.

The third principle is that, subject to the other two principles stated, tax programs should be as much simplified as possible.

Of the many inequities in our tax structure, few can match the complete avoidance of tax payments by the well-to-do. The income tax statistics for 1966, the latest year available, show that there were 12,088 individual tax returns which reported adjusted gross incomes of $15,000 or more, with an average income of over $35,000, but which were completely nontaxable. Of these 12,088 nontaxable returns, 367 reported incomes of $100,000 or more, averaging $383,000 apiece; 18 of them reported incomes of $1,000,000 or more, averaging nearly $3,340,000 apiece. (See Table 2)

At the other end of the scale, we are today taxing many families who live in actual poverty--and taxing into poverty families who are on the verge. Table 3 shows the poverty-line and near-poverty-line income figures, as defined by the Social Security Administration and adjusted to reflect price levels as of January, 1969, for nonfarm families of various sizes. Table 3 also shows the combined income tax and Social Security premium that would be paid by the head of such a family, assuming all his income is earned and is subject only to the appropriate exemptions and the standard deduction. (In the case of a family of "7 or more," the taxes are calculated on the basis of 8 members, since it is clear from the figures that this is

approximately the size of family for which the income is indicated.) These poverty and near-poverty income figures are conservative in the extreme. For example, the allowance for food budgets for the poor is considered by the Department of Agriculture as "temporary or emergency use when funds are low."

For the near poor, the food expenditure "by no means guarantees that diets will be adequate." (Social Security Bulletin)

Impact of Federal Taxes Alone

While the income tax system is intended to be progressive throughout, it is in fact regressive for the higher income brackets. Based on data from the table on page 81 of "Tax Reform Studies and Proposals, U. S. Treasury Department, Part 1," of last year, together with data from the "1966 Statistics of Income," Table 4 shows that while the standard tax rate--the rate that would be paid if no deductions were taken except the standard deduction--increases steadily with rising income, actual taxes paid begin to decline as a percentage of income somewhere near the $200,000 income bracket.

While these figures do reflect the excluded portion of long-term capital gains, there are additional kinds of income not included which make the presentation conservative--e. g., exempt interest on state and municipal bonds, deductions for unlimited charitable contributions, special percentage depletion allowances, etc. (The chart following the table graphs

Table 2

Nontaxable Returns Reporting Income Over $15,000 -- 1966

Adjusted Gross Income Class (AGI)	Nontaxable Returns		
	Number	Total AGI (millions)	Average AGI Per Return
$ 15,000 under $ 20,000	6,0[illegible]0	$ 103.7	$ 17,226
20,000 under 50,000	5,084	141.6	27,852
50,000 under 100,000	617	42.7	69,206
100,000 under 200,000	213	28.5	133,803
200,000 under 500,000	103	30.8	299,029
500,000 under 1,000,000	33	21.2	642,424
1,000,000 or more	18	[illegible]0.1	3,338,889
Total $15,000 and over	12,088	428.6	35,457
Total $100,000 and over	367	140.6	383,000

SOURCE: U.S. Treasury Department, I.R.S.; 1966 Individual Income Tax Returns

Table 3

Federal Taxes Paid By Families at Poverty and Near-Poverty Line Incomes

Household Size a/	Poverty Line Income b/	
	Amount	Total Federal Tax c/
1 Member	$1,903	$ 211
2 Members	2,338	206
3 Members	2,782	190
4 Members	3,568	238
5 Members	4,205	259
6 Members	4,719	254
7 or more Members	5,810	257 d/

Household Size a/	Near-Poverty Line Income b/	
	Amount	Total Federal Tax c/
1 Member	$2,188	$ 294
2 Members	3,151	365
3 Members	3,665	357
4 Members	4,649	439
5 Members	5,436	489
6 Members	6,099	513
7 or more Members	7,431	562 d/

a/ Nonfarm household head, under 65.
b/ Adjusted to reflect price level of January 1969.
c/ Federal income tax plus Social Security tax.
d/ Tax calculation based on 8 members.

SOURCE: Based on 1969 Economic Report of the President; U.S. Master Tax Guide

Table 4

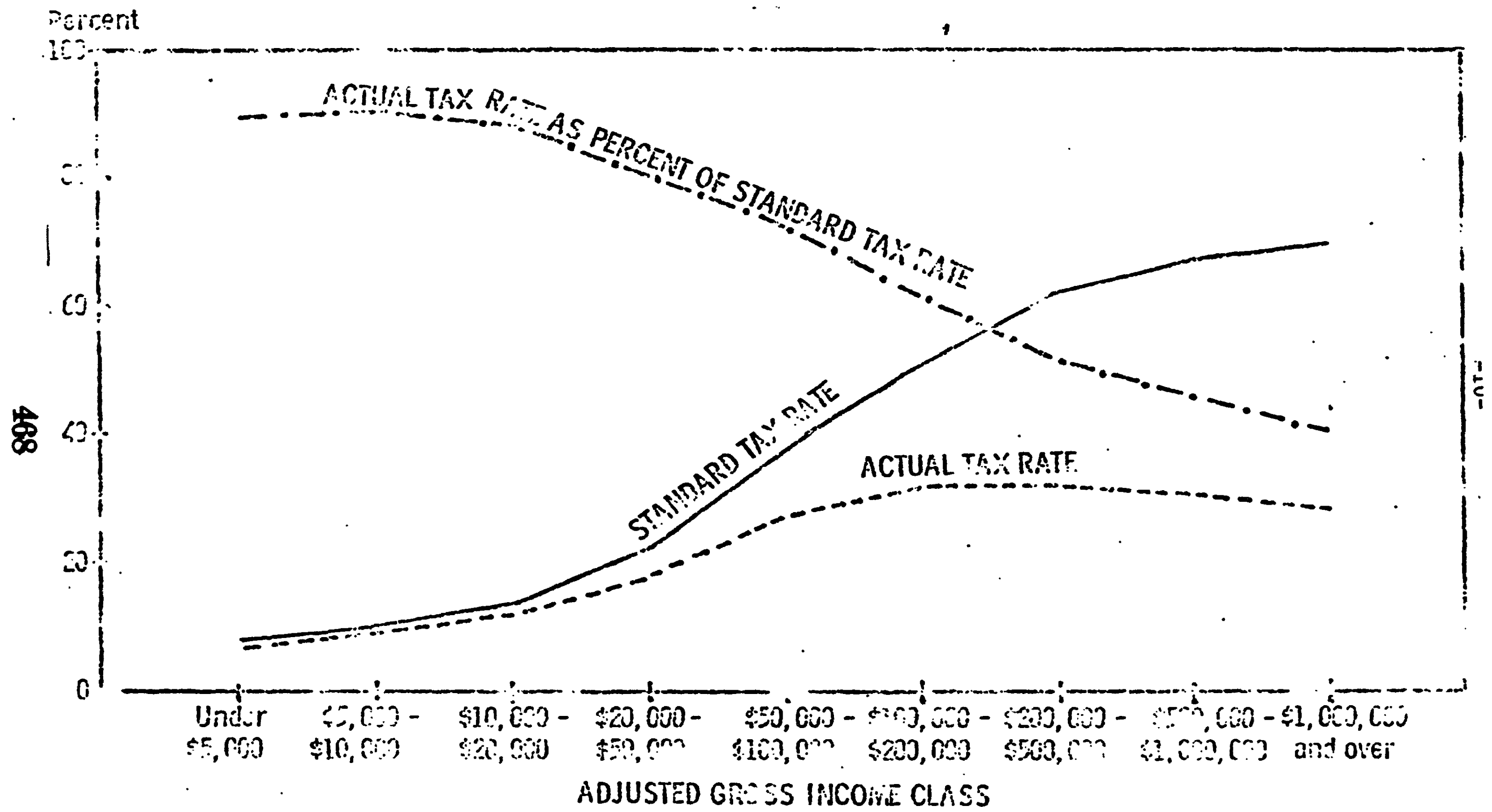
Effective Actual Tax Rates and Effective Standard Tax Rates By Income Group
1966

Adjusted Gross Income Class	Effective Rate on Amended Adjusted Gross Income a/		
	Standard Tax b/	Actual Tax	
(thousands)	(percent)	(percent)	(standard=100) c/
0 - $ 5	8.3%	7.4%	39
5 - 10	10.4	9.4	90
10 - 20	13.9	12.2	88
20 - 50	22.5	18.0	80
50 - 100	38.0	27.3	72
100 - 200	51.1	31.9	62
200 - 500	62.1	32.0	52
500 - 1,000	67.1	30.7	46
1,000 and over	69.2	28.4	41

a/ Amended adjusted gross income includes income from capital gains.
b/ Standard amended taxable income computed by subtracting exemptions and standard deductions from estimated amended adjusted gross income. All standard amended taxable income taxed at rate for joint returns except that reported by single individuals.
c/ Actual effective tax rate divided by effective standard tax rate.

SOURCE: Tax Reform Studies, Part 1
UAW Research Department estimates based on
"1966 Statistics of Income"

BEST AVAILABLE COPY



DATA: Tax Reform Studies, Part I; 1968 Statistics of Income

the fact that the actual tax rate paid by income group as a percentage of the standard tax declines the higher the income group.)

The effect of including these amounts is shown for the higher brackets on page 110 of the same Treasury study. For incomes from $100,000 to $500,000, while the income tax paid is 46.3 percent of taxable income, it is only 16.8 percent of total income. In the $500,000 to $1,000,000 bracket, the tax has risen to 54.1 percent of taxable income, but it has fallen to 11.7 percent of total income. Over $1,000,000, the tax is 52.3 percent of taxable income, but only 10.3 percent of total income. In other words, over 80 percent of total income in this top bracket is nontaxable.

Taxing the Poor Must End

The chief inequity afflicting low income taxpayers is the taxation of poverty incomes. There are various proposals which have been advanced to eliminate this unconscionable levy. In my testimony before the House Ways and Means Committee (April 3, 1969), I suggested several alternative methods.

An additional proposal calling for a minimum standard deduction of $1,100 for all families has been put forth by the National Committee on Tax Justice, of which I am a member. With such a minimum standard deduction, plus current exemption provisions, families living below the poverty line, as presently defined, would be excluded from the payment of federal income

tax. Such a minimum standard deduction would benefit millions of families, mostly wage earners, who are now being squeezed between the pressures of inflation and an unjust tax burden. The minimum standard deduction of $1,100 would modestly assist most of these overburdened taxpayers with incomes up to $11,000.

The Tax Reform Act of 1969 (H. R. 13270) adopted this part of the reform package which the National Committee on Tax Justice had proposed. That provision goes far in meeting the objective of the reform of the NCTJ to remove from the tax rolls persons who fell below the poverty line income figures. It has been estimated that close to six million poor persons who now, despite their impoverished state, pay federal income taxes will be relieved of that inequitable burden.

A second step taken by the Tax Reform Act of 1969 which we support is the raising of the standard deduction to 15% with a $2,000 maximum. That long-needed liberalization of the standard deduction provisions, along with the new minimum standard deduction, will provide much needed tax relief for low and middle income families. That too was an important component of the reform advocated by the National Committee on Tax Justice, and we urge its retention by the Senate.

Among the special provisions that favor the wealthy and which must be corrected if we are to have a fair tax system, are the treatment of capital gains and percentage depletion allowances, the handling of charitable contributions, provisions relating to interest-free bonds of state and local governments,

fictitious farm losses, and a range of tax favors which corporations enjoy.

Capital Gains

There can be no basis in equity for giving specially favorable treatment to money which has been gained on the stock market or through other forms of speculation, or even by sound long-term investment, as compared with income which a man has earned by the sweat of his brow.

If long-term capital gains were taxed as ordinary income is, we recognize that there might be some inequity when a very large appreciation is realized in any one year. This could be dealt with through an extension of the averaging provision, which would allow the taxpayer to average such amounts over a longer period of years.

A particularly inequitable loophole in the law is the provision that if assets are held to death, any appreciation that has taken place is wiped out at that point for capital gains tax purposes. This seems to us completely unjustifiable. We support the proposal that such appreciation should be taxed in the same manner as any other long-term capital gain.

In light of the estimated $10 billion in tax revenues which escape through the preferential treatment of capital gains--by far the largest single loophole--the changes recommended in the Tax Reform Act of 1969 are incredibly limited. They recoup only a tiny fraction of the revenue lost and leave

completely intact the capital gains transferred by gift or death.

Making a Profit on Property Contributed to Charity

Several highly technical loopholes permit wealthy persons in some cases to make a profit out of a charitable donation--that is, the taxpayer is actually better off after making the gift and taking a corresponding tax deduction than he would have been if he had sold the gift, retained the money himself and paid the appropriate taxes on it.

We support the Treasury proposals designed to prevent such a taxpayer from not only forcing his fellow taxpayers to completely subsidize his charitable giving, but to pay him a profit on it as well.

Interest-Free Bonds

Failure of the federal government to tax the interest on bonds issued by state and local governments provides wealthy persons with still another tax haven. Such bonds carry a very low interest rate--typically about three percent--which makes them uneconomic for the ordinary taxpayer to purchase. But

(continued on page 14)

since the interest is nontaxable, it is worth much more to the top-bracket taxpayer than a much higher rate of interest that would be taxable. Another aspect of tax exempt interest on state and local bonds relates to industrial development bonds.

The situation is inequitable enough when it is merely a matter of a company which is deciding where to expand its facilities. But one injustice is piled upon another when the device is used to lure a plant away from a town in which it is already located. The local government which does this is stealing away another town's economic lifeblood, depriving workers of their jobs and the whole town of its economic security--and we taxpayers, through the exemption, are paying to have it done.

We propose that the privilege given state and local governments to issue tax-exempt bonds should be ended immediately. The federal government should be giving more financial aid to state and local governments, but it should be done directly, not by tax devices.

Proper safeguards should be devised so that the equity of taxpayers currently holding bonds with tax exempt status be protected.

Fictitious Farm Losses

Farming is probably the only industry in this country where the bigger your income is, the bigger your losses are. This is because of loopholes in the law regarding taxation of income

from farming operations, which enable so-called "gentleman farmers" with large nonfarm incomes to show factitious paper losses on their farm operations and charge them up against their nonfarm income.

By taking advantage of these provisions, taxpayers with large nonfarm incomes are able to show their actual capital expenditures on the farm as apparent losses, which are then offset against nonfarm income at a large tax saving. At a later period, the asset so created can be sold, and taxed only as a capital gain at a much lower rate.

We consider the Treasury's proposed remedy, which limits the amount that may be deducted from nonfarm income while at the same time protecting the genuine farmer who may also have an off-farm job, to be sound.

Percentage Depletion Allowances

The tax treatment of depletable resources urgently needs revision. The preferential tax treatment applies primarily to the oil and gas industry, though some other industries based on depletable resources do get favored tax treatment also.

No other industry, however, has succeeded in getting so many tax favors or making so much out of them as the oil companies.

They are permitted to charge off intangible drilling costs as a current rather than a capital expense.

They are permitted a so-called depletion allowance which is not really a depletion allowance at all, but a direct tax

deduction. It consists of the lesser of 27.5 percent of gross income from oil or gas, or 50 percent of net income from the property, each year. Over the years, this can exceed the actual cost of the assets used up many times over.

Other Oil Industry Loopholes

Fairly recently, a new device has been dreamed up by the tax lawyers, called a "carved-out production payment," which effectively removes the 50 percent of profit limitation on depletion. A company sells the right to all or part of the following year's production, receiving payment in advance but usually paying interest on it. This is added to the current year's sales thus increasing the sales figure and greatly increasing the profit figure, since no expenses have been incurred against it. This, in turn, enables a much greater depletion allowance to be taken. In the following year the costs of production are charged up to income, but since the sales of that year have already been taken account of, the result is a large paper loss in the second year. This loss in turn can be written off either against the profits of other years, or against profits of other investments in the same year.

In addition, a statement by Senator Proxmire indicates that oil companies are permitted to write off foreign royalties as though they were actually taxes. That is, instead of writing them off against income, as would be normal with royalties, they are permitted to write them off against U. S. tax liabilities.

The result of these tax favors is that the oil companies pay far less than their share of taxes.

The Quarterly Financial Report of Manufacturing Corporations, published by the Federal Trade Commission and the Securities and Exchange Commission, shows that for the twelve months ending September 30, 1968, companies in the "petroleum refining and related industries" paid federal income taxes equal to only 13.3 percent of their profit before taxes. By comparison, all other manufacturing industries combined paid 45.3 percent of their profits before taxes in federal income taxes.

Many individual oil companies pay much less than the industry average. A table inserted in the Congressional Record on January 2?, 1969, shows that in 1967 Texaco paid only 1.9 percent of its gross profit in federal income taxes; Standard Oil of California paid 1.2 percent; Union Oil paid 6.3 percent; Marathon paid 2.8 percent; in many years some companies paid no federal income tax at all--some even received a tax credit in spite of profits running into the tens of millions of dollars.

Many huge personal fortunes have been made in the oil industry, partly through these tax favors. Any list of the wealthiest persons in the U. S. would include a number who had made their fortunes from oil.

We would strongly urge your Committee, not only to approve putting an end to obvious attempts to evade the intent of the law, such as carved-out production payments, but to examine carefully all the special tax favors allowed this and other

mineral industries, with a view to taxing them as nearly as possible on the same footing as other industries.

Foundations

Foundations have come in for considerable criticism recently in Congress and in the press. Those criticisms have centered largely on situations where foundations have been used to serve the private purposes of individuals rather than any philanthropic purpose, and there has been some criticism also of the activities financed by some foundations.

According to the Treasury report, while it is true that "the preponderant number of private foundations are performing their functions without tax abuse," nevertheless it is also true that "a minority of such organizations are being operated so as to bring private advantage to certain individuals, to delay for extended periods of time benefits to charity, and to cause competitive disadvantage between businesses operated by foundations and those operated by private individuals."

Where such abuses exist, they must be tracked down and stopped.

We support, for example, the proposed prohibition against financial transactions between a foundation and its founders, contributors, officers, directors or trustees.

In order to prevent foundations hoarding their funds to build up little- or big empires, we support the proposal that private foundations be required to distribute their income

33-758 O - 69 -- No. 18 -- 31

(other than contributions) within a year after the year of receipt, unless they were accumulating the income for a specific, stated charitable purpose. An exception might also have to be made in the case of a lump sum of income from long-term capital gains, but in this case the time limit for distribution should merely be extended for an appropriate period of years--perhaps, five years.

In order to prevent foundation managers from becoming more concerned with the operation of a business than with the pursuit of the foundation's philanthropic purposes, we would approve of the proposal that, in general, no foundation be allowed to own 20 percent or more of any business.

In order to prevent use of a foundation to maintain family control over a corporation or other property, we support the proposal that where an interest in such a corporation or property is given to a foundation, no charitable deduction be allowed unless the donor's control over the business or property ends. We do not think the proposals to allow the deduction if the foundation disposes of its interest or devotes the property to active charitable activities will adequately meet the problem.

We support the proposal that speculating and foundation borrowing to purchase investment assets be prohibited, and that foundation lending be confined to categories which are clearly necessary, safe, and appropriate for such institutions.

We would also support the provision to prevent perpetual family control over a foundation to the extent that the donor

and related parties may constitute no more than 25 percent of its governing body after 25 years.

These restrictions, we believe, are clearly desirable. They are the kind of limits that would be placed unilaterally by a reasonable man desiring to establish a foundation with a purely philanthropic purpose.

We would urge, however, that the Committee resist any proposals to limit the philanthropic scope of foundation activities. One of the virtues of a foundation is that it can break new ground, pioneer new territories, try out new ideas. It can finance research into areas that no government and perhaps not even a university would be prepared to enter--and the advancement of science in large part has rested on researches and experiments that in the beginning were frequently considered a waste of time. It can finance efforts in other countries, particularly underdeveloped countries, to find answers to specific problems where it might be politically unwise for the U. S. government to provide similar assistance. In so doing, foundations can help to brighten and strengthen the image of this country in the world.

Proposals tentatively agreed upon by the House Ways and Means Committee preventing the use of foundation funds in projects which may influence the decisions of government bodies are, we believe, indefensible.

We would have no objection to language spelling out prohibitions against foundation sponsorship of partisan political activity or direct lobbying campaigns. But, the Committee should diligently protect the right of foundations to fund projects which explore national social problems or the effectiveness of government programs, which encourage voluntary organizations to seek solutions to community problems, which seek to protect and enhance constitutional rights and liberties before the courts, and which in general encourage orderly social progress and change.

Order of Priorities

We suggest the following order of priorities for the Committee's consideration:

1. Plug as many tax loopholes as possible, especially those recapturing the most revenue, such as capital gains, oil depletion, tax-free interest, etc.

2. Out of the additional funds available, provide assurance that no family in poverty will be taxed and no family will be taxed into poverty.

3. The next priority is to lighten the tax burden for those above the lowest income brackets, and to lighten the taxes of all those who have been meeting their full obligations.

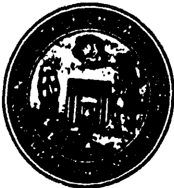
However the House bill reduces the rates on higher income taxpayers, the resulting revenue loss is far greater than the revenue gain from loophole closing.

In addition to contributing to inequities in sharing the total tax burden, the bill fails to produce revenues to be applied to domestic needs.

We believe that extra revenues must be obtained by plugging loopholes to meet the pressing social needs of our time--the problems of our cities and our rural slums, the health and housing needs of the people, the education of our children, the need to clean up the air and the water around us.

We urge the Committee to fashion a bill to achieve these ends.

Form C.O. 584 15M



CITY OF CHICAGO
OFFICE OF THE CITY COMPTROLLER

ROOM [illegible], CITY HALL, CHICAGO, ILLINOIS [illegible]

TELEPHONE, 744-4000

RICHARD J. DALEY
MAYOR

OTTO H. LOSER
CITY COMPTROLLER

PAUL J. KOLE
THOMAS F. MURPHY
DEPUTY COMPTROLLERS

September 29, 1969

To The Honorable Members of the
United States Senate Finance
Committee Conducting hearings
on House Bill # HR 13270

Gentlemen:

As City Comptroller of the City of Chicago and, as President of the Municipal Finance Officers Association of the United States and Canada with a membership of approximately 4400 representatives of states, cities and counties of the United States, Canada, Puerto Rico and Virgin Islands, I requested permission to appear before your honorable body to testify on tax reform as it pertains to interest on municipal bonds. Due to the large number of witnesses who desire to testify on tax reform and the short time available for such hearings, the Chief Counsel of the Senate Finance Committee requested that I submit copies of my written statement to the Committee for consideration.

My comments follow:

States, Counties and Municipalities are continually beset by new problems -- requests for greater services, mounting costs of construction and administration and a struggle to obtain the revenues needed to provide the services and capital improvements. Now a new problem has been thrust upon us - "Tax Reform" in the form of H.R. 13270. Together with inflation, this has played havoc with many capital improvement plans. The principal item in the "Tax Reform" so far as it affects governmental units is the proposal to tax the interest on State and Municipal Bonds. Various proposals have been made as to the method of taxing municipal bonds:

A. Providing a minimum tax on the interest from all municipal bonds outstanding as well as new issues.

B. Allocation of allowable tax deductions of the taxpayer between taxable income and certain previously considered non-taxable income including interest on municipal bonds.

Interest Rates

As a result of the tax reform provisions as they effect interest on municipal securities, the municipal bond market has tightened to a degree where it has become almost impossible for municipalities to obtain funds.

Due to high interest rates, The Bond Buyer estimates $1,749,991,000 of municipal bond issues were cancelled, postponed or displaced by failure to receive bids and rejection of bids received during the period September 3, 1968 to August 22, 1969.

Interest rates since 1968, particularly since the taxing of interest on municipal bonds has been brought to wide public attention, have risen from 1-1/2% to 2%. Many states and municipalities have interest rate ceilings of 6.00% which were set by referendum or by State Legislatures years ago. Consequently they are unable to sell their bonds in a market which provides rates as high as 8-3/8% on AAA rated utility bonds with rates of 7-3/4% on other industrial bonds.

Few cities and states enjoy a triple A rating. Take the City of Chicago, for example, whose bonds have an A rating from Moody's Investment Service and AA from Standard and Poors Investment Service. On July 29, 1969 we tried to sell $25,500,000 of General Obligation Bonds, backed by the full faith and credit of the City of Chicago, which has never been in default on any obligation, at a rate of not to exceed 6% over the life of the bonds with varied maturities up to 20 years. The only bid received was 6.2202% which we could not accept due to 6% ceiling. On September 22, 1969 a member of one of the underwriting groups checked the New York and Chicago financial districts to ascertain whether these bonds would have a market at 6%. The answer came back that the best probable bid would approximate 7%.

Interest On Tax Anticipation Warrants

In Illinois taxes are levied during the year following the year in which appropriations for operating expenses are expended. In other words, in 1969, taxes are collected to cover 1968 expenditures. It, therefore, becomes necessary to substantially finance our general operations in each year through the sale of tax warrants (or tax notes) which become payable upon the collection of taxes during the ensuing year. Approximately $100,000,000 of tax warrants will be sold by the City of Chicago, excluding the six independent taxing bodies, in 1969 to finance its general operations and which will be paid off commencing June 1, 1970 when property tax installments become payable by the taxpayers. A year ago we sold such warrants to banks at 4-3/8% to 4-5/8% interest. Recently a group of largest Chicago Banks quoted a 7% interest rate on this type of paper.

Municipal bonds have enjoyed lower interest rates than industrial bonds in the past but, if the interest on such bonds becomes taxable in one form or another, the rates will rise to approximate those on industrial bonds.

The following schedule sets forth the approximate financing required by the City of Chicago and its six related taxing bodies during 1969 and 1970:

	Tax Anticipation Warrants		General Obligation Bonds	
	1969	1970	1969	1970
Chicago Junior College	$ 4,700,000	$ 9,500,000	$ -	$ 15,000,000
Chicago Sanitary District (1)	31,630,000	32,000,000	60,000,000	60,000,000
Chicago Park District	23,500,000	24,000,000	9,500,000	-
City of Chicago, Board of Education	148,200,000	148,700,000	-	-
Forest Preserve District	3,500,000	3,500,000	15,000,000	15,000,000
Public Building Commission of Chicago	-	-	35,000,000	165,000,000
City of Chicago:				
City - General Operations	100,000,000	100,000,000	-	-
Urban Renewal Preliminary Loan Notes	63,255,000	*63,000,000	-	-
Water Revenue Bonds (3)	-	-	-	30,000,000
Chicago O'Hare International Airport (3)	-	-	70,000,000	160,000,000
Electric Street Lighting (2)			2,000,000	-
Municipal Buildings			1,500,000	16,000,000
Public Transportation			6,500,000	-
Sewer			6,500,000	9,000,000
Garbage & Refuse Disposal			5,500,000	1,500,000
Redevelopment & Urban Renewal			3,500,000	26,500,000
Cook County	36,000,000	36,000,000	30,000,000	9,000,000
TOTAL	$410,785,000	$416,700,000	$245,000,000	$507,000,000

(1) A telegram to the Illinois Senators and Congressmen under date of August 1, 1969 from John E. Egan, President of Metropolitan Sanitary District of Greater Chicago (representing the City of Chicago and over 80 smaller metropolitan towns and villages in the Chicago Metropolitan area within Cook County, Illinois) reads as follows:

"The taxpayers of Metropolitan Chicago are committed to issue $380,000,000 in bonds to combat water pollution and meet federal water quality standards. We have not received the federal financial assistance we need to accomplish this task. Please do not add to our burden by removing our tax exemption."

(2) To complete installation in progress since 1966

(3) Revenue bonds (not general obligations of the City)

* Estimated renewals

Assuming a 2% increase in interest rates has resulted from proposed tax reforms, the additional annual interest cost in 1970 to the Chicago-Cook County taxpayers on 1969 issues alone will approximate:

	Interest Payable	On Tax Warrants And Preliminary Loan Notes	On Bonds
On 1969 Issue	1970	$8,215,700	$4,900,000

The bonds are scheduled to mature in 2 to 20 years with an average life of 10 years; hence, added interest costs continue in reducing amounts over 20 years.

The States of Connecticut and Ohio, the City of New York, and many local governments which could not postpone their bond sales will pay millions of dollars more in interest over the life of the bonds sold in the current market.

Inability to Finance the Needs of Government

The effect of the attempt by Congress to tax the interest on municipal securities has been a reluctance on the part of bond dealers and bankers to bid on an issue. Early in 1969, we attempted to sell approximately $70,000,000 of bonds; we had to reduce this by 50% and reschedule the issue in order to obtain a bid. In a later attempt to sell bonds, we had to agree that the sale would become void if Congress passed the tax bill in its present form before the bonds were delivered to the purchasers.

Even the United States Government is having trouble selling its guaranteed obligations. On September 10, 1969, $156 million H.A.A. Notes were unsold due to the 6% interest limitation. On the same day, $10 million Jefferson School District, Louisiana bonds failed to sell.

Investors are unwilling to purchase municipal securities until they can ascertain what the federal legislation will be. No investor wants to purchase a 6% or 7% bond (in a market where utility AA and AAA rated bonds bring 8% to 8½% and some Canadian bonds 9%) only to learn at a later date that the interest on his municipal bonds is partially or wholly subject to Federal Taxes on Income.

The big question is whether it has become necessary for Congress to "Cripple the Financing Power of States and Municipalities".

The Need for Municipal Financing

The needs for financing were never greater. Due to the population explosion and changing desires of the people there is a nation-wide need for:

A. New schools, new high schools, new or enlargments of colleges

B. Hospitals. Medicare and greater population has created a need for new hospitals and new equipment. Medicare has helped to create an unprecedented demand for hospital care. Greater attention is being paid to mental diseases. This requires additional clinics and hospitals giving this specialized care.

C. Transportation. The advent of larger airplanes has made many airports obsolete or partially so. To provide for the handling of the large airplanes, which will make their first appearance this Fall or early next year, require additional runways and other airport facilities. The railroads have given up much of their passenger service, adding to airline travel. The largest airports are so congested that flights are frequently delayed from one-half hour to more than an hour in takeoffs and considerably delayed in landing on the ground with extended delays before they can taxi to the terminals for debarkation. It is estimated that $300 million a year Federal funds will be needed for airport expansion. Local costs will exceed that figure.

Local transportation needs have outgrown existing facilities. Better transportation and extensions to accommodate the poor people of the community require outlays running to millions of dollars.

Most large cities and the states require superhighways to relieve local and through transportation for automobiles with outlays of many millions of dollars.

Sewerage systems require extension and enlargement to provide for increased population.

Model Cities Programs, Urban Renewal and Redevelopment plans require huge outlays to preserve our cities and to alleviate discontent of the poorer segments and middle class segments of the population. While Federal Grants provide some of these funds, the Cities must provide certain amounts as matching funds.

All of the foregoing require financing and much of the financing is an immediate need. Why should Congress on the one hand provide grants for the use of municipalities and then make it practically impossible for municipalities and states to finance their share of the costs. The very idea is "fantastic".

<u>Higher Interest Rates Will Be Reflected In Construction Costs</u>

As a result of higher interest rates, the costs of construction are rising. Taking into consideration higher interest cost and the effects of inflation, municipalities which appropriated amounts for Capital Improvements a year ago now find their appropriations inadequate.

Major capital improvements must be planned several years in advance and construction takes several years. Construction once started must be completed or the contracts must be escalated considerably to cover inflation and changing money rates. All this adds to the burden of the local taxpayers with no increasing benefit due to the delayed completion of the project.

The Boomerang Result Is Increased Local Taxes

The unavoidable result of the increased interest costs is higher state and local taxes or reduced public services -- or both. The most obvious result would be HIGHER REAL ESTATE TAXES since most of the bonds subject to the taxes are local government bonds and local governments must still rely on real estate taxes as their main source of revenue. Thus the "Reform" will mean higher costs of owning a home or apartment. The irony of this part of the "Reform" Package Legislation, touted to be a response to the demands of the "little people" is that it will boomerang right back on the average American homeowner and citizen it is supposed to pacify.

It is true that reforms have been demanded, but they need not be boomerang reforms. Mr. Average American was not asking for "reforms" to increase his cost for new schools, new hospitals and other improvements or to increase his sales taxes or his state income tax. That is exactly what he is being offered as a result of House Bill 13270.

Equity or Inequity

There isn't even an argument in "tax equity" for including municipal bond interest in the tax base of the bill. The bill identifies certain classes of "tax preference" income and proposes a minimum tax on them. For people in the top tax brackets -- 60% to 70% -- the minimum tax would be half, or not over 30% to 35%.

By coincidence, 30% to 35% is exactly the amount municipal bondholders have traditionally "paid" by accepting lower interest rates on municipal bonds instead of buying equivalent private obligations (that is, municipals have sold in recent years at yields of 65% to 70% of corporates).

As a result the municipal bondholder has already in effect, "paid" his minimum tax at the top bracket rates which the bill sets for other "sheltered" income. Thus in the case of municipal bond interest alone, the bill would impose a double levy by taxing the residual balance (the interest) by another 30% to 35% at top bracket rates. Few people find anything but inequity in taxing the interest on bonds already outstanding, as the House Bill plans to do.

What About The Tax Free Millionaires

The alleged present "taxpayers' revolt" was procured by adroit propaganda concerning 154 millionaires who paid no income tax although they had at least $200,000 in adjusted income. But when the details about their tax returns came out, THERE WAS NO SHOWING OF THE AMOUNT OF MUNICIPAL BOND INTEREST RECEIVED by them. Nevertheless, the House Ways and Means Committee report subtly juxtaposes the recommendation for taxing municipal bond interest with a recital about 154 millionaires.

I have seen estimates to the effect that the Federal Government would collect $88,000,000 a year by taxing interest on local government bonds. You can be assured that the additional property taxes which would be paid by all property owners as a result of the higher interest costs on bonds would offset this income tax many fold.

There is Doubt As To Constituitionality

The Attorney General of the United States has stated that grave consititutional problems are raised by including municipal bond interest in a "minimum tax" base. Therefore, the administration did not recommend such inclusion. But the House has now overridden the constitutional objection. The inevitable litigations, if this measure is finally passed, are expected to unsettle the municipal bond market for years. Attorneys General over many years repeatedly taken stands against the taxing of interest on municipal bonds.

Tax Subsidy Plan

House Bill 13270, having ended traditional "tax exemptions", then purports to give an option to state and local government issuers to receive a "subsidy" if they agree to issue their bonds in a fully taxable basis.

The most obvious flow in this plan is that the Secretary of the Treasury is given the authority to determine the measure of the "subsidy" which is supposed to make the states and cities financially whole. The floor under the amount he can select (25% of the taxable rate after 5 years) is lower than the traditional benefit which states and cities have enjoyed in issuing their bonds. They could hardly expect to avoid loss under such a subsidy plan -- coupled as it is with mandatory taxes (LTP and allocations) on bonds issued under the alternative "option".

The Ready Marketability Of Local Government Bonds Would Be Impaired

The tax legislation now before the Senate, if enacted into law, will mean that new buyers must be found for from $10 billion to $20 billion annually of new debt securities of the local sector of the economy according to a survey of the financial community opinion made by "The Bond Buyer".

Prior to the attempt to tax the interest on local government bonds, governmental bodies with reasonable credit ratings could readily dispose of their bonds. Based upon the experience of many municipalities in dealing with the Federal Government, endless delays would be encountered in attempting to sell municipal securities to any Urban Development Bank formed by the Federal Government for the purpose of purchasing such bonds as an aid to the local governments.

Investors' Crisis

The members of the Senate Committee and the United States Senate are respectfully requested not to turn the uncertainty which has seized the tax-exempt bond market into a crisis which will curtail drastically the much needed social improvements in all sections of the country for years to come. The only way to avoid this is to veto the bill which will tax in whole or in part the interest on municipal bonds.

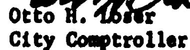
The Cities will have three choices if this bill goes thru:

1. To curtail much needed improvements and spread them over a longer period of years. This means "Retrogression" and not "Progress". No large city can afford this.

2. To pay the higher interest rates on their bonds, passing them on to the taxpayers in the form of property taxes.

3. To obtain a greater amount of financing for improvements by including the estimated cost of improvements in the current year's tax rates. Property taxes already are so high that some municipalities face a taxpayers strike.

Respectfully submitted,



Otto H. Loser
City Comptroller

OHL:co's

STATEMENT OF AMERICAN INDUSTRIAL CLAY COMPANY OF SANDERSVILLE, ENGELHARD MINERALS & CHEMICALS CORPORATION, FREEPORT KAOLIN DIVISION OF FREEPORT SULPHUR COMPANY, GEORGIA KAOLIN COMPANY, J. M. HUBER CORPORATION, AND THIELE KAOLIN COMPANY RE H.R. 13270

This statement is filed by the following producers of china clay: American Industrial Clay Company of Sandersville, Engelhard Minerals & Chemicals Corporation, Freeport Kaolin Division of Freeport Sulphur Company, Georgia Kaolin Company, J. M. Huber Corporation, and Thiele Kaolin Company.

For the reasons set forth below, these companies are opposed to Section 501(a) of H.R. 13270, as passed by the House of Representatives, insofar as it reduces the 15 per cent rate of percentage depletion which has been applicable to china clay since 1947.

The Mineral

China clay (or "kaolin" as it is sometimes called) is one particular, comparatively scarce, variety of clay. Its unique properties make it a valuable raw material for many important industries. Its principal use is in paper, both as a coating and as a filler, but it also has a wide variety of other uses, including whiteware (porcelain, electric insulators, plumbing fixtures, etc.), certain refractories, medicines, and as a filler for rubber, paint, plastics, insecticides, and many other products. It is clearly distinguishable from the low grade, inexpensive clays which are found in many parts of

the country, and, in fact, from all other clays, on the basis of the following characteristics: china clay has a clay mineral content of substantially pure kaolinite, it is white or nearly white or can be beneficiated to be white or nearly white, it will fire to a white or nearly white color, and it is amenable to beneficiation by known methods to make it suitable for use in whiteware, paper, rubber, paint, and similar uses.

Size of the Industry

The principal producing area for china clay in this country lies in a belt of rural counties in Georgia (principally Twiggs, Wilkinson, and Washington Counties) and South Carolina (Aiken County).

The china clay industry is small when compared to most other mining industries, but it is extremely important to the economy of the rural area of Georgia and South Carolina where it is located. China clay, in fact, accounts for about 47% of Georgia's mineral production value. The six principal producers submitting this statement, with a combined payroll cost of approximately $20,000,000, employ about 2,800 people, the great majority of whom live in this rural area. These six companies have invested more than $50,000,000 in plant and equipment during the past five years and more than $75,000,000 in the past 10 years.

Development of the Industry

During the early part of this century, substantially

all of the china clay used in this country was imported from England. The development of the domestic industry began in the 1920's; today, the Georgia and South Carolina area is the largest producing area in the world. The domestic industry now supplies practically all domestic needs and it also contributes to a favorable balance of trade by exporting substantial quantities. In order to achieve this growth, the producers were required to develop means to process the domestic clay to improve its color, which, in the ground, is not as white as the English clay and to provide the users of the clay with superior service. At the same time, they have worked with customers to develop new uses and to improve the technology of processing and utilizing the clay.

Accordingly, the present position of the industry is due in substantial part to the large sums spent by the industry on research and development, and the future success, and even survival, of the industry depend on continuing this work.

In addition, as the markets have grown and the specifications of customers have become stricter, the industry has had to spend large sums prospecting for additional deposits of suitable clay. Because of the ever shifting demands of customers, no company can be certain of the extent of its reserves; clay which is suitable for today's market may be

33-758 O - 69 -- No. 19 -- 32

unsuitable a year from now. Thus, the industry must constantly search for new deposits, at the same time that it seeks to develop new processing techniques to utilize known deposits.

The Importance of Percentage Depletion

The amount of tax involved in the depletion deduction for china clay is negligible from the Government's standpoint, but it is extremely significant to this industry. Thus, in the past five years, the total annual tax saving, from percentage depletion, for the six major producers combined has averaged less than $3,500,000. The reduction to 11% adopted by the Ways and Means Committee would have reduced this amount, and increased revenues, by less than one million dollars a year. Obviously, such an increase in tax would have no noticeable effect on revenue collections or on curbing inflation. However, the increased tax resulting from this proposed reduction in the depletion rate would adversely affect the future of this small industry for the following reasons.

It must be realized, first of all, that any increase in tax will constitute an additional increased cost, which will be imposed upon the producers on top of increases in all other costs. Of course, all businesses are experiencing cost increases today, but such increases have been particularly severe for this industry. Thus, as the more accessible

deposits of china clay have been exhausted, it has been necessary to remove more and more overburden to reach suitable clay, and to transport the clay farther and farther to the processing plants. The competition for suitable clay deposits has increased tremendously the cost of buying or leasing clay land. Over all, the expenditures by these companies for royalties and rents have more than doubled in ten years. In addition, recently enacted legislation requires the industry to incur substantial expenses for land reclamation, as well as for air and water pollution control.

Accordingly, the increase in taxes resulting from a decrease in depletion would be imposed on top of other escalating costs, and would further and materially reduce the profitability of the business at present price levels.

If the producers would try to offset that decrease in profits by increasing prices, they would face a loss of business, both here and abroad, to the English producers.

English China Clays, Limited, which controls vast reserves in the Cornwall district of England, is the largest producer of china clay in the world. The china clay production of this one company, which has total assets of $155,000,000 and sales of over 2,000,000 tons of china clay a year, is almost as large as that of the six major U.S. producers combined. It exports 75% of its production and has the know-

how to supply all markets. The English producers have at least two cost advantages as compared to American producers: first, their labor rates are substantially lower than the rates in Georgia and South Carolina and, second, their deposits are adjacent to seaports so that they can load directly on to ships which provide low cost transportation to customers. In addition, the English producers enjoy a special advantage under British tax laws in that they receive rebates from the government of 40% of new capital investments in the china clay business.

During 1968, Canada and the United States imported 175,000 tons of china clay from England, having a value in excess of $4,000,000, whereas U.S. producers exported 389,000 tons valued at almost $13,000,000. All of these export sales are in direct competition with the English. The china clay industry has contributed to a favorable balance of trade, but any price increase resulting from a reduction in percentage depletion would allow a substantial penetration of the U.S. market by the English and would reduce substantially U.S. exports; obviously, there would be a substantial adverse effect on our balance of payments.

If the producers could not recoup the lost profits by increasing receipts, they would either have to reduce other expenses or be satisfied with a smaller return on their investment. Any program to reduce expenses, in order to

compensate for the loss of depletion, would necessarily affect primarily non-production expenses such as exploration and research and development. A reduction of expenditures in either or both of these categories would, of course, slow or halt the search for suitable clays and prevent work on the development of new processing techniques and uses and thus affect adversely the future growth of the domestic industry.

If costs cannot be reduced, the producers' return on investment is lowered, and the additional tax cost is borne by the individual investors in the producing corporations who invested their money in this industry in reliance on the existing depletion allowance, which has remained unchanged for over 20 years.

Furthermore, the lower return means that less capital will be invested to expand present production and to utilize improved processing techniques. One of the major producers recently studied the possibility of constructing facilities to utilize reserves which it holds in the Sandersville area of Georgia. Its projections showed a return, after taxes, at current prices and with the present depletion deduction, of only 8.4% on an investment of over $10,000,000. Obviously, such a return on investment is low today, especially in view of the high interest rates. Any reduction in this rate of return could well prevent further investment in this industry.

Although the proposed reduction in the depletion rate to 11% might not be sufficient in and of itself to dry up sources of capital, the resulting cost increase is substantial to these companies and this increase, together with other cost increases, would have a significant effect on earnings.

In addition, such a cut in the rate would, at the very least, cause the financial community to be wary of possible additional cuts, and the complete repeal of percentage depletion would reduce profits to such a point that it is doubtful that any funds would be available in today's money market, especially for the smaller producer. Thus, a study sponsored in 1966 by the Georgia Department of Industry and Trade and the U.S. Department of Commerce ("Mineral Resources of the Central Savannah River Area") reported that dry process operations (conducted by the smaller companies) are "only marginally profitable" and that in some cases "the profit margin lies within the depletion allowance." Accordingly, even a small cut in the depletion allowance might well result in eliminating or severely limiting future investment.

Conclusion

In summary, the domestic china clay industry, although small, contributes significantly to the economy of the Southeast and supplies a wide market with a unique product having many important uses in our present day civilization.

The industry has been able, through research and outstanding service to its customers, to preempt markets (domestic and foreign) of foreign producers. Those foreign producers, however, still compete vigorously, and any increased tax caused by a reduction in depletion, especially when combined with other rapidly rising costs, would seriously impair the industry's ability to compete. The increased revenue, of less than $1,000,000, is of negligible significance to the Government, but is of critical importance to this industry.

Whatever may be the merits of cutting the rates for other minerals, where more tax is involved and where the effect on the industry may be less severe, Congress should retain the 15% rate for china clay, just as the Ways and Means Committee has done for oil shale and gold, silver, copper, and iron ores.

American Industrial Clay Company of Sandersville
Engelhard Minerals & Chemicals Corporation
Freeport Kaolin Division of Freeport Sulphur Company
Georgia Kaolin Company
J. M. Huber Corporation
Thiele Kaolin Company

STATEMENT OF HENRY C. VAN RENSSELAER

TO THE

COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

Application of H.R. 13270
to Independent Canadian Oil and Gas Companies

My testimony is submitted as a United States citizen and as a Vice President and director of Bow Valley Industries, Ltd., an independent Canadian oil and gas company whose common shares are listed on the American Stock Exchange. I am deeply troubled over the effect of the provisions of H.R. 13270 relating to the elimination of foreign depletion and the provisions of that Bill and of the Administration's proposals relating to limitations on the use of deductions for intangible drilling expenses. I am concerned that enactment of any of these proposals will reduce the availability of Canadian oil and gas to the United States and will adversely affect the future of independent Canadian oil and gas companies. I am also concerned that enactment of any of these proposals will impede the economic growth of western Canada and, concomitantly, reduce western Canadian purchasing power for United States products.

The interest of the United States in the continued development of Canadian oil reserves which are linked to the United States by pipeline and secure from the viewpoints of national defense and political stability is clear. It is

even more clearly in the interest of the United States consumer that Canadian gas reserves, which now stand at 47.6 trillion cubic feet and are expected to eventually exceed 700 trillion cubic feet, be developed rapidly enough to prevent a major escalation in gas prices in the United States, where domestic reserves are not at present considered adequate to accommodate the future market. In 1968, 47% of total Canadian gas sales of 1.29 trillion cubic feet went to the United States, the export percentage having risen from 14% since 1957.

Either the elimination of foreign depletion or the adoption of the restrictions placed on the use of deductions for intangible drilling expenses under the Allocation of Deductions provision of H.R. 13270 would have a substantial adverse effect on the future exploration for oil and gas in Canada. Enactment of the proposal of the Administration also to include intangible drilling expenses in the Limit on Tax Preferences unless at least 60% of the taxpayer's gross income is derived from the sale of oil and gas would be even more damaging.

Total oil and gas exploration expenditures in western Canada last year were just under $500,000,000, with independent companies drilling 59% of the exploratory wells. A survey conducted by the Independent Petroleum Association of Canada among the 125 companies comprising

its membership reveals that in excess of $100,000,000 of the Canadian independents' annual exploration budget currently comes from United States individual and corporate participations with the greater part coming from individual spending. An example of the impact of the proposed legislation on this exploration is the case of our company, whose exploration program amounted to $4,004,128 in the fiscal year ended May 31, 1969. $3,307,084, or approximately 82.5%, was provided by a small group of United States individual investors who have notified us that they expect to terminate their activities with our company if Congress eliminates depletion on Canadian oil and gas production or restricts the use of deductions for intangible drilling expenses.

The elimination of foreign depletion would have a particularly serious effect on U.S. oil and gas investments in Canada due to a provision in Canadian tax law (to which the U.S. individual or corporate participant having operations in Canada is subject) classifying gains from sales of oil and gas property as ordinary income. This provision of Canadian tax law was enacted in 1962, at which time the Canadian law was also changed to permit certain purchasers of oil and gas properties to currently expense the cost of all land or production acquisitions. Under the combination of Canadian and United States tax laws to which a United States investor would be subject, in the absence of U.S.

depletion there would be no way for such an investor to realize on his investment without paying either Canadian ordinary income rates with a top bracket of 80%, in the event of a sale, or United States ordinary income rates with a top bracket which is presently 77% (including the surcharge), in the event the property is held for income. Thus, if the U.S. depletion deduction were eliminated for Canadian oil and gas production, the U.S. investor would be taxed at full ordinary income rates in Canada if he sold his interest and at full ordinary income rates in the United States if he operated it.

The proposal to restrict the full benefits of the deduction of intangible drilling expenses under the Allocation of Deductions provisions of H.R. 13270 is an additional factor making individual investors in Canadian oil and gas drilling ventures reluctant to make forward commitments at the present time; the threat of enactment of the Administration's proposal relating to including intangible drilling expenses in the Limit of Tax Preferences in the case of taxpayers deriving less than 60% of their gross income from oil and gas is even more serious. This is so because the exploration programs of a number of individual investors (who typically do not derive 60% of their gross income from oil and gas) have, to date, not been particularly profitable even under present tax laws.

In the case of exploration programs managed by my company, investors over the last ten years have participated in 265 exploratory wells without experiencing a really significant discovery. While our exploration is primarily designed to find major reserves, and is, therefore, involved in a large percentage of high risk ventures, our results are closer to typical than the sensational discovery and "get-rich-quick" story which the public popularly identifies with the oil and gas independent.

The independents are the high-risk exploration arm of the Canadian oil and gas industry. Using their own cash flow and acting as managers for U.S. individual investors the independents habitually drill prospects which the major companies consider too risky to drill in their lower tax brackets. As a consequence, the independents drill many dry holes but they also make many of the major discoveries, indicating that exploration for oil and gas is a long way from being a precise science and that it still takes a lot of drilling and, at times, exploration concepts not necessarily developed by the major companies to find large reserves. In fact, the three most notable gas discoveries in western Canada during the past few years -- Edson, Quirk Creek and Strachan-Ricinus -- involving reserves expected to exceed 5 trillion cubic feet were all made by independents who use exploration funds provided by

U.S. individual investors. During the same period the largest oil discovery in Canada was made by a small independent company in the Zama-Rainbow country in the northwestern part of Alberta. The company in question had experienced a decade of disappointing exploration results and investor discouragement. The discovery was made in an area written off by the major companies as gas-prone and opened up a trend which now has in excess of a billion barrels of proven oil reserves.

The exploration for oil and gas is a high risk business and cannot compete for capital with less risky investments unless the tax benefits are correspondingly high. Even under present tax laws the rate of return on invested capital for the oil industry is comparable to the rate of return of other less risky industries. Any cutback on the ability of taxpayers to deduct intangible drilling expenses or to secure depletion deductions on production will deal a severe blow to the independent segment of the oil and gas industry due to its reliance on exploration funds from individuals and corporations with non-oil and gas income. The result would be a further concentration of the industry in the hands of the larger companies and a lower level of exploration activity and eventual higher prices to the consumer.

Whatever the justifications may be for eliminating depletion on foreign oil and gas production, these

arguments are not applicable to the Canadian situation. The discovery of additional Canadian oil and gas reserves is important to the United States for economic and defense conditions; recent discoveries on the North Slope of Alaska have served to confirm the potential of the Canadian Artic as a future major source of supply to North America. Accepting that fact, it is essential that a full tax deduction for drilling expenses be accorded to encourage investment in the type of expensive, high risk exploration ventures typical of northern development. The acknowledged argument in favor of domestic depletion -- the stimulation of discovery and development of oil and gas deposits to make the United States self-sufficient and independent of questionable supplies of foreign oil and gas -- has equal validity in support of depletion for Canadian oil and gas production.

In sum, I urge your committee to:

(1) retain the depletion allowance for oil and gas production in Canada; and

(2) retain the present unencumbered deduction for intangible drilling expenses.

There is, of course, well established precedent for shaping U.S. law and policy to take into account the special relationship between the U.S. and Canada, and especially their economic interdependence. Examples in point are the

recent favorable treatment given Canada under the interest equalization tax and the Foreign Direct Investment Regulations. Furthermore, in view of the emerging unified Continental oil and gas policy, it would make no sense to discriminate against Canadian oil and gas exploration and production through U.S. tax legislation.

October 2, 1969.

STATEMENT BY JAYE F. DYER

EXECUTIVE VICE PRESIDENT, APACHE CORPORATION

TO COMMITTEE ON FINANCE, U. S. SENATE

WITH RESPECT TO TAXATION OF THE PETROLEUM INDUSTRY

September 30, 1969

UNIQUE FORMULA PROVIDES ECONOMIC THRUST

A unique tax formula has been at work in the United States over the past 35 to 40 years, giving powerful thrust to America's economic growth.

This formula embodies two key elements which, when applied together, have contributed significantly to the generation of the strongest, most dynamic economy in the history of mankind.

Those two elements are:

1. The progressive, confiscatory income tax
2. And, tax incentives

Taken alone, the high income tax rate stifles individual initiative and thereby becomes a deterrent rather than a thrust to economic growth.

But when combined, these two elements tend to encourage the flow of risk capital into the economy. Dollars taxed at lower rates would simply be paid in taxes. When subject to high confiscatory rates, these same dollars are attracted to investments which offer tax incentives.

Thrust has been given to the petroleum industry by this very combination of elements -- the rapid increase in income tax rates in the early 1930s, following adoption of the depletion

33-758 O - 69 -- No. 19 -- 33

provisions, and then the vitally important provision for expensing intangible drilling costs.

During that 35-40 year period, our gross national product has catapulted from less than $60 billion to nearly $900 billion -- testifying to the dynamics of the American economic formula.

To substantially alter either the income tax rates, or tax incentives applicable to the oil industry, would upset the fine balance and do immeasurable harm to not only the petroleum industry but our total economy as well.

INCENTIVES SHOULD BE BROADENED

Rather than reduce such incentives, they indeed should be broadened and put to work to meet other national needs, to solve social and economic problems just as they have helped create a strong and productive petroleum industry.

Similar incentives could attract risk capital into the solution of the shortage of low-income housing, the control of pollution, development of parks and recreational land, rural economic development.

American ingenuity, as demonstrated by our lunar landing, is capable of accomplishing virtually any objective it sets out to achieve. Given the economic incentive, the American investor will tackle any job deemed to be in the national interest. Americans want to invest ... this is the basic cause of the American economic miracle.

APACHE CORPORATION IS A CASE IN POINT

My company, Apache Corporation, is a case in point. I can categorically state that we would not be in business today if it weren't for the dynamic combination of economic elements I have cited.

Application of that formula has made it possible, over the past 15 years, to build a $59 million corporation owned by 8,000 shareholders, employing more than 2,000 people in 11 states.

Apache's original business, and still our primary endeavor, is the operation of petroleum exploration and production programs for individual investors. Those investors are successful professional men and businessmen who are putting the product of their labors to work creatively. They are risking dollars in the highly speculative business of petroleum exploration in the hope of earning a return commensurate with that risk. Perhaps even more importantly, they are contributing to our National Income by the discovery of new energy sources and the multiplier effect of their expenditure as it cycles through our economy.

Employing that private risk capital, Apache explores for and develops new oil and gas reserves throughout the United States and Canada.

For the sake of simplicity, I will deal in round numbers. Over the past 10 years, Apache has put some $100 million of normally taxable income to work in the search for and production of petroleum.

Of that $100 million, approximately $50 million would have been paid in federal income taxes had it not been invested in petroleum exploration and production. Thus, the high tax rates forced $50 million into the private sector of our economy, which was accompanied by another $50 million. It was attracted to the petroleum industry by the existing tax incentives.

Now let's take a look at the economic thrust those dollars generated:

1. The $100 million was paid principally as wages and salaries to employees of drilling contractors, petroleum service companies, and others supplying goods and services. It contributed to finding more than 300 million barrels of petroleum reserves.
2. $37 million have been returned to investors as their share of oil and gas sold thus far, with additional income to flow over a period of 20 or more years.
3. $9.5 million has been earned by the company and its shareholders for managing the drilling activity.
4. Three other company divisions have been spawned by the income and equity produced by oil. One operates public utility firms, another manufactures tools and equipment for industry and government, and the third develops and operates urban and suburban real estate.

The U. S. Treasury, too, has benefited directly from this economic thrust. As the attached chart (Chart I) shows, each

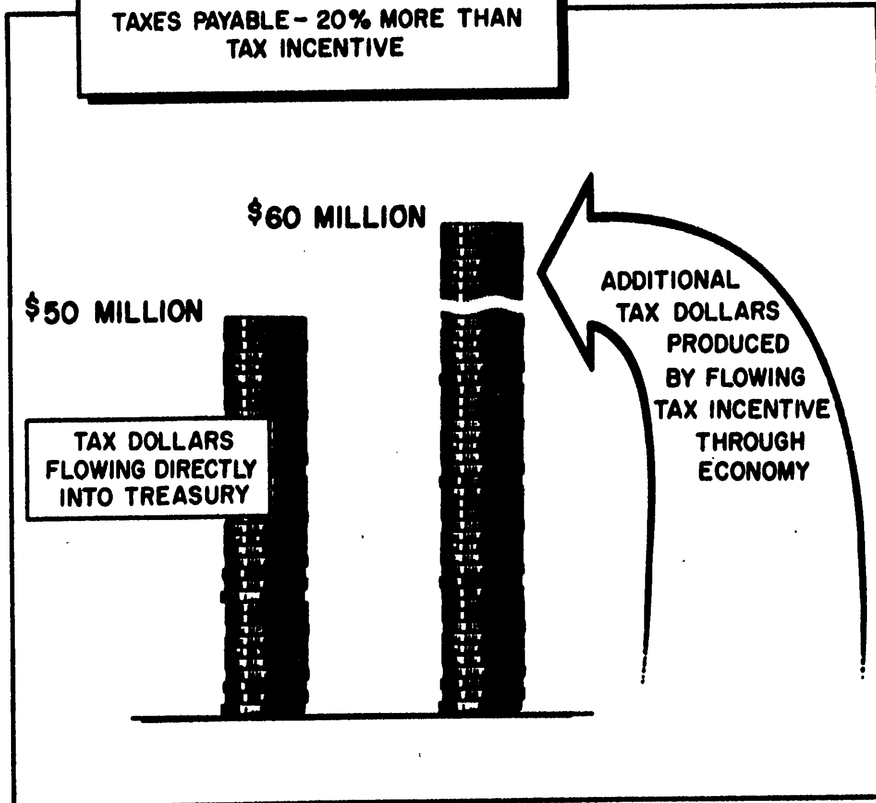


CHART I
APACHE PETROLEUM EXPLORATION
TAXES PAYABLE - 20% MORE THAN TAX INCENTIVE
$60 MILLION
$50 MILLION
ADDITIONAL TAX DOLLARS PRODUCED BY FLOWING TAX INCENTIVE THROUGH ECONOMY
TAX DOLLARS FLOWING DIRECTLY INTO TREASURY

dollar of tax incentive will generate $1.20 of taxes as it flows through our economy prior to reaching the Treasury.

1. Expenditures for services generates about $35 million of income taxes paid by wage earners.
2. Corporate suppliers will pay about $4.4 million in corporate income taxes.
3. Investors will pay about $21 million of income taxes on the production revenue derived from their share of the discovered petroleum reserve.
4. Therefore the $50 million tax incentive will provide about $60.4 million in taxes.

This represents only a portion of the multiplier effect caused by our confiscatory tax incentive system. Further, it is probable that none of the $100 million would be available if it were not for the incentives of the depletion provision and the deduction of intangible drilling expenses.

U. S. CAPITAL DEVELOPED CANADIAN INDUSTRY

Another case in point is the development of the petroleum industry in Western Canada. There is very little tax incentive for Canadian citizens to invest in petroleum exploration. But U. S. taxpayers derive the same benefit from an investment in that country as in the United States. So, here again, the magnet of opportunity, supported by our dynamic tax formula, has attracted U. S. risk capital, totalling some $10 billion during the last 22 years, to the development of the vast Western Canada oil industry.

By comparison, it is estimated that only $4 billion of Canadian capital has been invested there. Thus, major impetus to an important Canadian industry has been provided by U. S. dollars.

In passing, I would venture that the recent Alaskan oil discoveries, so important in our total domestic reserve picture, would not have been made were it not for the combination of tax elements cited here. Petroleum exploration of the North Slope began in about 1944 under the auspices of the federal government. Little economic value has been contributed to the nation by that activity. On the other hand, the petroleum industry, operating under the tax incentive system, began significant exploration in 1964, and this year -- five years later -- has increased the domestic reserve by at least 20% and has provided the State of Alaska with more than $1 billion and a continuing source of income for several decades.

WHY INCENTIVES ARE NEEDED

Critics of petroleum tax provisions are saying: "Why so much fuss about oil? The industry appears to be in robust health. World-wide supplies are almost limitless. A little belt-tightening in the interest of tax reform is a small price to pay."

These premises may all be true, considering the industry on a global basis.

But the very factors taken into account in initially establishing the tax structure for oil are even more salient today for the very survival of the domestic oil industry.

Other testimony, I am sure, has discussed these factors in detail, and I will not attempt to reiterate that evidence. Let me simply cite some of the key reasons why oil tax provisions should be preserved:

1. Our nation's defense and economic well-being require an adequate domestic source of oil.
2. A high risk factor works against the attraction of all but very speculative capital.
3. High costs have reduced the amount of drilling activity.
4. As a nation we are rapidly consuming known existing reserves, thus bringing about an impending shortage.

The threat of a petroleum shortage is not a theoretical one. It exists here and now and is most vividly seen in the diminishing availability of natural gas.

John G. Winger points out in the August 26, 1969 issue of "The Petroleum Situation" published by Chase Manhattan Bank, that conditions could rapidly reach a critical stage for the nation's natural gas industry and its customers.

As he indicates, gas is found incidental to the search for oil. And if the industry severely curtailed its hunt for oil in the United States, very little additional gas would be found, and although gas can be imported, the potential sources are limited and more costly.

On the basis of Chase Manhattan surveys, Mr. Winger has expressed the opinion to us that at least $3 billion <u>more per year</u>

must be spent in the U. S. for oil exploration and development just to maintain our current level of self-sufficiency.

ECONOMIC PHILOSOPHY IN QUESTION

In reality, the point we face today in the discussion of so-called tax reform is a philosophical one: Who spends more productively, government or private enterprise?

The alternative to incentive is subsidy.

Speaking for but one small segment of a giant industry, I unhesitatingly go on record as being opposed to subsidy. Just as strongly do I urge the continuation of existing oil tax incentives:

1. The 27-1/2% depletion allowance
2. The deduction of intangible drilling expenses.

These are not "loopholes" in themselves. Their misuse is. And certainly I concur that the 155 millionaires who reportedly escape all taxes indeed are misusing these incentives.

Rather than diminish or curtail the incentives which, when harnessed to the progressive income tax system have given dynamic thrust to our total economy, let us expand those incentives and broaden them to other areas. In the hands of creative, motivated men they can produce solutions to our most crying national needs. And all America will benefit.

- 30 -

SENATE FINANCE COMMITTEE

TAX REFORM BILL OF 1969 - H.R. 13270

Statement of Dr. J. Roscoe Miller
Chancellor and President,
Northwestern University

Certain Provisions Relating to Charitable Deductions

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 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 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 variety 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, 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. *

---

*Tax Reform Studies and Proposals, U. S. Treasury Department, Committee Print, February 5, 1969, Part 2, p. 205.

33-758 O - 69 -- No. 19 -- 34

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."*

---

*Staff Summary of H.R. 13270, August 18, 1969, p. 31.

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 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.

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 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 pervent 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 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.

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Tax Reform Bill Proposals Affecting Employee Benefits (H.R. 13270 as passed by House of Representatives)

by

Committee on Employee Benefits

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Summary of Report on

Tax Reform Bill Proposals affecting Employee Benefits

(H. R. 13270 as passed by House of Representatives)

by

Committee on Employee Benefits

H. R. 13270, as passed by the House of Representatives (hereafter referred to as the "Bill"), proposes seven measures affecting employee benefits that have been considered at a series of meetings held by the Committee on Employee Benefits.

General observations: Effect on Committee's views of 50% limitation of maximum tax rate on earned income [Bill, §802]

The views of the Committee on Employee Benefits towards provisions of the Bill which would affect employee benefit plans are in part based on the Bill's limitation of the maximum tax rate on earned income to 50%. Of necessity, the provisions of the Bill relating to employee benefit plans must be considered in connection with this proposed limitation.

Our Committee favors the proposed limitation for the following reasons:

1. We concur that the limitation will tend to reduce the variety of complex plans that have evolved which have as an important purpose the reduction or averaging of ordinary income so as to prevent application of the highest tax brackets. The Bill would thus encourage payment of current compensation in lieu of deferred compensation.

2. There has long been an unjustifiable discrimination in the tax laws against individuals whose income is primarily derived from their services, as compared with individuals with capital to invest. This discrimination has been caused by the substantial spread between the high progressive rates of tax on ordinary income and the capital gains rates. Any measure which reduces this discrimination is a forward step essential to the equitable application of the tax law constituting a basic objective of the Bill.

SUMMARY

Our Committee's views on each of the seven measures proposed in the Bill may be summarized as follows:

I. Employee Stock Purchase and Restricted Stock Option Plans-increase in holding periods [Bill, §§514(b)(7) and (8)]. If the holding period for long-term capital gains treatment on the sale of securities generally is to be extended from six to twelve months (a question not within the province of the Committee on Employee Benefits), our Committee concurs in a similar extension of the holding period requirements for favorable tax treatment under employee stock purchase and restricted stock option plans. If the employee is to be required to hold the employer's stock for twelve months to obtain long-term capital gains treatment, as proposed in the Bill, simplicity would best be served by requiring the employee to hold the stock for the same period to avert receipt of compensation.

II. Qualified Retirement Plans of Subchapter S Corporations [Bill, §541]. We do not favor further extension of the present restrictive limitations on contributions applicable to qualified retirement plans for the self-employed, i.e., sole proprietors and partners. Moreover, the proposed changes for Subchapter S corporations would result in three different sets of tax rules for qualified plans - one for corporations other than Subchapter S corporations, a second for Subchapter S

corporations, and a third for the self-employed. Thus, still further complications would be added to already complicated tax rules.

Our Committee favors the development of a single set of tax rules which should be applicable to qualified retirement plans and contributions to such plans; the objective of a retirement plan is the same, irrespective of the form of business operation, and no distinction should be made based on the form of business operation. A uniform set of rules has become even more necessary now that the Commissioner of Internal Revenue has agreed to corporate tax treatment for individuals engaged in a profession who incorporate as a professional corporation (TIR 1019, August 8, 1969).

III. <u>Employee Relocation (Moving) Expenses [Bill, §231]</u>. Our Committee is generally in accord with the provisions of the Bill relating to employee relocation expenses for reasons stated in our prior reports*. Our only reservations concern (a) the proposed $2,500 ceiling on deductible expenses, which we would like to see replaced with a qualitative limitation based upon reasonableness similar to that imposed on business

* See Supplementary Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated May 9, 1969, and the prior Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated November, 1968.

and travel expenses generally, and (b) the proposed increase in the minimum distance for moves (in respect of which expenses may be deducted) to 50 miles, which we would like to see replaced by the 20-mile test in the present law, to provide for office or plant relocations between densely populated areas and suburbs.

IV. Lump Sum Payments from Qualified Retirement Plans [Bill, §515]. We do not favor the five-year carry-forward formula, with the accompanying procedure for refund claims, proposed by the Bill as a means of alleviating the bunched-income problem incident to receipt of lump sum payments from qualified plans. The Bill's method of taxation involves administrative complexities and burdens on Government and taxpayers alike. Particularly if the 25% ceiling on the tax on capital gain is eliminated or curtailed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on a lump sum payment and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to call for continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

33-758 O - 69 -- No. 19 -- 35

V. Restricted Property [Bill, § 321]. Our Committee is in the process of completing a study, which has extended over a period of several months, directed toward the varied business practices in the use of restricted property. Pending completion of that study, our Committee makes the following recommendations:

1. The Bill does not make provision for the deduction by the employer of the amount considered compensation to the employee in respect of restricted property. Our Committee believes that, if restricted stock is to be made the subject of legislation, provision should be made for the employer's deduction by statute rather than Treasury Regulations.

2. Numerous employees who have been receiving bonuses in the form of restricted stock under existing plans have rendered services during 1969 in the expectation of receiving such bonuses for such services. Many employees irrevocably elected in 1968 to forego cash or other compensation in favor of such bonuses. Against this background, the Bill would make the new rules inapplicable to transfers of stock prior to February 1, 1970 if made pursuant to a plan adopted and approved prior to July 1, 1969. However, bonuses are usually

fixed with reference to corporate profits and the amount of such profits is not known with certainty until certified by accountants. Certification of the profits is usually not available until the month of February for calendar year corporations, and the committee or other body making the awards usually does not act until the end of February or early March. To permit normal conservative corporate procedure, our Committee accordingly recommends that transfers of restricted stock pursuant to plans in existence on July 1, 1969 be permitted under present tax rules until April 1, 1970.

3. Restricted property might be considered as involving deferred compensation. If so regarded and if the minimum tax provisions in the Bill relating to deferred compensation were to be adopted, the Bill should make it clear that the minimum tax provisions are not to be applicable to transfers of restricted property made prior to the effective dates of the new rules relating to restricted property. It would be anomalous for the minimum tax provisions to be interpreted to apply in future years when restrictions lapse with respect to property transferred subject to restrictions prior to the effective dates of the new rules relating to such property.

VI. Payments to Non-Qualified Trusts and Annuity Plans [Bill, §321(b)]. Our Committee agrees with the principle proposed by the Treasury and accepted in the Bill that the tax rules relating to payments to non-qualified employer trusts and under non-qualified annuity plans should generally correspond to the tax rules relating to restricted property. To this end, statutory provision should be made for the employer's tax deduction to allay the uncertainty that has existed in this area and foreclose further litigation. While approving the principle proposed by the Treasury, we believe that there should be a special rule in the case of disqualification of a qualified retirement plan, so that the innocent employee-beneficiaries will not be adversely affected, as, for example, by becoming subject to tax on vested benefits prior to the year in which the benefits become distributable to them.

VII. Other Deferred Compensation [Bill, §§802, 331]. Our Committee believes it inappropriate and unnecessary to enact tax measures against individual deferred compensation arrangements represented by (a) the Bill's general exclusion of deferred compensation payments from the definition of earned income and (b) the additional minimum tax provisions for deferred compensation. Deferred compensation arrangements often

have business purposes other than spreading of taxable income. In any event, a 50% maximum tax on earned income should itself be sufficient to discourage future use of deferred compensation arrangements stimulated solely by a desire to shift taxable income into low tax years after retirement. The Bill presents numerous technical difficulties, such as the absence of a definition of "deferred compensation", and the entire subject calls for further study, as requested by the Treasury Department.

COMMITTEE ON EMPLOYEE BENEFITS

By: V. Henry Rothschild 2nd
Chairman

DISCUSSION OF VIEWS

OF

COMMITTEE ON EMPLOYEE BENEFITS

I. **Employee Stock Purchase and Restricted Stock Option Plans - increase in holding periods [Bill, §514(b) (7) and (8)]**

1. As part of the provisions of the Bill lengthening from six months to twelve months the holding period which separates short-term from long-term capital gains and losses, the Bill would extend the six months' holding period applicable to employee stock purchase plans and to restricted stock options [Bill §514(b) (7) and (8) which would amend Code §§ 423(a) (1) and 424(a)(1) and (c)(1) and (2)]. Thus an employee would be required to hold stock acquired under an employee stock purchase plan or upon exercise of a restricted stock option for twelve months, instead of six months as under present law, if no income is to result from the exercise of his option.

2. Our Committee considered the limited retroactive effect of such a change on employees who now have a right to purchase stock or hold a restricted stock option, particularly on an employee who had already purchased stock or exercised a restricted stock option with the six-months' holding period having expired or nearly expired on January 1, 1970, the effective date of the proposed change of the law on employees on a calendar year basis [Bill, §514(d)]. If the general holding period for long-term capital gains is to be extended from six to twelve months (a question not within the province of the Committee on Employee Benefits), our Committee concurs

in a similar extension of the holding period requirements for favorable tax treatment under employee stock purchase and restricted stock option plans. In the event that the employee is to be required to hold the employer's stock for twelve months to obtain long-term capital gains treatment, as proposed in the Bill, simplicity would best be served by requiring the employee to hold the stock for the same period to avert receipt of compensation.

II. Qualified Retirement Plans of Subchapter S Corporations [Bill, §541]

1. The Bill would impose limitations on contributions to qualified retirement plans by individuals who are "shareholder-employees" of corporations that have elected to be taxed under Subchapter S of the Code. Such limitations are intended to be generally similar to the limitations now applicable to contributions by self-employed persons (proprietors and partners). For this purpose, a shareholder-employee would be defined as an officer or employee who owns or controls at any time during the taxable year more than 5% of the shares of the corporation's stock (as distinguished from the 10% ownership or control to which the "owner-employee" rules for partnerships apply).

2. A shareholder-employee of a Subchapter S corporation would be required to include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent that such contributions exceed 10% of his salary or $2,500, whichever is less. The amount the shareholder-employee would thus be required to include in his income would be treated as his contribution to the trust and would be recovered tax-free at the time he is entitled to benefits from the plan. In the case of profit-sharing or stock bonus plans, the Bill would prohibit forfeitures of con-

tributions that had been deducted in Subchapter S years to be used to benefit shareholder-employees (except forfeitures of contributions made in taxable years before 1970).

3. Except for the proposed changes with respect to contributions and forfeitures, the present tax rules for qualified plans of corporations would continue to apply to qualified plans of Subchapter S corporations. Thus the additional requirements for qualification applicable only to plans covering self-employed "owner-employees" would not apply to plans of Subchapter S corporations. The rules applicable to certain distributions, such as Section 101(b) of the Code relating to the $5,000 death benefit exclusion, and Section 105(d) relating to the sick pay exclusion, which apply to distributions from corporate plans but not to plans covering self-employed individuals, would continue to apply to distributions from plans of Subchapter S corporations.

4. Our Committee does not favor extension of the present restrictive limitations on contributions applicable to qualified retirement plans for the self-employed. Moreover, the proposed changes for Subchapter S corporations would result in three different sets of tax rules for qualified plans - one for corporations other than Subchapter S corporations, a second for Subchapter S corporations, and a third for the self-employed. Thus, still further complications would be added

to already complicated tax rules.

5. Our Committee favors the development of a single set of tax rules which should be applicable to retirement plans and contributions to such plans; the objective of a retirement plan is the same, irrespective of the form of business operation, and no distinction should be made based on the form of business operation. A uniform set of rules has become even more necessary now that the Commissioner of Internal Revenue has agreed to corporate tax treatment for individuals engaged in a profession who incorporate as a professional corporation (TIR-1019, August 8, 1969).

III. Employee Relocation (Moving) Expenses [Bill, §231]

1. The Bill would eliminate any distinctions still remaining between old and new employees and direct and indirect moving expenses, by requiring the inclusion in gross income of all amounts received in reimbursement of moving expenses (proposed new Code §82) and the deduction of such expenses only pursuant to Section 217 of the Code. Our Committee affirms its previous support for such uniform tax treatment.*

2. The Bill would also eliminate from the provision for deduction for house-hunting expenses the previous limitation to moves essentially within the geographical limits of the United States which was made in the Treasury proposals and in previous bills. Our Committee affirms its support for the elimination of this restriction.

3. The Bill would also codify the provision previ-

---

* See Supplementary Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated May 9, 1969, and the prior report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated November, 1968.

ously contained in the Treasury proposals limiting such deductions to expenses incurred on trips started after obtaining employment at the new place of business. Our Committee supports this provision.

4. The Bill would add to deductible expenses those incurred in leasing a new residence at the new place of work (other than payments or prepayments of rent). Such expenses were not included among those deductible in the Treasury proposals or in previous bills. Our Committee affirms its support for this addition.

5. The Bill also makes technical provision to prevent the inclusion of deductible items in cost basis, which we heretofore recommended and believe sound.

6. The Bill would change the minimum distance from the present 20 miles to 50 miles for moves in respect of which expenses may be deducted. Our Committee believes the 20-mile test should be retained to permit the deduction of expenses incurred by employees incident to office and plant relocations between densely populated areas and suburbs.

7. The Bill would impose an overall limit of $2,500 ($1,250 for husband and wife filing separate returns) on the three new categories of deductible expenses (house-hunting, temporary living, and qualified residence sale, purchase or

lease expenses), with a sub-limit on expenses for house-hunting and temporary living of $1,000 ($500 for husband and wife filing separate returns). Our Committee affirms its previous position that it would be more desirable to impose a qualitative limit, based upon reasonableness or a prohibition of expenses that were lavish or extravagant, for expenses of all types other than those of disposing of the employee's old residence. However, if revenue considerations require the imposition of dollar limitations, our Committee believes the classification employed in the Bill not unreasonable.

IV. Lump Sum Payments from Qualified Retirement Plans [Bill, §515]

Summary of Changes

1. The Bill would confine capital gains treatment of lump sum payments from qualified pension, profit-sharing and similar plans to appreciation and income on employer and employee contributions, with employer contributions being subject to tax at ordinary income rates when payment is received.

2. The Bill would tax and in effect treat securities of the employer distributed under a qualified plan as part of, and on the same basis as, the employer's contribution, with only income and appreciation considered subject to capital gain. Taxation of the net unrealized appreciation in employer securities would continue to be postponed, as under present law, until the securities of the employer are sold (Code, §402(a)(1), second sentence, and §402(a)(2), second sentence).

3. (a) Benefits accrued after December 31, 1969 attributable to amounts contributed by the employer would be taxed as ordinary income under a five-year "forward" averaging formula (five times the increase in tax resulting from including 20% of the distribution in gross income). However, if the tax paid by the employee proves at the end of the five-year

33-758 O - 69 -- No. 19 -- 36

period to be more than the tax that he would have paid in each of the five years during such period on 20% of the distribution, the employee would be entitled to a refund. If the employee dies before the fifth taxable year, recomputation of the tax with respect to the ordinary income portion of the distribution would be made by adding 20% of such distribution in each of the taxable years the employee lived of the five-year period (other than the taxable year ending with his death), and multiplying the average of the increase in tax so computed by five. If the recomputed amount is less than the tax actually paid, the employee's estate would be entitled to a refund.

(b) The carry-forward formula would be available only to employees who had been participants in the plan for at least five years.

(c) Although the amount taxed as capital gains would be eligible for averaging under the provisions of the Bill [§311] permitting capital gains to be included in income averaging, if the employee chooses the benefit of income averaging, the five-year carry forward averaging provision for the ordinary income element of the lump sum distribution would not be available to him (Code §1304(b)(2) as proposed to be amended by Bill §515(c)(4)).

Reasons Given for the Change

The following reasons are given by the House Ways and Means Committee for the proposed change in tax treatment of lump sum distributions:

1. The capital gains treatment of lump sum pension distributions was originally enacted in the Revenue Code of 1942 as a solution to the bunched-income problem of receiving an amount in one taxable year which has accrued over several years. Therefore, as a means of achieving an "averaging" effect for these amounts received in one year, Congress defined a lump sum distribution as a gain from a sale or exchange of a capital asset held for more than six months, subject to the more favorable capital gains tax rate - presently, a maximum of 25 percent, as compared to the top marginal tax rate which has ranged up to 91 percent.

The capital gains treatment allows employees to receive substantial amounts of what is in reality deferred compensation at a more favorable tax rate than other compensation for services rendered.

2. The more significant benefits from capital gains treatment of substantial amounts go to those with adjusted gross income of over $50,000.

Views of Our Committee

A. Specific Problems of the Bill

1. The complicated provisions of the Bill would create a number of practical problems of administration for both the Treasury and employers. A determination would have to be made of the portion of the distribution accrued by the employee before January 1, 1970. This may not be too difficult in the case of profit-sharing plans and pension plans of the money purchase type. Although there is a precedent for determination in the case of other types of pension plans in the present rules for determining the portion of a pension attributable to pre-1963 foreign service (Income Tax Regulation §1.72-8(a)(4)), the individual calculations are often complicated.

A determination would also have to be made of the portion of the distribution which is considered attributable to employer contributions for plan years after December 31, 1969. The House Ways and Means Committee indicated in its general explanation (House Report No. 91-413, page 155) that forfeitures would be treated as employer contributions for purposes of the new rules. The problem of determining which portion of a distribution is attributable to forfeitures, which portion is attributable to investment earnings and which

portion is attributable to employer contributions would be administratively complex and unduly burdensome, particularly in the case of the typical aggregate funded pension plan in which determinations are rarely made or records kept as to the amount of contributions made or investment earnings applicable to specific individual employees. It would add a highly expensive cost to make such determination or to maintain such records for individual employees, unnecessary to the proper administration of the plan.

2. The calculation of the amount of tax due on the lump sum distribution would be complex and unduly burdensome for employees, generally requiring the assistance of a tax advisor. In most cases, employees would be making an over-payment of the tax due and would be entitled to a refund five years later, even if distribution were made in the year after the employee terminates employment. The over-payment would be due to the fact that the employee's gross income for the year of distribution would be increased by one-half the distribution attributable to income and appreciation, putting the employee in a higher tax bracket than he would be in the years after the distribution. For an employee with long service, the income and appreciation portion of a distribution may amount to 40% or more of the total distribution.

B. General Comments

Without approving or disapproving the policy of special treatment for lump sum distributions, our Committee does not favor the Bill's substitution of the five-year forward averaging and refund provisions for the capital gains treatment of the portion of a lump sum distribution attributable to employer contributions, for the following reasons:

1. With the maximum capital gains tax rate of 25% and a top tax rate of 77% on ordinary income, there could be a substantial spread between the tax payable on a large distribution from a qualified plan paid in a lump sum and taxed at the 25% maximum capital gains rate and such distribution paid in installments or as an annuity and taxed at ordinary income rates. With the elimination of the 25% ceiling on capital gains and the lowering to 50% of the top tax rate on earned income, as proposed in the Bill, the discrepancy between the rate of capital gains tax on a lump sum payment and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to call for continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

The attached tables indicate that in most cases the amount of taxes payable if the distribution is made in

the form of an annuity would be less than the taxes payable if the distribution is made in a lump sum which is accorded capital gains treatment under the proposed new capital gains rules. For example, on a $25,000 total distribution, based on the assumptions outlined in the explanatory notes to the tables, the present value of the employee's total taxes for a 15-year period would be $3,436 if the distribution were paid in the form of a 15-year annuity, as compared to $3,660 if the distribution were paid in a lump sum and the net after tax proceeds reinvested to yield a return taxable as ordinary income over the 15 years. On a $100,000 distribution, with outside taxable income of $5,000 after retirement, the present value of the employee's taxes on a lump sum distribution would be $23,422, as compared to $20,615 representing the present value of taxes on a 15-year annuity. On a $200,000 distribution, with outside taxable income after retirement of $10,000, the present value of taxes for the 15-year period would be about the same for a lump sum distribution as for a 15-year annuity. Even in the atypical case of an employee with high outside taxable income after retirement and a large distribution from the plan, the disparity between the taxes on a lump sum distribution and the taxes on an annuity is not that great.

2. Our Committee believes that capital gains treatment of the entire lump sum distribution in excess of employee contributions, under the proposed new capital gains rules of the Bill, offers a simple alternative to the complex and administratively burdensome averaging approach of the Bill in solving the bunched-income problem caused by the receipt of the amount attributable to employer contributions in one taxable year.

3. A lump sum distribution from a qualified plan generally represents an amount which has accumulated over long years of service to an employer. Capital gains treatment of such lump sum distributions under the proposed new capital gains rules is a simple fair "averaging" method of taxing such distribution which has accrued over many years of service as an employee.

EXPLANATORY NOTES

The following tables show the difference in taxes payable under lump sum and annuity distributions of equal value, using tax rates proposed in H. R. 13270, as explained below. Taxes applicable to the lump sum distribution represent the present value of total taxes payable over a 15-year period. It is assumed that the total distribution is taxed as a capital gain in the year distributed and that the after-tax proceeds are reinvested to yield a 5% annual return taxable as ordinary income over the 15 years.

The taxes applicable to the annuity distribution represent the present value of total taxes payable over a 15-year period. The annuity payout is assumed to start at age 65, the normal retirement age, and the 15-year period represents the average life expectancy of a male aged 65 (Income Tax Regulations, Sec. 1.72-9, Table I). The annuity payments are based on a 5% annual interest rate.

Taxes shown assume a married taxpayer filing a joint return under the tax rates proposed in H. R. 13270 for taxable years after 1971, assuming that the 25% alternative capital gains rate is not applicable. Present value of the taxes reflects the application of a 5% compound discount factor to tax payments for the second through fifteenth years.

In Table 1 it is assumed that the employee has other income in each of the 15 years, beginning with the year distribution is made or the annuity commences but that the employee's deduction and exemptions equal such other income.

In Tables 2, 3 and 4 taxes are computed on two bases: the first assumes no other taxable income; the second assumes a specified amount of other taxable income each year.

Computations for these tables were prepared by Theresa B. Stuchiner with the assistance of George B. Buck Consulting Actuaries, Inc. Presentation of these tables was prepared by Towers, Perrin, Foster & Crosby, Inc.

TABLE 1 - $25,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value)	$ 3,660	$ 3,436
Taxes as Percent of Total Distribution	14.6%	13.7%

TABLE 2 - $100,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 21,848	$ 17,054
Taxes as Percent of Total Distribution	21.8%	17.1%

	Lump Sum Distribution	Annuity Distribution
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%

V. Restricted Property [Bill, §321]

The subject of restricted property has been under study by the Committee on Employee Benefits for several months and may be made the subject of a separate report.

Pending completion of that study, our Committee made three recommendations, set forth in the Summary to this Report, relating to the transitional rule and clarification of certain provisions of the Bill.

VI. Payments to Non-Qualified Trusts and Annuity Plans [Bill, §321(b)]

1. The Bill would apply to beneficiaries of non-qualified trusts and annuity contracts the proposed rules applicable to restricted property. Thus if an employer makes contributions to a non-qualified trust or under a non-qualified annuity plan and the employee's rights are forfeitable when the contribution is made but later become non-forfeitable, the employee would be taxed on the contribution at the first time his rights are not subject to a substantial risk of forfeiture. Under the present tax rules, if the employee's rights are forfeitable at the time the contribution is made, the employee is not subject to tax at the time his rights become non-forfeitable but is subject to tax only when distribution is made (except in the case of annuity contracts purchased by an employer exempt under Section 501(a) or 521(a) in which case the employee is subject to tax when his rights change from forfeitable to non-forfeitable except to the extent excludible under Section 403(b)).

2. The proposed rules would apply in two general situations: (a) contributions made under a qualified plan for employees which loses its tax-exempt status (either permanently or temporarily) and (b) funded deferred compensation arrangements, under which the employees' rights are forfeitable at the time the contributions are made.

3. Our Committee agrees with the principle proposed by the Treasury Department and accepted in the Bill that the tax rules relating to payments to non-qualified trusts and under non-qualified annuity plans should generally correspond to the tax rules relating to restricted property. To achieve such conformity, the present tax rule on deductibility of employer contributions to non-qualified plans (Code §404(a)(5)) would also have to be changed to conform to the tax rule on deductibility of payments in the form of restricted property.

4. Our Committee believes, however, that the application of the proposed rules could have unforeseen and harsh results in the case of qualified plans which inadvertently lose their tax-exempt status. The employees covered under such a plan would be subject to tax at the time their rights become vested or would be taxed immediately if their rights were not subject to a substantial risk of forfeiture. This result would occur in the case of disqualification because of a prohibited transaction even though the prohibited transaction were to be cured and the trust were to qualify for tax exemption in a later year. Moreover, since withholding would probably be required with respect to this income, the employees take-home pay would be reduced even though no distributions were made to the employees from the trust.

5. In a number of instances, funded (rather than unfunded) plans of deferred compensation have been utilized

as a result of bargaining between exempt organizations and key employees. As in the case of deferred compensation arrangements, the result of this bargaining is reflected in existing employment contracts. This is especially true of exempt organizations that are not entitled to the benefits of Section 403(b) of the Code. Since the enactment of Section 321(b) of the Bill would eliminate the use of such funded deferred compensation plans, it would seem appropriate to provide rules similar to the transition rules contained in proposed Section 1354(g) [Bill, §331] relating to deferred compensation (particularly the rule in Section 1354(g)(2)) in order to provide a period during which such employees could renegotiate their employment agreements.

33-758 O - 69 -- No. 19 -- 37

VII. Other Deferred Compensation [Bill, §§802, 331]

Summary of Changes

The Bill contains two sets of provisions affecting deferred compensation payments:

1. The Bill provides that the highest graduated rate on "earned income" will not exceed 50 percent for any taxable year beginning after December 31, 1969, but would exclude "any deferred compensation payment" from the definition of "earned income." (§802)

2. Income tax on deferred compensation payments would continue to be deferred until the year of receipt, but a minimum tax would be imposed on such payments to the extent that they exceed $10,000 in any year. (§331)

(a) The minimum tax would be the lower of two alternative amounts;

(i) The first alternative amount would be the aggregate increase in tax resulting from adding to the employee's taxable income for each taxable year in which the excess is deemed to have been earned, the portion of the excess over $10,000 deemed to have been earned in that taxable year. For this purpose (and for purposes of determining the second alternative amount) the deferred compensation would be deemed to have been earned ratably over the employee's entire

period of service with the employer (or any predecessor or successor, or parent or subsidiary, of the employer), or over a portion of the period of service if, under regulations to be prescribed, the payment is properly attributable to a portion of the period. This alternative amount could be used only if the taxpayer supplies such information as the regulations prescribe with respect to his income for each taxable year in which the deferred compensation payment is deemed to have been earned.

(ii) The second alternative amount would be determined under a short-cut method which would be used if the taxpayer does not supply the information with respect to his income that would be required by regulations for each taxable year in the earning period or in cases in which a lower minimum tax would result -- generally, cases where the employee's income has declined in his last ten years with the employer. Under this method, the average increase in tax would be computed with respect to the portion of the excess over $10,000 deemed to have been earned in the three taxable years for which the employee's taxable income is highest during the last ten years of the earning period.

(iii) For purposes of applying either alternative, the employee's taxable income for each taxable year in the earning period would be first increased by any amount added to the taxable income for that year with respect to any deferred compensation payment received previously.

(b) The term "employee" would include any individual who performs services for any person, even if the individual is not regarded as the employee of that person for any other purpose under the Code.

(c) The above described provisions would not apply to any deferred compensation payment made under a written plan which meets the non-discrimination requirements of Section 401(a) of the Code, or which would meet such requirements but for the fact that the plan is unfunded, or under a plan in existence on August 4, 1969, which is amended to meet these requirements before January 1, 1972.

(d) Although the amendments would apply with respect to taxable years ending after June 30, 1969, the minimum tax would not apply (1) to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1970, or (2) to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1974, if paid or made available

pursuant to an obligation which was binding on July 11, 1969, and at all times thereafter, without regard to the effect of any possibility of forfeiture by the employee.

Reasons Given for the Changes

1. The general reason for the 50-percent maximum tax on earned income is to reduce the incentive for the use of tax loopholes by highly compensated individuals. With respect to the exclusions from the definition of earned income, the explanation of the provision by the House Ways and Means Committee states as follows:

> ". . . Earned income does not include lump-sum distributions from employee's trusts or employee annuity plans when long-term capital gains treatment is afforded the employer's contribution, nor does it include the employer's contribution if that is eligible for the special averaging rules applicable if the total distribution occurs in one year. In addition, any deferred compensation is not to be considered earned income." (House Report No. 91-413 (Part 1), page 209)

2. The general reasons given for the minimum tax provision are that highly compensated individuals who are able to bargain for discriminatory deferred compensation arrangements should not be able thereby to reduce the rates of tax that would have otherwise been applicable thereto. The House Ways and Means Committee Report states:

> ". . . Your Committee believes that the 50-percent limitation on the marginal tax rates applicable to earned income contained in its bill is a further reason for the adoption of this provision." (House Report No. 91-413 (Part 1), page 90)

3. The arguments in favor of the provision were summarized as follows by the Staffs of the Joint Committee on Internal Revenue Taxation and the Senate Committee on Finance:

> "(1) This provision is supported on the basis that the employee who receives deferred compensation has received, in most cases, a valuable contractual right on which an immediate tax could be imposed, and the bill represents a reasonable compromise between immediate taxation and complete deferral. The payment of the tax is deferred until the compensation is actually received, but the original marginal rate is preserved as a minimum rate.
>
> (2) The tax treatment of deferred compensation should not depend on whether the amount to be deferred is placed in trust or whether it is merely accumulated as a reserve on the books of the employer corporation, because an unfunded promise by a large, financially established corporation is probably as sufficiently sound as the amount of deferred compensation which is placed in trust. Usually these benefits are not available to the average employee-taxpayer.
>
> (3) The possibility of shifting income from high-bracket years to low-bracket years after retirement is generally available only to high-bracket and managerial employees who are in a financial position to demand them -- not to the average employee.
>
> (4) Another provision of this bill reduces maximum tax on earned income to 50 percent. With this lower rate, the incentive to seek deferral is lessened and the special tax treatment of deferred compensation can be ended without harsh consequences." (Summary of H.R. 13270, the Tax Reform Act of 1969, page 53)

Views of Our Committee

1. Our Committee believes that enactment of the 50-percent maximum tax on earned income should itself be sufficient to reduce the future use of those deferred compensation arrangements stimulated by the desire of employees to shift taxable income into low-bracket tax years after retirement. Our Committee therefore believes it inappropriate and unnecessary to enact tax measures against individual deferred compensation arrangements represented by (a) the general exclusion of deferred compensation payments from the definition of earned income and (b) the additional minimum tax provision. These provisions impose a new, complex and, we believe, unnecessary set of tax rules very difficult to administer. Such new rules will make it difficult for employers, and particularly small and medium-sized corporations, to make arrangements prompted primarily by the proper business purpose of conserving corporate cash for current business needs or assuring continued employment and non-competition by key employees.

2. Our Committee believes that it would be appropriate to exclude from "earned income" entitled to the 50-percent limitation on marginal tax rates, those deferred compensation payments deemed earned during years prior to the effective

date of enactment of the Bill.

3. On the other hand, if deferred compensation in excess of $10,000 is to be taxed as current compensation in the year in which earned, it should in equity be considered "earned income" in the year in which earned and subject to the 50-percent maximum rate of tax, unless deferred compensation arrangements are considered so much against public policy as to call for a discriminatory penalty tax.

4. With respect to deferred compensation earned after the effective date of the Bill, it would seem that the benefits to be gained by the combination of the exclusion of the 50-percent rate plus the minimum tax are not proportionate to the administrative and computational complexity that will result. The 50-percent maximum rate will tend to assure that most highly compensated employees will not seek such arrangements except perhaps as a compulsory savings device, to provide a continuing source of income in later less productive years. If the 50-percent maximum rate is enacted, we see no reason why the tax law should otherwise affirmatively discourage such arrangements. . . . . .

Technical Questions Raised by Provisions of the Bill

Maximum Tax Rate on Earned Income

1. There is no definition of "any deferred compensation payment" in Section 802 of the Bill or in the House Ways and Means Committee Report, other than the statement, referred to above, that "any deferred compensation is not to be considered earned income." The question presented is whether the term "deferred compensation" in Section 802 is to be limited to payments under non-qualified plans and arrangements, or whether it also includes distributions under plans which are qualified under Sub-chapter D. Distributions under qualified plans are payments of deferred compensation and expressly so referred to in the title to Sub-chapter D.

Inasmuch as Section 802 specifically excludes distributions under qualified plans to which the special averaging rule or capital gain treatment applies, it is believed that other payments or distributions under qualified plans are not intended to be excluded. If exclusion of all payments and distributions under qualified plans of deferred compensation had been intended, it would not have been necessary expressly to exclude the types of qualified plan distributions now enumerated in Section 802 of the Bill.

If the intention is as stated above, it would appear to be advisable to amend Section 802 of the Bill to provide expressly that payments of deferred compensation under plans or arrangements not qualified under Sub-chapter D are excluded from the definition of earned income. In addition, if the ordinary income portion of any qualified deferred compensation distribution is not to be excluded from the right to maximum tax under Section 802, it would be well to specify that it is the portion of any distribution which is taxed under Section 72(n), 402(a)(2) or 403(a)(2) that is excluded.

2. Many incentive plans provide for the award and payment of bonuses after the end of the taxable year, computed by reference to corporate earnings and employee performance during such year. Payments under such plans would literally be excluded from the definition of earned income. Consideration should be given to providing that all payments received prior to retirement, death or other termination of employment would not be considered deferred compensation within the meaning of the Bill.

3. Many deferred compensation plans involve payments which are measured by the value of stock of the employer contingently credited to the accounts of employees, plus dividend equivalents in respect of such stock, or payments that may otherwise be subject to increase by interest equivalents. The Bill leaves open the question of the years to which such increases would be attributable.

4. Similar definitional questions are presented by the items of income arising in the following circumstances:

(a) Disqualifying dispositions under statutory or qualified stock options;

(b) The exercise of non-statutory stock options;

(c) The vesting of previously forfeitable interests under restricted stock plans (Bill, §321(a)) and funded non-qualified deferred compensation arrangements (Bill, §321(b)).

Since the above-described items of income do not involve "payments" to the employee by the employer, they might well be entitled to the 50-percent maximum rate of tax, but the broader reference in the House Report indicates that the exclusion may not be limited to "payments."

5. Another question is whether payments will be considered "earned income" or "deferred compensation payments" when the right to receive such payments is dependent upon consultation and advisory services, non-competition, and other types of "earn-out" arrangements.

6. The minimum tax provision evidences an intention to encourage non-discriminatory non-funded deferred compensation by excluding them from the minimum tax. Nevertheless, such arrangements do not appear to be entitled under the Bill to the maximum 50-percent rate of tax on earned income. The reason for this disparity in tax treatment is not apparent.

Minimum Tax on Deferred Compensation Payments

1. It is clear under the Bill that no portion of a deferred compensation payment (whether more or less than $10,000) would be entitled to the 50-percent maximum tax. It is not clear, however, whether the 50-percent maximum rate applies for the purpose of the alternative minimum tax calculations. Under both of the alternative methods, the minimum tax is determined by adding to the "taxable income" of certain prior years the "portion of such excess deemed to have been earned in each such year." The Bill does not specify whether, for this purpose, the "portion of the excess" added to the "taxable income" of each prior year is to be considered "earned income" that would have been eligible for the 50-percent limitation in such year.

The 50-percent maximum tax provision of the Bill expressly excludes "deferred compensation payments," but it does not expressly exclude any amount deemed to have been earned. Therefore it might well be argued that an amount deemed to have been earned during the prior year should be considered earned income for the purpose of computing the additional tax liability that would have been due with respect to that year if the amount earned had been paid during that year. Note also that if such amount earned had been paid it would have been eligible for the 50-percent maximum rate of

tax, inasmuch as such payment would not have been deferred compensation for such prior year.

If it was the intention to allow the 50-percent maximum tax to apply to the amounts deemed earned, little if any additional tax will result if such payments are not subject to the limitation for the purpose of computing the tax otherwise applicable to the year of receipt. If, on the other hand, the limitation is not available for the purpose of computing the additional minimum tax, the Bill will operate in punitive fashion against deferred compensation arrangements which are prompted by corporate business reasons.

2. The minimum tax provisions leave open a number of questions:

(a) The minimum tax provision of the Bill states that, "If an individual receives a deferred compensation payment during the taxable year, the tax . . . which is attributable to the excess (if any) of such payment over $10,000 shall not be less than" the minimum tax. The reference to a "payment" raises the question whether the minimum tax is to be computed separately with respect to each such payment. Inasmuch as many arrangements for deferred compensation provide for more than one payment during the year, e.g., monthly or quarterly, the provision should be amended to make it clear that the computation is to be made with respect to all payments of deferred compensation received during the year from whatever source.

(b) How is the period of time over which the payments are deemed to have been earned, as stated in new Code Section 1354(c), to be determined? Under both alternatives, such period is deemed to be the employee's entire period of service with the employer (including any successor or predecessor or a parent or subsidiary) "or a portion of such period, if, under regulations prescribed by the Secretary or his delegate, such payment is properly attributable to such portion." Since deferred compensation payments are almost always made pursuant to written contractual arrangements, it seems likely that such payments will in most cases be attributed to a shorter period of time than the entire period of employment, except in the case of the executive who enters into such a contractual arrangement when he joins a new employer at a high level.

(c) The first alternative provided by Section 1354(a)(1), under which a portion of the excess is added to the taxable income of each year in which it is deemed to have been earned, is applicable only if the information requirement of Section 1354(e) is satisfied. The nature of the information that will be required is not indicated. It would seem that what might reasonably be required is a computation of the taxable income, with and without the earned amount attributable to each of the taxable years over which the deferred compensation payment is deemed or

claimed to have been earned. This would seem to be justified by the administrative difficulties that might otherwise be encountered if the taxpayer did not supply the figures from his returns of prior years, figures which are often difficult for revenue agents to obtain, even though they are on file with the Service.

Nevertheless, it will be necessary for the Treasury to have this information available for the last ten years for the purpose of making the second alternative computation, so that the second alternative seems to be a punitive provision for failure to keep records.

3. The relationship between the transition rule (§331(a)) and the effective date provisions of the Bill (§331(e)) are not entirely clear and should be clarified.

STATEMENT

OF

LOUIS O. KELSO AND NORMAN G. KURLAND

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

91st CONGRESS, FIRST SESSION

OCTOBER 2, 1969

ON

FEDERAL TAX POLICY TO CREATE FULL EMPLOYMENT

BY BROADENING THE OWNERSHIP OF PRODUCTIVE CAPITAL

33-758 O - 69 -- No. 19 -- 38

STATEMENT OF LOUIS O. KELSO AND NORMAN G. KURLAND BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, 91ST CONGRESS, FIRST SESSION, OCTOBER 2, 1969 ON FEDERAL TAX POLICY TO CREATE FULL EMPLOYMENT BY BROADENING THE OWNERSHIP OF PRODUCTIVE CAPITAL

		Page
I.	INTRODUCTORY REMARKS AND SUMMARY	1
II.	THE UNEXPLORED PROBLEM OF OUR TAX POLICY: HOW OUR TAX POLICIES FRUSTRATE BROADER CAPITAL OWNERSHIP.	6
	A. How Corporate Tax Laws Encourage the Continuing Concentration of Wealth.	6
	B. How Corporation Taxes Have Weakened our "Private Property" System.	10
	C. How Other Tax Laws Accentuate the Concentrated Ownership of Capital.	13
	D. A Slightly Different View of the Taxpayer Revolt.	14
	E. Tax Policy and the Loopholes.	16
	F. Tax Policy and Inflation.	16
	G. Tax Policy and Economic Growth.	19
	H. Tax Policy and Unemployment.	20
	I. Tax Policy and Skyrocketing Welfare Costs.	21
III.	THE SECOND INCOME PLAN TRUST: A HIGH-POWERED QUALIFIED DEFERRED COMPENSATION TRUST FOR CONVERTING EMPLOYEES INTO OWNERS OF NEWLY FINANCED CAPITAL	22
	A. Description of Second Income Plan Financing and the Operation of Second Income Plan Trusts for Corporate Employees.	22
	B. Some Examples of the Use of Second Income Plan Trusts and Related Financing Techniques to Broaden Capital Ownership.	30
	C. Comparison of Financial Effect on Stockholder Equity of Employee Second Income Plan Trust Financing of Corporate Growth with Straight Loan Financing.	36

		Page
IV.	THE SECOND INCOME PLAN: A COMPREHENSIVE STRATEGY FOR BROADENING OUR TAXPAYER BASE BY ENABLING ALL FAMILIES TO OWN CAPITAL.	47
	A. A Graphic Presentation of the Second Income Plan.	47
	B. Questions Most Often Asked About the Second Income Plan.	79
	C. Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy.	90
V.	RECOMMENDED TAX REFORMS	104
VI.	BIBLIOGRAPHY	108

STATEMENT OF LOUIS O. KELSO* AND NORMAN G. KURLAND** BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, 91st CONGRESS, FIRST SESSION, OCTOBER 2, 1969, ON FEDERAL TAX POLICY TO CREATE FULL EMPLOYMENT BY BROADENING THE OWNERSHIP OF PRODUCTIVE CAPITAL

My name is Norman Kurland. I represent the Institute for the Study of Economic Systems, an educational and research organization that seeks within the strengths and dynamics of a private property, free enterprise system the new and creative solutions to the problems of our economy. My presentation today was developed in collaboration with Louis O. Kelso, noted economist and senior partner of a widely respected San Francisco law firm specializing in corporation, tax, and finance law.

We would like to address ourselves to issues thus far ignored in the current deliberations on tax reform. Our main focus is on aspects of our tax policies which perpetuate and encourage concentrated capital ownership. Our analysis, we feel, will amply demonstrate that tax policy designed to restore health to our economy and promote economic justice has, in fact, inhibited economic vitality and has denied most Americans equal opportunities to participate in the production of wealth

*Mr. Kelso is an economist and senior partner in the San Francisco law firm of Kelso, Cotton, Seligman, and Ray which specializes in corporation, tax and finance law. He is author of The Capitalist Manifesto, The New Capitalists, and Two-Factor Theory: The Economics of Reality, and numerous articles on economic theory and new techniques of financing broader capital ownership.

**Mr. Kurland is a member of the District of Columbia bar and directs the Institute for the Study of Economic Systems. He was former Director of Planning of the Citizens' Crusade Against Poverty. He studied economics at the University of Chicago.

as owners of capital.

Our national fiscal policies today have missed the target on this important issue:

> How can we motivate all employable persons to expand to the fullest our economy's output of useful goods and services, synchronizing that expanded productive power with expanded purchasing power among people who need and desire to consume that new wealth?

In brief, today's economic problems cannot be solved without a recognition of these basic facts:

* Capital instruments in America's largest corporations produce the overwhelming bulk of our wealth.

* Capital ownership is highly desirable for people fortunate enough to acquire a capital estate.

* Capital ownership is highly concentrated and is becoming even more so.

* Current tax policy, because it encourages the use of conventional techniques for financing new capital formation, denies access to capital ownership to 95 percent of the American people.

* American industry has the physical capacity (i.e. the managerial and technical know-how, the physical capital, the trainable manpower and the resources) to expand its output of useful goods and services many times its present rate, if it had customers with sufficient buying power.

As we will attempt to demonstrate (see section II) the inability of most Americans to legitimate their incomes through capital ownership is the root cause for today's most pressing economic problems:

* Rising government costs.

* Dangerous inflationary trends.

* Inadequate economic expansion.

* Underutilized manpower and resource wastes.

* Unhealthy and increasing dependency of major corporations, local communities, and millions of citizens on Federal spending in order to survive economically.

* The continuing failure of the private sector of our economy -- the major U.S. corporations and our labor organizations -- to solve our economic problems with minimal government intervention.

* Our inability to broaden our taxpayer base.

* The ominous taxpayers' revolt.

We propose two basic and interrelated strategies for broadening the base of capital ownership -- without eroding or redistributing the private property of existing owners -- so that every household in America could begin to acquire legitimately a reasonably-sized capital estate as a supplementary source of its purchasing power. We propose that Congress enact tax reforms (see section V) which would:

(1) Encourage the expanded use of Second Income Plan Trusts, an approved variation of a qualified deferred compensation stock bonus trust, by the major U.S. corporations so that corporate employees could acquire significant capital estates as corporations financed their capital expansion programs.*

(2) Launch the Second Income Plan, a comprehensive strategy for achieving general affluence and broadening the taxpayer base by enabling all families to own capital.**

*See section III of this testimony and chapter 16 of Two-Factor Theory: The Economics of Reality by Louis O. Kelso and Patricia Hetter.

**See section IV of this testimony; also by Mr. Kelso, see: The New Capitalists (co-author, Mortimer Adler, Random House, 1961); chapter 17 of Two-Factor Theory: The Economics of Reality (co-author, Patricia Hetter, Random House, Vintage paperback, 1968) and "Eliminating the Purchasing Power Gap through Two-Factor Theory and the Second Income Plan" (co-author, Patricia Hetter), Income Maintenance Programs, Hearings . . ., Joint Economic Committee, 90th Congress, 2d Session, Vol. II, pp. 633-652, 1968. The Appendix of Two-Factor Theory contains the "Full Production Act," the model for Federal legislation to plan and implement the Second Income Plan as national policy.

This approach would:

* Build a "second economy" within 25 to 30 years that would be 7 to 10 times larger than the present economy, which is physically incapable of supporting general affluence.

* Create, within 2 years from start-up time, tens of millions of new and useful jobs in private industry to build the physical capital structure (e.g. the buildings, power plants, transportation systems, anti-pollution systems, computers, etc.) needed for a rapidly expanding "second economy."

* Broaden capital ownership among tens of millions of workers without reducing their take-home pay, fringe benefits, or savings.

* Link workers to a supplementary source of income beyond that derived from wages or salaries.

* Broaden capital ownership among the remaining 95 percent of capital-less Americans. (Conservatively, we estimate that, after a 5-year start-up period, one million families every year could leave the welfare rolls, each producing a legitimate income of $4,000 per year through its productive capital. After a second 5-year period, five million familes per year could acquire similar estates. Within 15 years, every American household would produce significant incomes through their newly acquired capital estates.)

* Generate a significant new and legitimate source of mass purchasing power not dependent on government intervention or redistribution but tied directly to newly added productive power in the economy.

* Widen the personal income tax base as the new owners produced their "second incomes" through their capital estates, enabling all Americans to share in support of necessary governmental activities.

* Encourage corporations to pay out 100 percent of net profits to shareholders and to finance their corporate expansion through techniques that lead to broader ownership.

* Enable industry to finance new capital on pre-tax net earnings.

* Gradually eliminate the need for corporation taxes.

* Reduce government costs by enabling the private sector to recapture from government the primary thrust for expanding our economy, thereby gradually reducing government's roles to its traditional functions as "umpire," "gap filler," peace keeper, and controller of our monetary machinery.

* Reduce resource and manpower waste resulting from welfare and from jobs artificially "created" with taxpayer dollars and create rewarding job opportunities for those in industry and in the military who will become "surplus" when the Vietnam conflict terminates.

* Create new and more rewarding roles for labor unions as the demand for employees (and therefore labor's potential constituency) increases under the expanding "second economy". (Labor's bargaining demands would broaden from their exclusive focus now on higher incomes from toil, to economic security and "second incomes from capital.)

* Lift the psychological and economic restraints to expanded use of our new technologies and automation. (Workers who share in the profits produced by a new machine welcome having it make their work easier or replace their toil entirely.)

* Begin to end the historic struggle between the haves and have-nots through a unique "private property" strategy that would turn have-nots into haves without taking from those who own today's capital.

* Gradually eliminate the root causes of our uncontrollable inflation:

  -- Increasing labor costs alongside decreasing labor productivity. (Capital, not labor, has become more productive.)

  -- High interest rates

  -- Non-productive government spending

  -- Unrestrained consumer credit

  -- Other causes which produce artificial purchasing power without simultaneously generating a corresponding increase in the output of wealth.

It should be noted that Second Income Plan financing would reduce corporation taxes flowing from future capital expansion. However, it would not affect Federal revenues currently derived from corporation taxes. The existing capital structure would continue to produce the same net earnings which, unless altered, would be subject to present corporation tax rates. Our proposals are geared exclusively to the future earnings produced by newly added capital. It is this new capital that our economic system so sorely needs to increase our national productive power, to raise our national standard-of-living, and to generate higher incomes for the millions of Americans with unsatisfied needs and wants. Hence, any future "losses" in corporate tax revenues would be far outweighed by revenue gains in the form of higher personal income taxes and lowered government costs.

Our specific recommendations for tax reform are outlined in section V of this presentation.

II. THE UNEXPLORED PROBLEM OF OUR TAX SYSTEM: HOW OUR TAX POLICIES FRUSTRATE BROADER CAPITAL OWNERSHIP.

A. How Corporate Tax Laws Encourage the Continuing Concentration of Wealth.

The fact that about 26 million persons in the United States own at least one share of stock, despite Wall Street's claim to the contrary, does not make them "capitalists." (A reasonable definition of this term would limit its coverage to those receiving at least half of their consummable incomes from income-producing property.) Less than one percent of American households really qualify to use this label. Most of the remaining shareholders could scarcely afford a meal in a decent restaurant if

they depended on their dividend income.

Capital has always produced the highest standard-of-living for those fortunate to own enough of it. But virtually all capital ownership in the American economy is concentrated in 5 out of every 100 families. Having ignored for too long the importance of broader capital ownership, our society has effectively and systematically barred the remaining 95 percent of families from the privilege of becoming capitalists.

One of the major institutional barriers to broader capital ownership, strangely enough, is the corporation tax, a tax solely on owners of capital. The effective rate of Federal and state corporation taxes on major corporations amounts today to about 56 percent.

On first blush this "double tax" on the earnings of capital would appear to be one of the many ways our society has developed for redistributing income from affluent Americans to increase the incomes of non-owners. But, in fact, this enormous "leak" in the income stream produced by capital only serves to perpetuate the traditional pattern of corporate finance, the primary cause of concentrated ownership. By selectively closing this leak and applying more modern techniques of financing new corporate growth, as we will explain, all Americans could become owners and produce significant incomes from capital in our expanding economy.

Our capital instruments -- not labor -- produce most of our society's wealth. Each year corporate managers -- who, interestingly enough, are basically capital-less themselves -- add new productive capital valued in the tens of billions of dollars.

This process increases our productive capacity by relentlessly shifting the burden of producing our wealth from human beings to more efficient new capital instruments. In 1969 alone, over $70 billion worth of buildings, machines, computers, power plants, oil refineries, aircraft, and thousands of other forms of capital will be added to last year's capital structure. But hardly any new owners will be created in the process. Almost all new capital will be financed out of past savings. Less than half of one percent of new capital formation during the eleven years 1955-1965 came from issuing new stocks to the public; 99.5 percent was generated internally.

Yet new capital in our major corporations is subject to "birth control." It is a standard rule-of-thumb among corporate managers that new capital will not be brought into existence in well-managed corporations unless it will rapidly pay for itself -- generally in less than 5 years -- from the future earnings that it will produce for the corporation. But under conventional corporate financing practices capital pays for itself exclusively for the benefit of present owners.

As has been successfully demonstrated in practice (for the benefit of thousands of new owners) since capital in major corporations is inherently financeable, anyone could become an owner of a significant capital estate if he could buy it on credit, let it pay for itself, and thereafter enjoy the income it produces. (See section III[illegible]. below.)

But new owners cannot be created unless we close various

leaks in the income stream produced by newly formed capital. The pre-tax net income produced by capital added in our 4,000 top corporations consistently averages 20 cents to 25 cents on every dollar invested. Most of that income is drained away by corporation taxes (about 56 percent) and earnings withheld by corporate managers for future investment, leaving the average shareholder with a dividend return of 4 to 5 percent. Such a low return may, of course, satisfy already affluent shareholders, who would, for various tax reasons, prefer taking their investment incomes in the form of "capital gains." But such low dividends would not even cover the interest on a capital acquisition loan for potential new owners under today's inflated interest rates.

As we will discuss later, newly discovered financing techniques have overcome these barriers to broader ownership. Some illustrated below (section III.[illegible].) are working now for the benefit of a significant number of corporate employees who could not otherwise gain a "second income" from capital. With minor tax improvements, these techniques would become more widely used as the major vehicle for restoring health to the private sector of our economy, thereby creating millions of legitimate new jobs in industry and widening our tax base. With other minor supplements to our tax policy, even persons not employed by corporations -- including the aged, the disabled, others on welfare, civil servants, and even legislators -- could become owners of a diversified portfolio of newly issued qualified shares and thus begin to produce for themselves significant independent incomes from our expanding economy.

B. <u>How Corporation Taxes Have Weakened Our "Private Property" System</u>.

<u>The institution of "private property"</u> -- whose origin in our own legal system can be traced to roots in Roman law -- <u>amounts to no less than the right to all the wealth that one's property produces</u>. This institution, of course, applies equally to one's right to the wealth produced by his own body and mind (labor) as well as by the non-human extensions of his body (his capital instruments). No one today seriously questions the right to wealth produced by one's labor. Ignored is the fact that the corporation tax (a tax solely on owners of capital), is a direct erosion by more than half of the "private property" of these owners.

Some may react by saying, "So what if the rich are soaked twice? At least the poor will benefit from the redistributed earnings." But are the poor really benefiting from corporation taxes? Are the rich really losing their share of the wealth of our economy? Are the forces of concentration working faster than the forces of redistribution? Is our weakening of the institution of "private property" socially and politically desirable? Is there a better alternative?

We would contend that the poor and others among the 95 percent of American households who are capital-less are seriously harmed by today's erosion of "private property" in capital because it virtually disqualifies them from ever acquiring a "piece of the real action," a private property stake in the industrial assets of the Nation.

On the other hand, the really affluent few, who by the very definition of "affluence" already receive more income than they can possibly consume, lose very little of substance by a "double tax" on their earnings. Under conventional financing techniques the same owners will automatically own all the new capital (and therefore all the new productive power) that comes into being this year, next year, and every year thereafter as we move further into the age of cybernation.

Today's corporation tax -- because it drains off indiscriminately over half of capital's earnings -- is a major factor keeping propertyless Americans economically disenfranchised from our "private property" system.

With no access to capital, most Americans must depend exclusively on toil (which often must be subsidized) and welfare as the sole sources of their subsistence.

It is little wonder then that alienation from our system has become more pervasive, particularly among the poor and our youth. It should not be surprising under the circumstances that so many young and poor people have limited respect for or understanding of the importance of "private property." Most of them, as things stand today, will never have an opportunity to acquire a genuine stake -- a vested interest -- in the property that produces most of our wealth. Does our earlier history suggest some new directions?

Thomas Jefferson envisioned a democratic American society where every family could become economically independent by owning property. The Founding Fathers generally understood

that "power naturally and inevitably follows property" and that the institution of "private property" was a primary shelter for an individual's civil liberties. They recognized that as an institutional check on the inevitable abuses that stem from concentrated power, "private property" had the same potential in the economic world that the "ballot" had in the political arena. Each placed ultimate power and responsibility directly in the hands of each citizen, where he could delegate it upwards and hold his representatives accountable for its exercise.

Under the Homestead Act, Jefferson's vision was realized. Formerly propertyless people responded with great enthusiasm to their new opportunity to free themselves economically by becoming owners of land. This historically unique "private property" approach unleashed enormously high levels of agricultural productivity, in turn releasing millions from work on farms to enter industry. Thus, this dramatic program -- possibly the most important enacted by any government in history -- served as the main springboard for this nation's rapid rise to leadership in the industrial revolution and to world prominence.

When the land frontier ran out, unfortunately, we failed to convert Jefferson's sound ideas to an economic strategy relevant to an industrial era. Industrial capital -- an even more significant form of capital than land -- remained narrowly owned. Our major corporations continued to build a "new frontier" of industrial capital -- unlike land, of almost limitless dimensions -- that continues to expand each year at a rate now rapidly approaching $100 billion worth of new structures, machines, and other forms

of productive capital.

Physically, we have the know-how, technology, resources, and trainable manpower to build enough capital instruments to produce in abundance for all. Institutionally, however, we have not yet reconciled ourselves to that industrial frontier.

C. How Other Tax Laws Accentuate the Concentrated Ownership of Capital.

The favorable personal income tax treatment of "capital gains" (limited to a ceiling of 25 percent) compared to dividend income (up to a 77 percent tax rate) for those in the top tax brackets is the widely acknowledged source of most of the complexity and inequities in our present tax system. What is not generally recognized is that it is one of the most significant structural causes of concentrated ownership. The tax preferences given to capital gains virtually "forces" the wealthy to leave their dividends in the form of retained corporate earnings, which is the main source of investment funds for capital expansion. New capital formation could just as easily -- and more logically -- be financed to broaden the base of capital ownership.

Accelerated depreciation, investment credits, and depletion allowances also tend to concentrate ownership of capital by making it easier for existing owners to acquire ownership of newly formed capital.

The tax-deductibility of gifts to general-purpose foundations -- by disconnecting ownership from people -- has a similar concentrating effect.

33-758 O - 69 -- No. 19 -- 39

D. A Slightly Different View of the Taxpayer Revolt.

Under our national economic policies for the past 35 years, best expressed in the Employment Act of 1946, we have struggled to generate mass purchasing power exclusively through "full employment", backed up by income redistribution, both of which are largely dependent on taxpayer support and to a lesser extent on the manipulation of our monetary machinery. We have no national policy to broaden capital ownership -- despite the fact that capital produces the overwhelming bulk of the goods and services we consume.

Millions of families each year find themselves joining the group of highly insecure Americans who depend for their subsistence on the taxpayers, who are themselves on the most part economically insecure and debt-ridden. Included in that taxpayer-dependent group are not only the growing number of restless people on welfare and on already swollen government payrolls, but the millions of workers in private corporations which would collapse overnight but for government contracts.

Taxpayers are generally willing to support governmental activities where they can realize direct personal or social benefits. But they are generally unwilling to support artificially contrived or unproductive employment or mere doles for others, except when they consider their very survival is at stake, such as in war or under conditions of mass hysteria like war.

Taxpayers will pay for Federal aid to education under the

rubric of "national defense" (e.g., the National Defense Education Act; R.O.T.C. scholarships; Aid to Federally Impacted Areas) but will resist paying the cost of programs expressly designed to help those at the bottom of the economic ladder (e.g., Title I of the Elementary and Secondary Education Act; the Economic Opportunity Act.)

Taxpayers will pay for "law and order" before they will pay for institutionalized charity imposed by fiat. In fact, trying to institutionalize "charity" (derived from "caritas," the Latin word for "love") is as consistent with human nature as any attempt to institutionalize creativity.

Under normal conditions, an undisguised dole is guaranteed to "keep the poor in their place," always limited to the amount that, from a standpoint of political feasibility, could be taken, under force of law, from some and given to others.

Even a program disguised as a "family allowance" or "children's allowance" -- cleverly structured so that every family would receive one -- will not go unnoticed by the taxpayers who will bear the burden not only of their own "gifts" from government but also for those going to millions of non-taxpaying poor families.

On the other hand, because the material expectations of the increasingly organized poor will unavoidably continue to escalate, programs providing doles will necessarily heighten and perpetuate the already perilous confrontation between the most powerless segment of our society -- the poor -- and their most unpredictable and powerful opponent, the average American taxpayer.

If we had no other alternative for answering the problem

of the purchasing power gap in a society capable of producing general affluence, there would indeed be cause for great despair. But with minor revisions of our tax laws and more rational economic goals, we could easily solve that problem.

E. Tax Policy and the Loopholes.

Too much attention given to tax loopholes diverts us from the pressing need for more basic tax reform.

Most fair-minded observers would agree to the closing of loopholes which allow the very wealthy to escape some or all of their fair share of supporting government; e.g., capital gains taxes, accelerated depreciation, investment credits, depletion allowances, and the like. But the very existence of these legal "escape hatches" points out the importance of "private property" in terms of individual security and power. These loopholes reflect the tremendous counter-reaction of the wealthy to minimize any erosion of their property rights.

The closing of tax loopholes, it should be further noted, would hardly lessen the increasing burden imposed by our present economic policies on the middle-class taxpayer, who under any circumstances must pay the bulk of our taxes. The system might become somewhat fairer than at present, yet still collapse from overload.

F. Tax Policy and Inflation.

More rational tax policy -- one which would help bring about

widespread capital ownership of newly added productive capital without violating property rights of existing owners -- would begin to reduce inflationary pressures.

Despite our technological advantages, inflation is forcing American goods out of competition on the world markets and is inducing the flow of American capital abroad.

As most people realize, inflation stems from adding dollars of consumer power without a corresponding increase in the volume of goods. Inflation is one of the best barometers of defective economic and tax policies. (See section IV. C. entitled "Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy.")

Clearly, the most significant inflationary effect can be traced to rising wage and salary demands, the only route left open by our "full employment" policy for most people to gain a "legitimate" income, thus ignoring the almost unlimited frontier of productive capital as an alternate means for legitimizing their incomes.

Labor costs are not subject to competition in our system; while labor's contribution to production continues to decline because of automation and shorter work-weeks, American labor costs continue to rise. This result is understandable when workers are institutionally denied ownership shares in the profits produced by the new productive capital that is replacing them.

Another "cost-push" factor behind inflation is the rising cost of government, much of which is caused by the need under

present economic policies for the government to artificially generate mass purchasing power through spending programs. Under more rational policies, the corporate sector itself could generate that purchasing power directly through more innovative financing techniques which would enable capital-less households to gain "second incomes" through the ownership of newly added productive capital.

We can find a major "demand-pull" force on our sky-rocketing cost-of-living by studying the misuse of our sophisticated credit machinery: we provide credit for further capital acquisition exclusively for existing owners; capital-less Americans are limited to credit for consumer purchases.

Artificial purchasing power is created by consumer credit, which, unlike credit for capital expansion, adds no new productive power to the system. Americans also give away their future purchasing power by paying 22 cents on every after-tax dollar they earn to cover private debt service. A home buyer must earn enough for three homes under today's interest rates to buy one, widening his purchasing power gap by two homes.

On the other hand, credit for capital expansion makes sense. Capital pays for itself when added by our major corporations.

Although there is no symmetry under our present policies between productive power and consumption power, this imbalance could easily be remedied under the Second Income Plan, as is explained in section IV. C.

G. Tax Policy and Economic Growth.

New productive power in our society is basically a product of the new physical capital that is added by our private corporations, the most efficient and productive users of capital in history. Physically, our major corporations could expand (as they have done during all-out wars) by rates far in excess of our present rates, if there were markets, i.e., purchasing power, to buy what the corporations could produce. (During war, the government provides a ready market, although what is produced for war obviously satisfies no one's material needs.)

Today, changes in the tax laws (i.e., eliminating the 7 percent investment credit) are being considered to reduce further our national economic (i.e., capital) growth. This policy might be understandable when ownership is concentrated and when the system has very inefficient, humanly distasteful, and inflation-creating ways for redistributing the necessary purchasing power to take the newly added goods off the market.

A government policy to slow down the production of useful goods and services, however, is obviously absurd when non-inflationary alternatives exist to synchronize the expansion of corporate productive power with the growth of mass purchasing power. (See section IV. C. below and "Eliminating the Purchasing Power Gap Through Two-Factor Theory and the Second Income Plan," by Louis O. Kelso and Patricia Hetter, INCOME MAINTENANCE PROGRAMS, Joint Economic Committee, 90th Congress, Second Session, Volume II, pp. 633-652 (1968)).

Some Second Income Plan techniques are available under present laws and are being used successfully by a few large corporations (see section III.B. for some operating corporate models.)

H. Tax Policy and Unemployment.

Unemployment today is basically the product of our defective economic strategies. During all-out wars when the military budget provides an almost unlimited market for its output, American industry has shown that it can rapidly expand to its full physical capacity to produce, and will "beat the bushes" finding people to be hired and trained on-the-job. From 1940 to 1945, the American economy grew by over 100 percent, 20 percent a year, even with 16 million persons taken from the labor force for military duty. Although over 11 million were unemployed prior to 1940, during the war unemployment was unheard of.

Because we are institutionally unable to synchronize our power to consume with our potential power to produce, growth of our Gross National Product today is limited to about 4.5 percent, with tens of millions of persons unemployed or engaged in non-productive work and wholly subsidized activities for which there is no market demand. (See IV. C.)

If the recommendations proposed here were implemented, we would predict a gradual increase to overall peace-time growth rates of 15 percent annually, building the vast capital structure needed to physically produce general affluence. Such a monumental

task would generate 25 to 30 years of intensive and legitimate "full employment." Because every employable person would, in effect, be building his own capital estate, this approach would attract millions of people into industry who are now unemployed, underemployed, or engaged in non-productive work in industry and government.

I. Tax Policy and Skyrocketing Welfare Costs.

According to the Annual Report of the President's Council of Economic Advisors, the United States is spending $60 billion for income maintenance. Yet even according to "official" poverty criteria over 26 million persons and 5.3 million families are classified as "poor." Over 6 million persons are on the rolls of the Aid-to-Dependent Children Program alone. And the rolls are expanding at an alarming rate.

For example, a New York State welfare study published in 1961 predicted that by 1970 about 700,000 persons would be on the state's welfare rolls, costing taxpayers slightly more than $500 million. In New York City alone in January 1969, the annual cost of welfare topped $1.4 billion for about one million recipients. With 4 percent of the U.S. population, New York City accounts for 11 percent of the Nation's welfare recipients. And 50,000 persons are added to the city's welfare population each month.

Furthermore, the National Welfare Rights Organization has mounted a nation-wide campaign among the poor to "break the welfare

bank" and force adoption of some form of guaranteed annual income. The cost to the taxpayers of such a program is, of course, impossible to estimate accurately.

On the other hand, as we will demonstrate, the expanded use of Second Income Plan techniques would remove millions from the welfare rolls and place them on the tax rolls as productive participants in an expanding American economy. (See sections ~~III. D.~~ I., IV. A. and IV. B.)

III. THE SECOND INCOME PLAN TRUST: A HIGH-POWERED QUALIFIED DEFERRED-COMPENSATION TRUST FOR CONVERTING EMPLOYEES INTO OWNERS OF NEWLY FINANCED CAPITAL.

A. Description of Second Income Plan Financing and the Operation of Second Income Plan Trusts for Corporate Employees.

Second Income Plan credit mechanisms are, without qualification, the most innovative and efficient financing "tools" available for new capital formation. Existing owners, new owners, and lending sources now using these techniques find them mutually attractive and economically beneficial. Because their main function is to broaden capital ownership in major corporations, they represent a major weapon for restoring health to the economy.

Arnold Schuchter, author of the recent book WHITE POWER, BLACK FREEDOM (Beacon Press 1969) and a top economic and community development consultant with Arthur D. Little, Inc., probably the world's most prestigious and experienced management and technical consulting firm, has stated:

> "Together with a number of key professionals in economics and other disciplines at Arthur D. Little, I am persuaded that Second Income Plan financing techniques offer unique potentials for

> economic development programs in existing and new communities benefiting both lower income whites and blacks, as well as participating corporations and financial institutions."

Mr. Schuchter is only one of many in the corporate world who are beginning to recognize the value of the Second Income Plan financing approach.

One of the main tools of the Second Income Plan is the Employee Second Income Trust, which is a U.S. Treasury-qualified adaptation of the standard deferred compensation trust (i.e., employee pension, profit-sharing and stock-bonus plans). The Employee SIP Trust (see diagram next page) is, however, vastly more advantageous for all parties concerned -- especially for corporate employees -- than any of the traditional pension, profit-sharing or stock bonus plans.

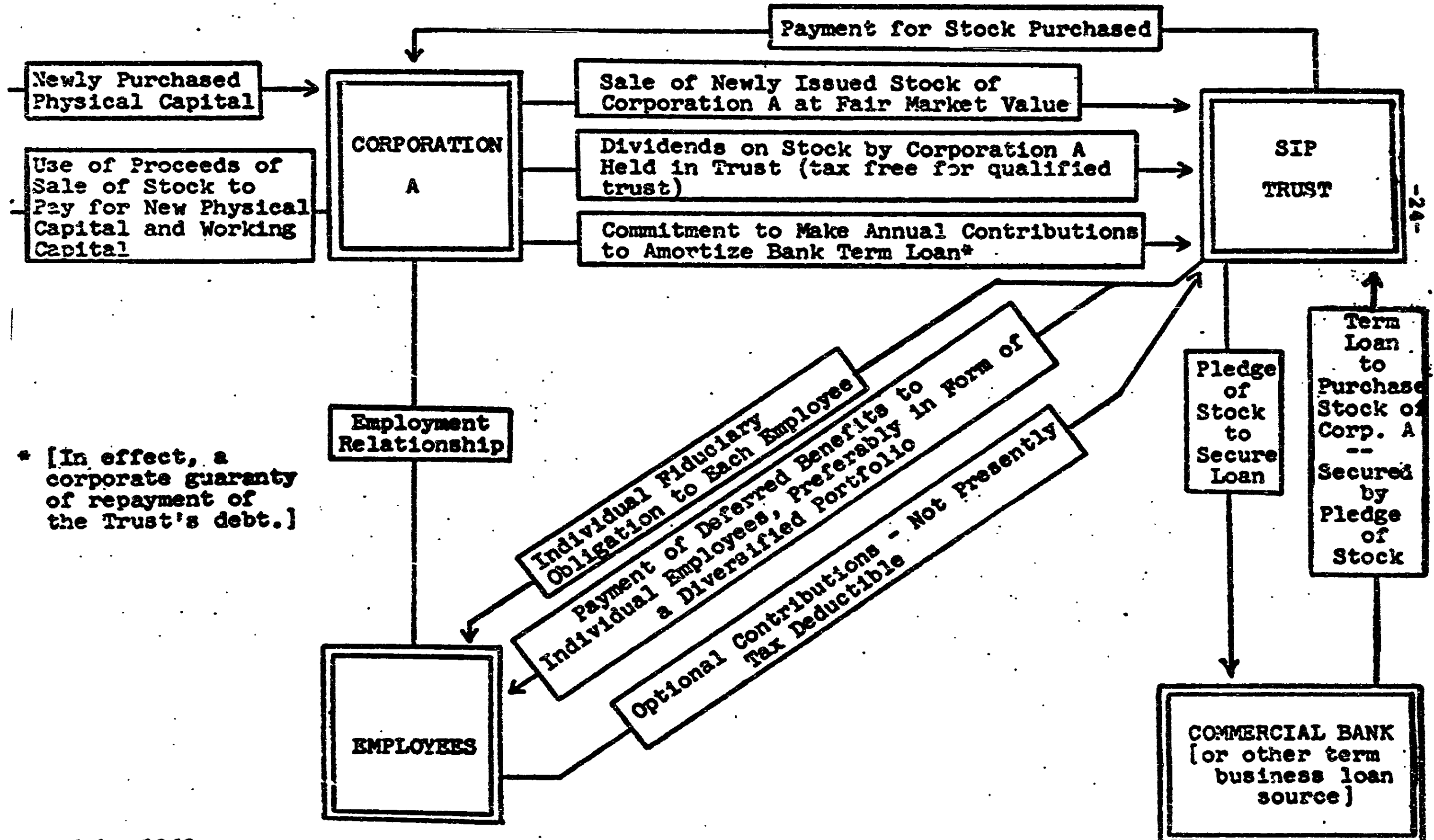
Second Income Plan techniques are explained more fully in the many writings of their architect, San Francisco finance and corporation lawyer and economist Louis O. Kelso. See especially THE NEW CAPITALISTS (Random House 1961), co-authored by the philosopher Mortimer Adler and TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Random House, Vintage paperback 1968) and "Uprooting World Poverty: A Job for Business," BUSINESS HORIZONS, Fall 1964, the latter writings co-authored by Patricia Hetter.

The most distinguishing technical feature of the SIP financing approach is that it permits new capital formation to be financed on credit repayable with future pre-tax earnings of the affected corporations. It thus surmounts a corporation's normal dependency on its past savings (i.e., retained earnings)

DIAGRAM I

SECOND INCOME PLAN FINANCING

[How to Promote Corporate Growth by Making Your Employees Capital Owners]



›pyright 1968: Louis O. Kelso and Patricia Hetter.

for expanding its capital assets. It is also the only technique now available to business for treating principal on a loan for newly added capital as a tax-deductible expense (interest is, of course, already tax-deductible). And, most significantly, this technique uniquely enables formerly propertyless persons to legitimately acquire an ownership stake and a "second income" from capital, without diminishing their savings or income from other sources. The net effect of this approach is to reduce government costs, slow down inflationary pressures, broaden the taxpayer base, and allow industry to expand more rapidly.

The main objects of Second Income Plan (SIP) Trust financing are as follows:

(1) To enable the employees of any well-managed and profitable corporation to acquire a part of the equity interest in the corporation (as much as 100% if desired) and to pay for the stock out of pre-tax corporate dollars, without diminishing their takehome pay or fringe benefits in any manner.

(2) To provide a means of repaying that portion of the financing required for acquiring new capital assets with pre-tax corporate earnings, rather than out of after-tax corporate net income as is normally required.

(3) To establish stockholder control of the company in the management of the company which would normally appoint the trustees of the employee Second Income Plan Trust, who in turn would vote the stock held by the Trust. This would provide long-term stability of management, together with the motivation on the part of management to manage well. (Voting power on stock

held by the Trust, if desired, can be passed on to non-management employee participants.)

(4) To make that part of the financing raised through the employee Trust attractive to the lendor by making it repayable out of pre-tax corporate dollars, enabling the company to use tax savings to finance any capital expansion program in a manner beneficial to all employees.

(5) To enable the employees to acquire their interest in the stock of the company at its initial offering price, and without any tax burden on the employees until they either retire or leave the employment of the company.

The steps in a typical financing plan might run somewhat as follows:

A. An employee Second Income Plan Trust ("SIP Trust") would be established by the company, and it would be qualified under the Internal Revenue Code as a stock-bonus trust. All employees of the company and of such subsidiaries as it may wish to include, subject to eligibility rules to be determined by management and incorporated in the Trust and Plan, would become participants in the Trust, the interest of each being proportionate to his relative income from time to time from the company.

B. The company, as the sponsor for the SIP Trust, would commit itself to contribute to the Trust each year up to 15% (the maximum deductible contribution for Federal corporate income tax purposes) of the overall payroll of employees -- generally all employees -- who participate in the SIP Trust. One of the distinguishing features of the stock-bonus trust is that the

sponsor corporation may commit itself to make the contribution each year, whether or not the corporation's earnings in that particular year are adequate to cover 15% of the covered payroll. Thus, the commitment becomes a general obligation of the corporation itself, payable in pre-tax corporate income dollars.

C. The employees of the company, as participants in the SIP Trust, could be required to sign a close-holding agreement among themselves, pursuant to which, under specified circumstances, after their retirement from active service with the company, they could be required to sell their stock to the SIP Trust. This provision might be of interest if it is desired on a long-range basis to keep the stock ownership in active employees of the company and to do this by buying the stock from retired corporate employees who desire to dispose of the stock, or from their estates, as determined in advance at the time of the drafting of the agreement. Such a close-holding agreement would normally contain a formula for the purchase of the stock that would give the retired employee or his estate the benefit of receiving the fair market value of the stock, as determined under a formula, at the time of the sale to the SIP Trust.

D. The loan by a lendor to the employee SIP Trust could, if desired, be secured by a first or second mortgage on the properties of the company. This would be done by using a mortgage to secure the company's guarantee to the lendor that it would make the contributions to the Trust necessary to enable the Trust to amortize its loan financing.

E. It should be kept in mind that employee Second Income

Trust financing could be combined with the sale of stock to the public if it were desired that the company bring about as broad participation of the public in the activities of the company as possible. (Present tax laws, however, do not allow members of the general public to pay for their stocks with pre-tax corporate dollars.)

F. The term of the loan to the employee Second Income Trust, and the terms of any other financing, would have to be tailored to the projected earnings of the company. In addition, in the case of the SIP Trust, the loan terms would have to be tailored to the ability of the company to handle its debt service out of 15% of the overall payroll of participating employees, in order to stay within the Treasury's limits on the amount of tax deduction that may be taken each year. If, for example, the payroll were $1,000,000 a year, the loan terms should be tailored so that the SIP Trust's note could be serviced (principal and interest) out of contributions of $150,000 per year.

The following are some of the characteristics of this arrangement:

1. The value of the stock of the company sold to the SIP Trust is fixed at the initial offering period to avoid any contest with the Treasury Department over such value in the future.

2. The SIP Trust should be designed so that as installments of its note are amortized, proportionate fractions of the stock would be allocated to the accounts of the employees in the Trust. These allocations are normally in proportion to the respective employees' incomes (through salaries, bonuses, etc.) from the

company. As stock is paid for and allocated to the accounts of the employees, any dividends declared on the stock should pass, with the minimum deferral period (presently three years) through the Trust into the employees' pockets. The object of this is to get a second income from dividends into the employees' pockets at the earliest possible time, while accumulating a capital estate for them in the tax-sheltered trust.

3. Employees are completely free from tax until they withdraw their accounts from the Trust at their normal retirement date, or upon leaving the employment of the company. Most SIP Trusts have a ten-year vesting schedule under which stock in an employee's account may not vest for the first two or three years, with 20% or 30% vesting at the end of the second or third year, and 10% vesting each year thereafter. The effect of this is to cause a forfeiture in the employee's account if he leaves the service of the corporation prior to the full expiration of the vesting period. Of course, instantaneous vesting is legally approved if desired.

4. Since the contributions of the company to the SIP Trust are deductible for state and Federal income tax purposes, the equity of the employees is built up on pre-tax corporate income. Another way of looking at this process, the purchase price for the shares acquired by the employees will be paid partly from future tax savings (roughly 56 percent at present state and Federal rates) and partly from remaining future corporate earnings derived from the productiveness of the new capital assets. The net effect is that as their incomes rise through both dividends and their wages or salaries, employees will in turn become more

33-758 O - 69 -- No. 19 -- 40

significant taxpayers to the Government.

5. Employees should be motivated in due course to minimize wage and salary demands, since such restraint would maximize the income of the company available for contribution to the SIP Trust and for dividends.

6. Normally, the management committee for the SIP Trust is appointed either by the management or the board of directors of the sponsoring company. Thus, the stock acquired by the SIP Trust is under the fairly secure control of management for the indefinite future.

7. As the stock purchase price if paid off, the employee SIP Trust can be continued in operation to build equity capital estates in diversified securities for the benefit of company employees, again using pre-tax corporate income dollars.

8. Similarly, the SIP Trust can be used to purchase newly issued stock by the company, thus providing it with funds for working capital or corporate expansion financed out of pre-tax corporate dollars.

B. Some Examples of the Use of Second Income Plan Trusts and Related Financing Techniques to Broaden Capital Ownership*

1. Second Income Plan Trusts to Turn Employees into Owners of Mature, Well-Managed Corporations

a. The First California Company.

The First California Company, one of California's top brokerage and investment banking firms, traces its ancestry back to days when it was the investment banking

* Extracted from a publication by Norman G. Kurland

arm of Bank of America. In 1964, its then owners, the Pepsi-Cola United Bottlers, Inc., suddenly sold the company to a saml1, little known Los Angeles securities firm. The officers and employees, concerned about the future under new owners, wanted to buy the company for themselves.

Had they attempted to use conventional financing techniques, it would have been impossible to borrow enough funds from normal private lending sources. By using a Second Income Plan Employees' Trust (a variation of the standard deferred compensation trust) as a financing vehicle, the employees purchased and now own the business.

The plan involved the arranging of bank financing running directly to the SIP Employees' Trust in an amount sufficient--when added to the small amount of savings the employees had to invest--to pay the price in cash. The employees used that cash to purchase the company's stock outright. Using the tax leverage of deductible contributions by the company to the trust, the trust was able to pay off the bank loans within four years. The company's business performance, which had historically been sound, markedly improved when the officers and employees began working for themselves. Today, the firm has about 45 offices strategically located up and down the West Coast and in Nevada and Hawaii.

b. Peninsula Newspapers, Inc.

The Peninsula Newspapers, Inc. is an employee-owned organization comprising The Palo Alto Times, The Redwood City Tribune, and The Burlingame Advance Star and Green Sheet, all published on the San Francisco Peninsula. It is one of the largest and most profitable chains of California newspapers.

In 1954, its owners wanted to sell 72 percent of the company's stock, preferably to its employees. Using a SIP Employees' Trust, the employees obtained credit to purchase the stock and paid off the loans entirely through the company's tax-deductible contributions to the trust. Since the employees made no contributions under this arrangement, their take-home pay and personal savings were not diminished in any way.

The value of the SIP Trust was $4.7 million in 1966, over 18 times its size in 1956, when the plan was approved by the U. S. Treasury Department. In 1966, the membership of the SIP Trust stood at 446.

The Peninsula Newspapers, Inc. plan holds the further distinction of being the first SIP Trust to involve

employees who were members of trade unions. In fact, since six different unions were involved, all subject to separate collective bargaining agreements, the arrangement required multiple trusts, all identical in the nature of the benefits they provide.

With corporate profits accruing to the benefit of its employees, this highly successful newspaper chain has succeeded in preserving its integrity and freedom from outside pressures, while promoting high morale and a significant measure of economic security for its employees and their beneficiaries.

2. Second Income Plan Trusts to Turn Employees of a New Business into Owners**

a. The Albina Corporation.

The Albina Corporation describes itself as "the only Black-owned, Black run and managed manufacturing company in the United States." It was the first enterprise launched under the War on Poverty program which used a Second Income Plan Employees' Trust to demonstrate the importance of broad capital ownership for overcoming poverty, in this case, for residents of the Portland, Oregon black ghetto.

In 1967, Linus J. Niedermeyer, a successful Portland businessman, became impressed with the Watts Manufacturing Company of Los Angeles, a "ghetto subsidiary" of the Aerojet Corporation, and met with leaders of the black community to discuss the possibility of a similar subsidiary in the Portland ghetto. It was agreed by all parties that, to be more meaningful, the business should be owned and operated by residents of the community. A $195,000 manpower training grant was provided by the Department of Labor and a 27,000-square foot plant--a former bowling alley that went bankrupt--was acquired through a Small Business Administration loan. The Office of Economic Opportunity provided a $186,000 grant for consultant fees and for initial operating expenses and a $100,000 guarantee for a loan from a private bank to be financed through a SIP Employees' Trust. The corporation scouted the country for top black managers, found some, and by mid-September had hired 40 persons to produce metal, wood, and fiberglas products for larger industrial establishments and government agencies.

** The Employee SIP Trust will only begin to benefit a sizeable segment of our labor force and thus produce a significant national economic impact when it is adopted by more of our large, mature, and well-managed corporations, preferably, the 4,000 or so top U.S. corporations. This financing technique, should not be considered a panacea for risky new small businesses or struggling, poorly managed businesses, whose failure rates are today so high--mainly because of technical reasons--that their continued existence is a blessing to no one, their owners, workers and consumers alike.

The Albina Corporation has agreed to contribute annually into the trust for the benefit of each of its employees 15 percent of his total compensation. The trust is also responsible for providing all employees education in capital ownership.

It is obviously still too soon to judge the success of this enterprise. Its plans, however, call for the employment of 150 persons and a payroll of $3-3.5 million by the end of its first year of operation. The Albina Corporation's highly advantageous financing plan and its pioneering of the concept of broad capital ownership among the poor vastly increases its likelihood of success compared to other ventures calling for "economic development" in black communities.

b. Congaree Iron and Steel Company.

The Congaree Iron and Stell Company of Congaree, South Carolina, received a $1 million working capital grant from the Ford Foundation under the Foundation's new program to invest part of its portfolio in business ventures with "a high social yield." According to Boudinot P. Atterbury, an attorney, experienced investment specialist and coordinator of the new program, lawyers for the corporation modelled its financing plan directly from the techniques described in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY.

As described in the Ford Foundation's press release of September 29, 1968 which announced the launching of its Program-Related Investments program, the Congaree Company, in receiving the foundation loan,

> "has agreed to establish for the benefit of its employees a trust fund to hold a sizeable stake in the present ownership and future profits of the company.
>
> "Congaree was founded ten years ago. Beginning operations in an open cotton field with a handful of employees, it has grown rapidly to the point that it now has annual sales of about $7 million and 350 employees. The company manufactures steel joists (a speciality product manufactured to fill custom orders) for the construction industry. Congaree is located in a rural area of central South Carolina that is marked by serious poverty and unemployment. The company is the only significant employer in its immediate area. It hires unskilled workers and trains them in the various skills the company requires. The management of the company has always pursued an equal opportunity policy in

hiring and promoting its employees; twelve of the firm's Negro employees have supervisory positions.

"The Foundation's loan will provide Congaree a needed infusion of working capital. At the same time, Congaree will help establish for the benefit of its employees a trust fund to which it will transfer 10 per cent of its outstanding common stock immediately, and in favor of which it will contribute 15 per cent of annual profits before taxes in the future. The trust fund will invest its assets for the benefit of Congaree employees, and may elect to purchase additional common stock of Congaree or to invest the funds in other ways. W. Frank Threatt, who founded and developed the company, envisioned it not only as a private profit-making business but also as a community development venture, providing economic opportunity to displaced farmers and farm workers, mostly Negroes in the Congaree area, without the need to migrate to Northern urban centers. The Foundation sees the venture as an experiment in the development of means of increasing Negro participation in the profits and ownership of American business, especially in the ownership of companies in which they work."

3. Second Income Financing to Turn Consumers into Owners

a. Valley Nitrogen Producers, Inc.

Few envisioned the incredible growth and success of this young farmer-owned cooperative when it was organized in 1957 to manufacture and distribute fertilizer for its members and, on occasion, to national and international markets.

In 1959, Valley Nitrogen Producers opened its headquarters plant complex at Helm in the heart of California's San Joaquin Valley, some 40 miles southwest of Fresno. From that point on, the enterprise has continued to expand. In 1967, a $20 million complex was added at El Centro, in southern California's Imperial Valley. Today, the company employs about 500 people, has $55 million worth of plant facilities in operation, and produces more than half the agricultural chemicals sold in California.

But the dramatic story of Valley Nitrogen Products cannot be understood apart from the legal and financial structure which enabled it to come into being and survive in the face of vigorous opposition from five companies,

including Standard Oil of California, Shell Oil Company, Union Oil Company and others, who dominated the chemical fertilizer business in California for some 20 years previously. After VNP entered the field, the major producers dropped the price of the basic nitrogenous fertilizer--anhydrous ammonia--from the $200 per ton area in 1958 to $66 per ton (F.O.B. plant) and have held the price in the $66 to $74 per ton range ever since. Thus, Valley Nitrogen has saved somewhere around $160 million to California farmers, whether they are shareholders or not.

Valley Nitrogen was structured as a cooperative organized like a corporation which, each year, pays out all of its net earnings to its shareholders, in this case farmers who are also customers for its products. Since the corporation pays out its earnings (after debt service) each year to its shareholders, who are also its customers, it avoids the double taxation faced by most corporate enterprises. This structure allowed Valley Nitrogen to finance its present capital plant, pay off about $25 million in debt, enabled about 70 percent of its shareholders to pay for their stock out of dividends, and, with this year's patronage refund, raised the incomes of its shareholders by nearly $25 million in dividends.

4. Some Other Second Income Plan Projects Under Consideration

a. A "new City" on the West Coast and in one of the Southern states.

b. Financing of a fleet of new airbuses by one of the nation's largest airlines.

c. An international hotel-motel chain interested in building hotels in the black ghettoes.

d. A major national grocery chain for financing its new facilities.

e. The purchase of a privately owned local transit system by its employees and passengers, using a combination of the Employee SIP Trust and the Valley Nitrogen model.

f. A comprehensive industrial, commercial, and agricultural development program in one or more of the developing economies of Latin America, Africa, and Southeast Asia.

g. Comprehensive industrial and commercial development programs in Eastern Kentucky, Central Harlem, Washington, D.C., and Roxbury, Massachusetts.

C. Comparison of Financial Effect on Stockholder Equity of Employee Second Income Plan Trust Financing of Corporate Growth with Straight Loan Financing.

No attempt will be made here either to repeat or to enlarge upon the case made in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Louis O. Kelso and Patricia Hetter, Vintage Books [paperback] 1968) for the advantages of employee Second Income Plan Trust financing in terms of employee motivation, sound corporate strategy, economic theory, national economic policy, or international economic development. Rather, it is proposed here to consider only the financial effect on the equity of existing stockholders of using employee Second Income Plan Trust financing rather than direct corporate loans or internally generated income to finance corporate growth. One of the most common mistakes made in initially appraising Second Income Plan financing is to assume that it resembles in theory the conventional deferred compensation trust, and that its potency as a means of accelerating corporate growth (as well as broadening corporate equity ownership and motivating employees) can be measured by the customary tests applied by analysts to other financing techniques. Neither of these conclusions is sound, for reasons pointed out herein.

Since the usual types of qualified employee deferred compensation trusts involve contributions made for the benefit of employees after all competitive wage and fringe benefits of other employers have been matched, the theory is

that such additional contributions will induce employees to make productive efforts <u>over and above the usual call of duty</u>. This simply is not so, for several reasons. The first is that the employee is hired and paid the competitive wage to render his highest and best efforts. If he fails to do so, or if he intends to withhold such best efforts, he is improperly employed in the first place. Secondly, all but managerial employees under Federal Wage and Hour Laws are required to be paid time and a half (and under some union contracts, even double or triple time) for <u>time</u> spent in addition to the normal work week. Finally, the Internal Revenue Code is designed to prevent a qualified deferred compensation trust being used in such way as to specially reward those employees who render unusually diligent service, and any attempt to so structure a plan as to achieve that result would cause disqualification of the plan. Consequently, the traditional deferred compensation trust is simply another of the many redistributive devices of one-factor economics calculated to transfer a portion of the wealth produced by capital to the non-owners of capital, that is, the employees. In actual fact, benefits under the usual deferred compensation plan are, as the name implies, merely additional compensation in a slightly different form, paid in ways which do instill stability of employment because of the provision for forfeiture in the event the employee leaves his job before his benefits are fully vested. Employee Second Income Plan

(SIP) financing is different both in concept, and in its financial implications.

So far as the concept is concerned, SIP financing is a method by which the employee is enabled to buy equity stock and <u>pay for it out of the wealth produced by capital</u> as the wealthy man is generally able to do. Second Income Plan financing benefits the corporation, as described later in this section , as well as the employees. SIP financing has all of the virtues claimed for conventional deferred compensation trust arrangements (pension plans, profit-sharing plans, and stock bonus trusts) as well as the unique advantages of both financially benefiting the corporation <u>without economic dilution of the equity of existing stockholders</u>, and the possibility of enormously accelerating the acquisition of equity ownership by employees. SIP financing has the further ultimate advantage that, by enabling employees legitimately to buy and pay for capital ownership without impairing their wages, salaries, or fringe benefits, they can eventually receive increased <u>incomes without increased wages</u>, which in turn means increased profitability for their company and the possibility of being able, because of lower labor costs, to undersell competitors.

The main purpose of this section, however, is to consider the implications of the SIP financing procedure which, while resulting in the issuance of stock to the

employee trust, expenses capital investment, and so lowers tax-reported or apparent income. This is compared to ordinary direct debt financing of corporate growth, which, in effect, capitalizes the investment (purchases it in after-tax dollars) and requires the corporation to pay corporate income taxes that would not be paid under SIP financing arrangements. Straight debt financing thus takes working funds out of the corporation that would otherwise be retained and presumably used productively for the proportional benefit of all stockholders. In other fact situations where management is presented with a comparable choice, it usually prefers the expense route over the non-expense route because in such instances the apparent reduction in earnings is in fact an increase in tax savings and an increase in equity dollars retained and at work in the corporation. An example of such optional alternative is accelerated depreciation authorized by the tax laws.

It is easy to see how this misinterpretation can come about. The standard rule of thumb for estimating the value of corporate equity is the price-earnings ratio of the stock (PE Ratio). The simple fact is that where financing is achieved in pre-tax dollars, a ratio that compares market price of an equity with its after-tax earnings does not measure the vital advantage of converting tax dollars into productive investment. This is why analysts frequently explain -- and so justify a higher

market price for -- a particular stock which "would have had" a higher PE ratio if it were not for depletion, investment credit, accelerated depreciation, or the like.

When a corporation uses Employee Second Income Plan financing, it both pays off the debt (in pre-tax dollars) and issues equity on which it must expect to maintain the same dividend payments in the future as on its other outstanding stock. Normally, however, such added dividend cost is offset within a year or two after the financing is completed as the result of corporate income earned on working capital retained in the form of equity that would otherwise be paid in corporate income taxes. Consider the following example:

Comparison of Financial Effect of Employee Second Income Plan Financing of Corporate Growth With Straight Loan Financing Under Specified Factual Assumptions

Assume:

(1) - $1,000,000 financing.

(2) - Effective combined Federal, Federal Surtax, and state corporate income tax bracket of 56%.

(3) - Loan interest rate to corporation of 6%.

(4) - Maximum dividend by corporation on its stock outstanding of 3% of current market price (the price at which the corporation sells its stock to its Employee Second Income Plan Trust).

(5) - A five-year amortization plan under which the corporation pays $200,000 per year on principal through contributions to its SIP Trust and pays interest annually by similar contributions on the outstanding balance.

(6) - That the market price of the stock and the dividend rate remain stable throughout the financing period.

(7) - That the corporation earns at least 20% annually, before corporate income taxes, on invested equity capital, this being less than the average of the 4,000 or so corporations reviewed each year in its study of corporate profits by the First National City Bank in its April monthly economic letter.

(8) - That the corporate dividend on $1,000,000 of stock of $30,000 (see Assumption (4)) will be used by the SIP Trust to pay part of its debt and that the corporation will accordingly adjust its annual contributions by contributing $30,000 per year less to the SIP Trust so long as the dividends are paid.

The diagram on page 24, taken from TWO-FACTOR THEORY: THE ECONOMICS OF REALITY, p. 87, illustrates the structure of Employee Second Income Plan Trust financing for ready comparison with simple or straight debt financing which involves merely a loan and some form of repayment instrument such as a note or debenture or the lease equivalent thereof.

The two alternative methods of financing corporate growth may then be compared as follows: *

Debt Financing

Step A-1:	Cost of new capital formation in after-tax dollars	$1,000,000
Step A-2:	Cost of new capital formation in pre-tax dollars	2,272,272
Step A-3:	Amount of pre-tax dollars lost in taxes	1,272,272
Step A-4:	Annual loss that would not have been incurred in after-tax net income each year after debt financing wholly paid off if pre-tax dollars had been retained and used as equity investment. (On the basis of Assumption (7), this would be 20% of the after-tax saving [44% of $1,272,272], or $112,000 annually.)	112,000

Employee Second Income Trust Financing

Step B-1:	Cost of new capital formation in after-tax dollars	$1,000,000
Step B-2:	Cost of new capital formation in pre-tax dollars	1,000,000
Step B-3:	Amount of pre-tax dollars lost in taxes	-0-
Step B-4:	Annual dividend on stock sold to the Employee SIP Trust (see Assumptions (4) and (5)) $30,000	

* NOTE: The interest cost is not included in the comparison, since presumably the lendor will charge the same rate of interest on a loan whether it is made to the corporation, or with the corporation's guaranty, to the Employee Second Income Plan Trust. This, however, may not be realistic when banks and other lendors become fully acquainted with this new type of financing, since a significantly lower rate of interest should logically apply to a loan repayable in pre-tax dollars. Perhaps at least a 2% differential would be reasonable.

Step B-5:	Annual reduction in debt service as result of dividend available to SIP Trust for use in paying its debt, thus resulting in reduced contribution by the corporation to its SIP Trust so long as debt is outstanding	30,000	
Step B-6:	Net cost of corporate dividend until debt of SIP Trust is repaid		-0-
Step B-7:	Annual after-tax income advantage from SIP Financing each year after debt fully retired (see Step A-4)		112,000
Step B-8:	Average annual after-tax income advantage from SIP financing during debt service period (one-half previous figure)		$ 56,000
Step B-9:	Aggregate pre-tax income earned during debt service period as result of use of Employee SIP financing rather than straight debt financing (5 x $56,000)		280,000
Step B-10:	Tax saving, during the five-year financing period, after payment of corporate income taxes thereon, resulting from use of Employee SIP financing rather than straight debt financing (see Step A-3)		559,798
Step B-11:	Total after-tax advantage during the five-year financing period to equity holders resulting from use of SIP financing (result of Step B-9 added to result of Step B-10)		839,798

Thus, the equity dilution at completion of the five-year financing period would be $160,000 ($1,000,000-$839,798, rounded) which would be erased within two years thereafter since the annual after-tax income advantage of the SIP financing is $112,000, reduced only by the annual dividend of $30,000. This results in an added annual net increment to equity of $82,000 indefinitely. This, in addition to all the intangible (but nevertheless vital) corporate and

social advantages of making equity partners of employees, laying the foundation for lower-than-market wage and salary scales in the future, strengthening management's stock control, etc. favors Employee Second Income Plan financing over financing out of internally generated funds. Furthermore, it should not be forgotten that both the $559,798 saved in the above example from corporate taxes and added to the corporate equity and the corporate earnings on that saving of $279,899 after-tax accumulated during the financing period will continue to work for all stockholders as invested equity indefinitely after the SIP Trust debt has been fully amortized.

It would seem that the only instance in which the actual cost of corporate capital is less than through Second Income Plan Trust financing is straight sale of equity to the public in a market regarded as favorable to stockholders, a method so little used that it currently accounts for only about one-half of one percent of new capital formation. However, such sale by this once common method, i.e. to wealthy individuals who can afford to buy securities, constitutes, like most conventional financing, an assault on the double-entry bookkeeping logic of the economy because it does not facilitate getting capital ownership, and thus Second Incomes into the hands of consumers with unsatisfied needs and wants, thus raising their power to buy the goods and services produced with the expanded corporate capacity.

Finally, several comments on financial and economic policy may be appropriate here. Sound banking, it would seem, would require a lower interest rate on Second Income Plan financing loans, repayable in pre-tax dollars, than on conventional loans repayable in after-tax dollars. It could be argued that under present tax laws, the reduction should be at least 50%, but it would probably be more realistic to anticipate a reduction of one-third, or say two points in the example used above. Such a reduction would further shorten the period required to eliminate the temporary equity reduction. Similarly, the brief period of equity dilution of existing shareholders would be further shortened or eliminated entirely if the corporation, like a large proportion of the largest firms, earns more than 20% on invested equity. In the example used above, for each 5% increase over 20% in the annual return on invested equity, the corporation would add $28,000 annually to invested equity as the result of using Employee Second Income Plan Trust financing rather than straight debt financing so long as the greater rate of return on invested equity continued.

The importance of reforming our national economy along lines indicated by two-factor theory, and adopting, at long last, a policy of systematically expanding the productive plant of the economy and creating millions of new holders of viable capital estates would seem to more than justify increased tax deductions to corporations

33-753 O - 69 -- No. 19 -- 41

that finance their expansion through Employee Second Income Plan loans. For example, a modification of the internal revenue code to authorize a deduction of 150% of contributions by corporations to deferred compensation trusts to repay such Second Income Plan financing would both accelerate corporate growth and the acquisition of viable capital estates by corporate employees. It would both contribute to reduction of potential future governmental welfare expense and to the building of the personal tax base for tomorrow's economy. It would also convert a small temporary economic dilution of the equity of existing shareholders into an immediate equity enrichment.

IV. THE SECOND INCOME PLAN: A COMPREHENSIVE STRATEGY FOR BROADENING OUR TAXPAYER BASE BY ENABLING ALL FAMILIES TO OWN CAPITAL.

A. A Graphic Presentation of the Second Income Plan.

The Second Income Plan is a comprehensive strategy, a set of practical measures and a complete legislative design (see Appendix of Two-Factor Theory: The Economics of Reality) for achieving widespread capital ownership.

Underlying the Second Income Plan are the analytical tools of Two-Factor economic theory and Mr. Kelso's advanced "pure credit" techniques of finance for emancipating economic growth from the limitations of conventional financing techniques (based exclusively on past savings.) (See The New Capitalists, co-authored with Mortimer Adler, Random House, 1961.) Henry Moulton of the Brookings Institution was the first to recognize that new capital formation does not have to be financed exclusively from past savings. (The Formation of Capital, Brookings Institution, 1935, p. 107.) Mr. Kelso extended these ideas by developing credit mechanisms which would create new capital owners simultaneous with new capital formation. He also adapted from the loan guarantee and monetary machinery developed for Federal housing programs (for expanding the supply and ownership base of private housing, a consumer item, for veterans and others without savings.)

Those interested in a thorough understanding of these ideas and techniques should read Mr. Kelso's three books and other materials listed in the Bibliography on Two-Factor Economics which is attached.

The following is a simplified graphic sketch of the Second Income Plan extracted from a 1966 publication by Louis O. Kelso Walter A. Lawrence:

THE SECOND INCOME PLAN

A plan to change our national economic policy.....

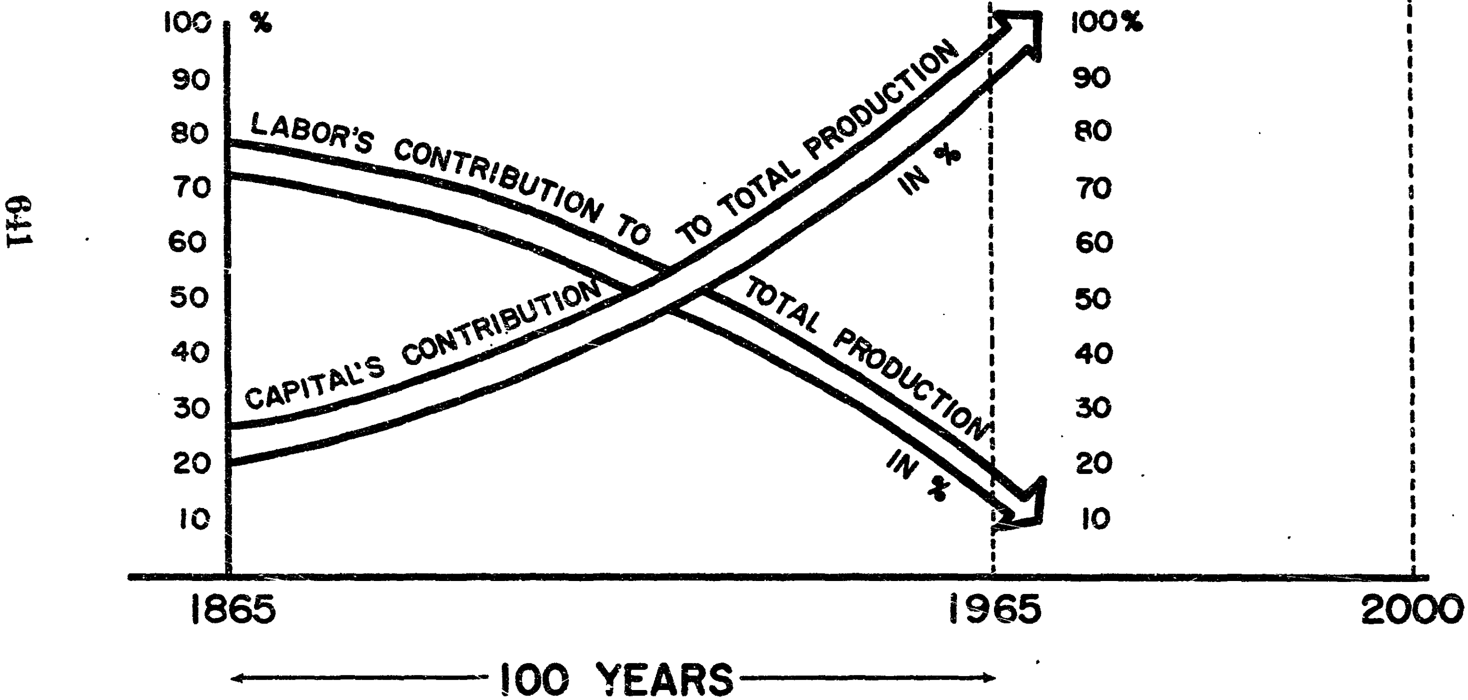
- From its present narrow focus on LABOR alone (with the limited goal of "full employment")
- To a new and broader focus on both LABOR and CAPITAL (with the larger goal of "full production")

Under this plan, it would be basic national policy to enable every family to participate in producing wealth, not only through their LABOR but also through their ownership of CAPITAL. To implement this, both government and business would seek ways to extend the ownership of capital to all families, so that ultimately they could have two incomes:

- A FIRST INCOME from wages paid for LABOR
- A SECOND INCOME from dividends paid on CAPITAL (stocks).

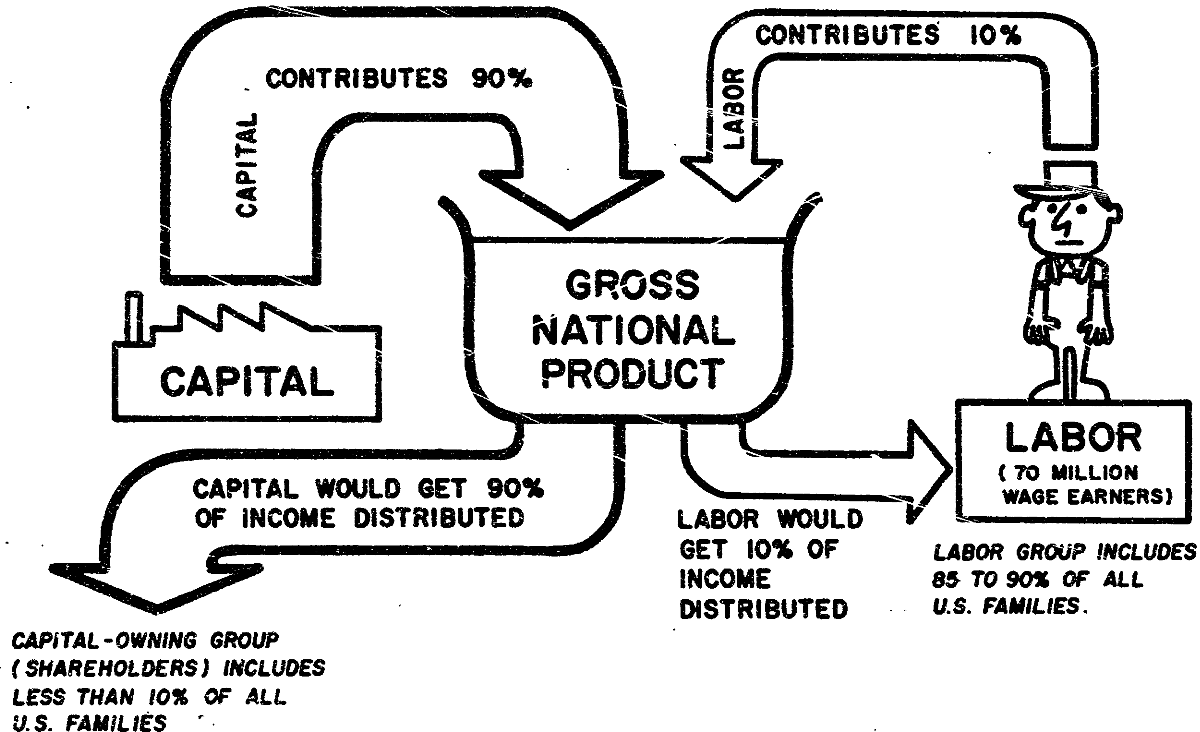
640

In the past century, capital has gradually taken over from labor:

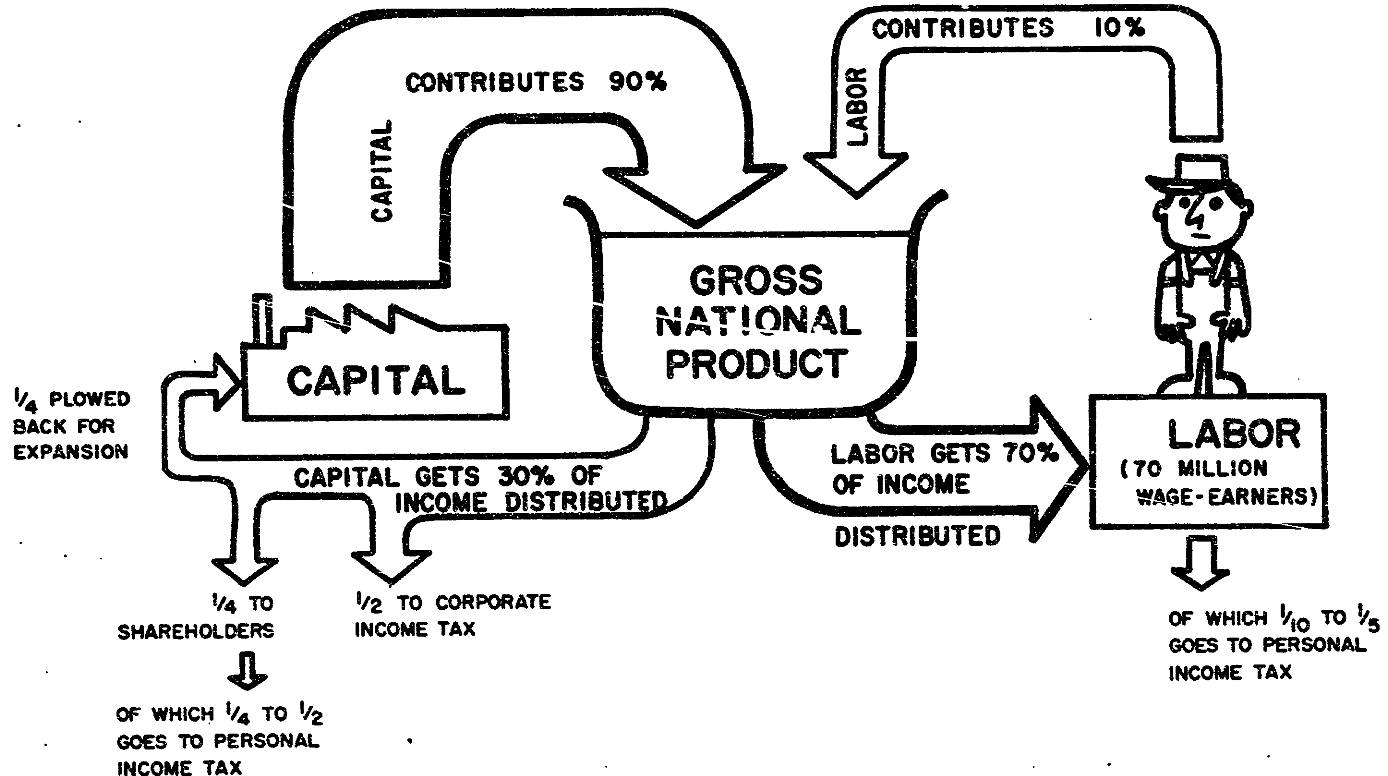


641

If wealth went proportionally to those who produce it, here's what would happen:



Wealth doesn't go proportionally to those who produce it. Here's what really happens:



ONE-FACTOR ECONOMIC CONCEPTS and TWO-FACTOR ECONOMIC CONCEPTS:

The income maintenance hangup is, and has always been, the attempt to make one-factor economic concepts work in a two-factor real world. Let me now -- in half a minute -- explain two-factor theory:

It is the idea that each of the two factors produces wealth in exactly the same sense:

This idea is contrary to explicit socialist dogma.

It is also contrary to U.S. economic policy: the Employment Act of 1946 and the Economic Opportunity Act of 1964.

Both political parties espouse one-factor economic policy.

The various studies on economic goals that have been made in the U.S. since the T.N.E.C. studies of 1938-42 uniformly conclude that our proper economic goal is full employment, so they are contrary to two-factor theory.

Two-factor theory is contrary to Keynesian doctrine.

While physical capital does not pass unnoticed in the western economies, we assert that its function is to enhance the "productivity of labor."

This, of course, is contrary to reality and to two-factor theory.

If two-factor theory is sound, and if double-entry bookkeeping is the logic of a market economy, then the only way to eliminate

poverty, and to bring about a condition of general affluence, is to make it possible for every family and every individual to produce general affluence.

To make a greater productive input into the economy.

But if most productive input is by capital, the non-human factor, this means virtually every individual and family must be enabled to become the private owners of productive capital.

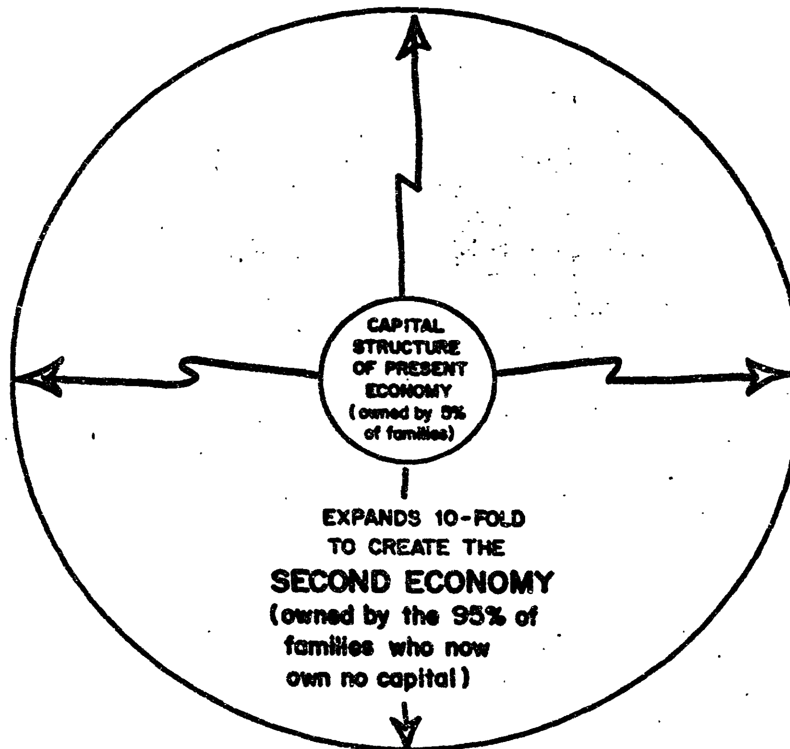
To buy, pay for, and own viable holdings of productive capital.

The tools of the Second Income Plan -- financing techniques and modifications of tax laws and corporate practices -- are designed to build productive power into households and individuals now insufficiently productive so that they may be enabled to produce an affluent share of income. This method has yet to be employed as national policy in any economy. It is a method designed to protect existing private property, highly concentrated though it may be, and to build a Second Economy owned in reasonable-sized holdings by the great majority of households who own no productive capital in the existing economy. This is the corrective method of the Second Income Plan.

The object of the program which we are urging industry and business to undertake can best be illustrated like this:

Let the small circle below represent the capital structure of the present economy of the United States, and let the larger circle surrounding it represent a second economy, to be built over an estimated 25-year period through expansion several times over of the present economy:

Objective of the Second Income Plan



The principal tool of the Second Income Plan is one that can be used by business corporations under present state and Federal laws. It consists of a radically new and different use of the familiar qualified deferred compensation stock bonus plan in such way that it can both finance corporate growth and build equity ownership into employees without diminishing their takehome pay. It is beneficial to the corporation, its existing shareholders, the employees, and the economy. Its use is outlined below.

In THE NEW CAPITALISTS (Kelso and Adler, Random House, 1961) and in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Kelso and Hetter, Random House and Vintage Press, 1968), we have shown that with modest legislative changes, equity ownership that can be built into corporate employees now under existing law could be built into non-corporate employees such as civil servants, teachers, judges, legislators, professionals, artists, invalids, widows with children, the aged, etc.

Income Maintenance
AND THE BUSINESS CORPORATION STRATEGY:

Roughly 80% of the goods and services produced in the non-agricultural, non-governmental sector are produced by corporations.

> This automatically means, under double-entry bookkeeping, that 80% of the purchasing power generated by the private economy (outside agriculture) arises in corporations.

Present strategy employed by business corporations consists of maximizing production and sales, minimizing costs, and being a law-abiding corporate citizen.

> Thus, while 80% -- approximately -- of the income (outside agriculture) generated by the private economy arises in corporations, there is no recognition that one concern of sound corporate strategy should be to make certain that income is channeled to people with unsatisfied economic needs and wants, and not to those whose needs and wants, however lavish, are already provided for.
>
> The chief productive factor in the modern corporation is the non-human factor of production: capital.
>
> > All modern techniques of corporate finance are designed to assure that the ownership of virtually all newly formed capital flows into the hands of the top 5% of wealth-holders who today own all the corporate capital.

What closes the purchasing power gap created by defective corporate strategy?

Answer: Government and consumer credit.

Government welfare distributions.

Redistribution of income from capital owners to non-capital-owners and from highly paid workers to the unemployed by graduated income taxes, personal and corporate; graduated estate taxes and graduated gift taxes; social security taxes, unemployment compensation taxes, property taxes, etc.

Government employment, particularly in public works, military overkill production, space waste, etc.

Governmental enfranchising of labor unions to use coercion in the marketplace to effect redistribution, by demanding progressively higher pay in return for progressively diminished quantity and quality of labor.

Governmental subsidies of agriculture, shipbuilding, military stockpiling, export of foreign aid, etc.

etc. *etc.*

Consumer credit closes the purchasing power gap today and makes it radically larger tomorrow.

A consumer may buy a home with a modest downpayment today

and pay for three homes over the rest of his lifetime.

The purchasing power gap is similarly, although less drastically widened by all other forms of consumer credit.

A CORPORATE STRATEGY FOR INCOME MAINTENANCE BASED ON **The Second Income Plan:**

What can *BUSINESS* do to solve the income maintenance problem?

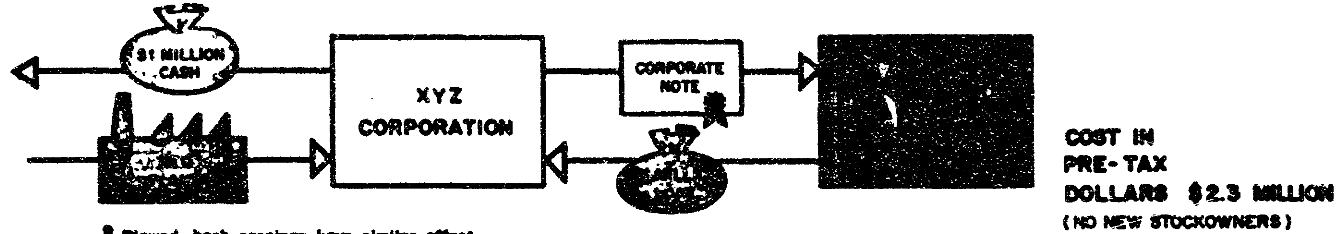
The answer is to employ as widely as possible

Employee Second Income Trusts.

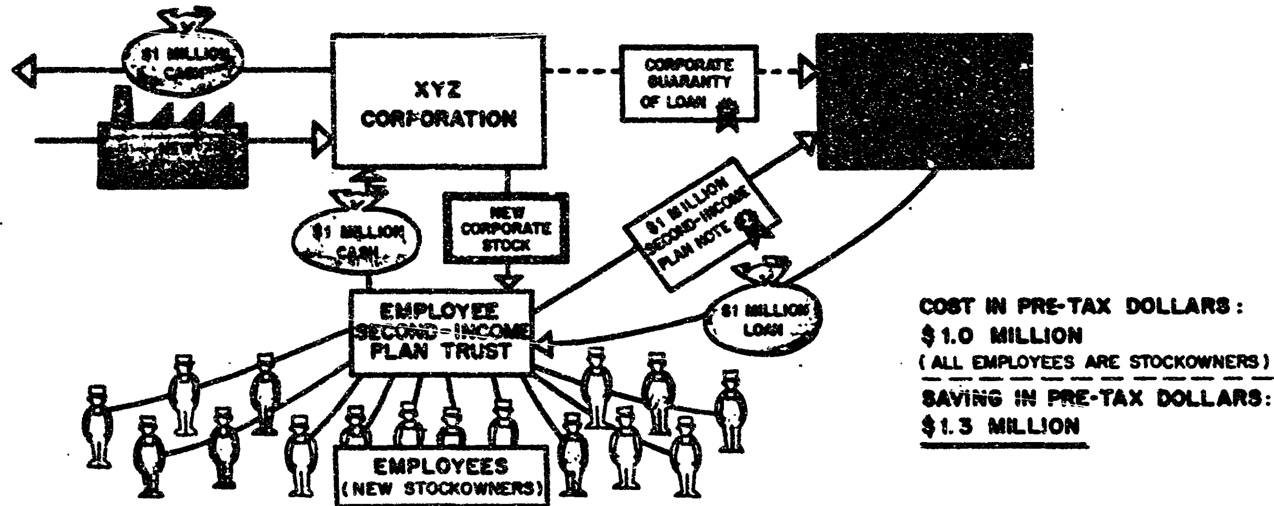
The following illustrates how these operate:

2 ways to finance corporate productive capital (new plant)

1. CONVENTIONAL DEBT FINANCING:*



2. EMPLOYEE SECOND-INCOME-PLAN FINANCING:



The main highlights of the operation of these trusts is as follows:

> An employee deferred compensation trust is established, or if one is already in existence, it can be remodeled to suit Second Income Trust financing purposes.
>
> Loan financing from conventional loan sources -- insurance companies, banks, etc. -- is arranged so that loans are made directly to the deferred compensation trust.
>
> The trust takes the loan proceeds and invests it in the sponsoring corporation's stock.
>
> The corporation sells and issues its stock, at the full current market value, to the trust.
>
> The trust gives its note to the lendor and may pledge the stock to secure it.
>
> The sponsoring corporation guarantees that it will pay off the note to the lendor in annual installments through the trust, rather than directly to the lendor as it would if the corporation itself were the borrower.
>
> The Internal Revenue Service, within the limits prescribed by the Code, will treat the corporation's loan repayments as "contributions" to the employee trust, because under this arrangement, the employees, including corporate management, become the owners of the stock as the debt is repaid, without any reduction in their takehome pay or fringe benefits.

WHAT CAN GOVERNMENT DO TO SOLVE THE INCOME MAINTENANCE PROBLEM THROUGH The Second Income Plan?

33-758 O - 69 -- No. 19 -- 43

The Second Income Plan can be accomplished in 2 steps:

Step 1: An Act of Congress to:

- Repeal the "Employment Act of 1946"
  (with its narrow focus on LABOR alone.)

- Enact the "Full Production Act of 196_"
  (with its broader focus on both LABOR and CAPITAL)

This would establish the national policy.

Step 2: A series of "Ways and Means" by both government and business to encourage the widespread ownership of CAPITAL. This would implement the national policy.

A partial list of proposed "Ways and Means" to implement the Second Income Plan.

- Change death taxes to induce the wealthy to spread out their wealth.
- Encourage corporations to set up more employee stock-ownership trusts.
- Devise ways for closely-held family corporations to sell out to employees.
- Finance urban-renewal projects so that the displaced families can own shares in the new buildings.
- Finance government water-and-power projects (like TVA) so that the families who live there can become owners.
- Finance anti-trust divestiture of corporate assets so that thousands of families can become owners.
- Finance sale of government-owned corporations (like General Analine) so that thousands of families can become owners.
- Finance industrial development in impoverished areas (like Appalachia) so that the families who live there can become owners.
- Set up the "financed capitalist" program whereby families can borrow on insured loans (like FHA) to buy stock which pays for itself out of dividends.

The Second Income Plan is broad enough to bring together both Conservatives and Liberals in common cause.

- It is <u>CONSERVATIVE</u> in that it preserves and extends private property, halts socialism, cuts taxes, and reduces the role of big government.

- It is <u>Liberal</u> in that it really does more for the common people than all the welfare legislation passed by government in the last 30 years.

655

Like the original Homestead Act which helped families own productive capital in the form of **LAND**,

this plan helps families own productive capital in the form of **INDUSTRIAL STOCK** .

Like FHA loan insurance which helped families own their own HOMES,

this plan uses similar loan insurance to help families own their own portfolio of STOCK, which pays for itself, with its own dividends - then pays them a Second Income, forever.

How the head of a low-income family acquires stock:

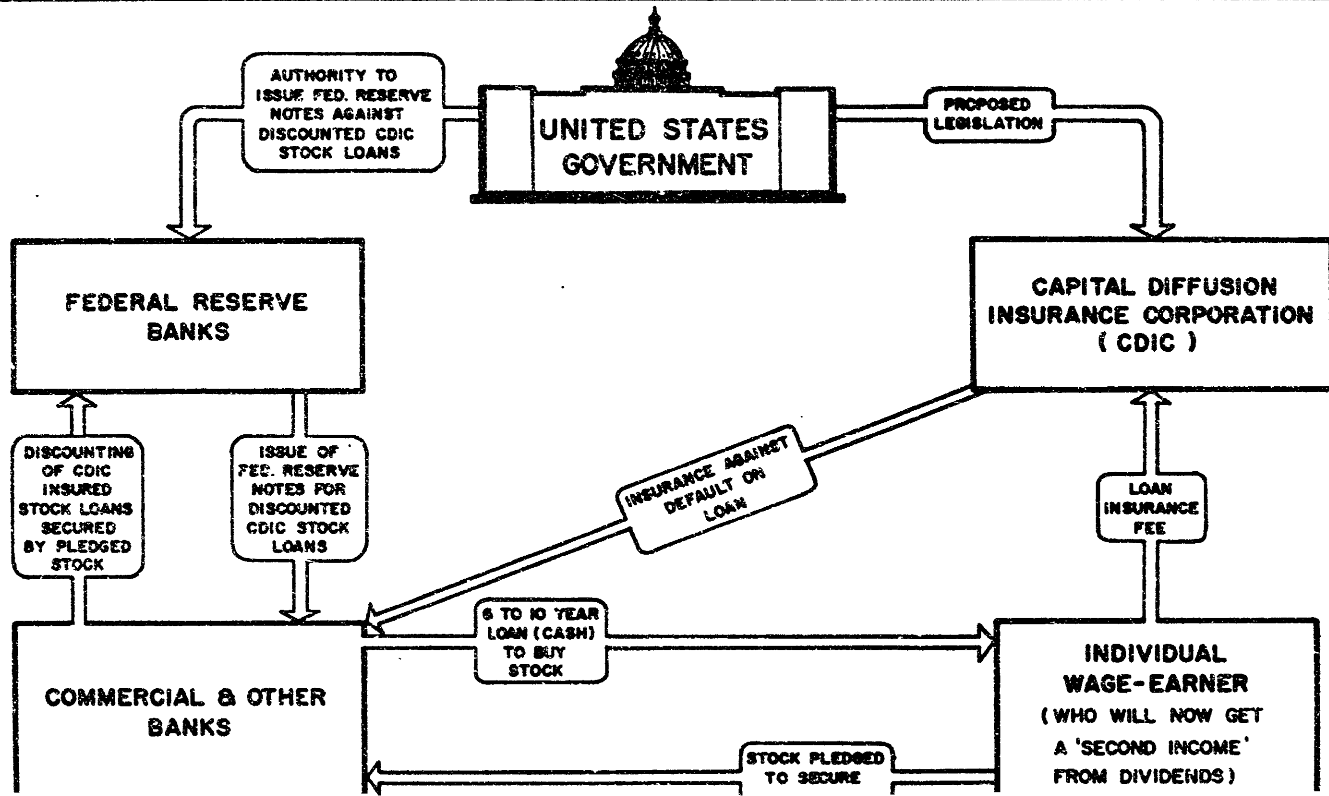
- Source of stock is newly created capital by U.S. corporations. (current expansion rate, about $60 billion/yr., enough to allocate $4000 worth/yr. to each of 15 million low-income families).

- Head of low-income family goes to bank, borrows $4000 each year for 5 years (government-insured loans, no risk to bank or to borrower). Makes small down-payment ($200). Buys stock (diversified portfolio), $4000/yr. for 5 yrs. = $20,000 worth.

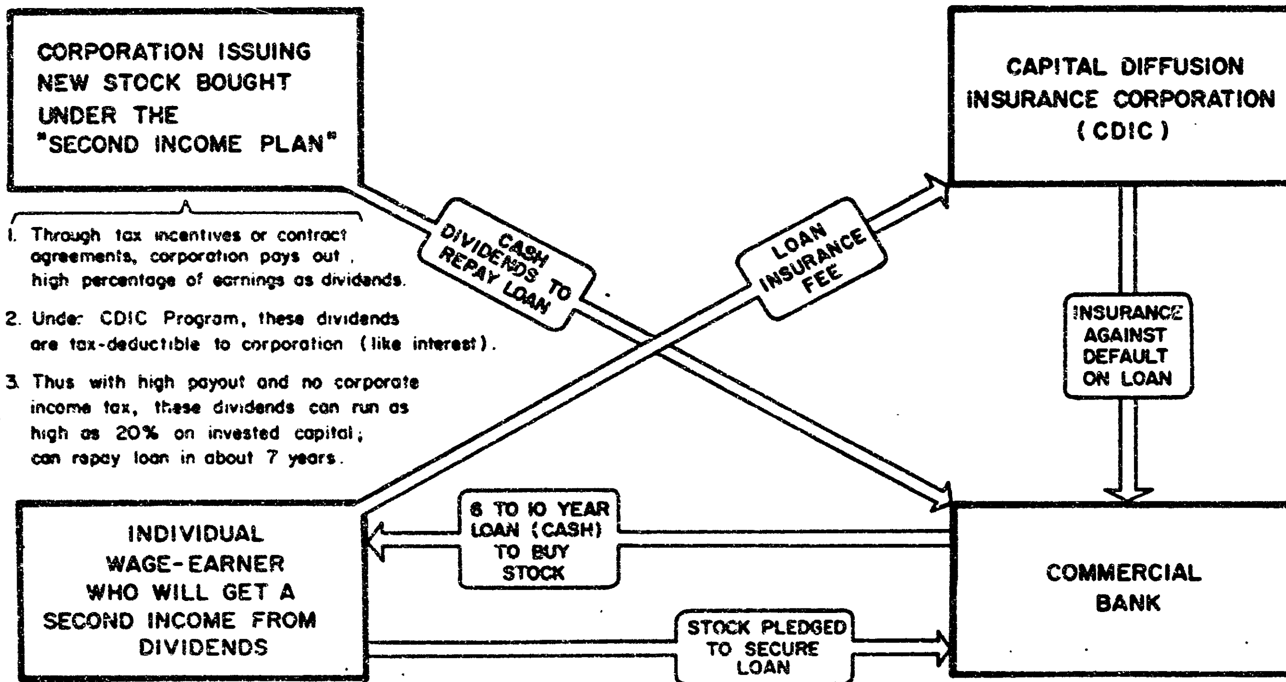
- Stock dividends (at 20%/yr. with no corporate income tax) pay off loans in 6 to 7 years from start date.

- Family then owns $20,000 worth of stock. Dividends provide <u>Second Income</u> of about $80/week or $4000/year.

How the Second Income Plan finances the purchase of stock by individual families.



How stocks pay for themselves under the Second Income Plan.



How a change in death taxes could create more capitalists at upper income level:

- Total U.S. wealth is at least $1000 billion. Most of it is owned by rich people who pass it along to heirs about once every generation (say 25 years). Thus about $40 billion changes hands each year.

- If through a change in death taxes, this could be distributed tax-free to less wealthy relatives and friends, in chunks up to $50,000 each, it would create about 800,000 to 1,000,000 new capitalists a year (or 20 to 25 million in 25 years).

- Present confiscatory death tax does not create revenue for government. All it does is drive the big estates into tax-exempt foundations, wherein the wealth is frozen forever.

What's in it for INDUSTRY ?

- A stable economy (no more boom-bust cycles).
- Increased markets because of increased consumer purchasing power.
- An opportunity for accelerating economic growth to supply increasing markets.
- Unlimited funds for expansion (through tax-exempt employee stock trusts or CDIC-insured loans).
- Less labor trouble (as employees become shareholders in industry and look to dividends as an important alternate source of income).
- An opportunity to automate without resistance from labor.
- An opportunity to compete again in foreign markets. (As wages remain stable and as automation cuts costs, U.S. products can undersell their competition all over the world).
- Less government interference.
- Ultimately, the repeal of all corporate income taxes.

What's in it for LABOR ?

- A stable economy (no more boom-bust cycles).
- Full employment (at least for this generation, or until automation can catch up with an economy that will be expanding at several times its present rate).
- No more demoralizing featherbedding, make-work, spread-work, etc.
- A better approach to collective bargaining. (Ask for stock trusts instead of wage increases).
- An answer to automation. (Let industry automate, the faster the better. But let the displaced workers acquire enough stock to have an alternate income from dividends).
- Lower personal income taxes.
- In addition to wages, a <u>second income</u> from dividends (from stock acquired through employee stock trusts, through CDIC loans, or both). Thus, provision for future unemployment or ultimate retirement.
- A capital estate to pass on to one's heirs.

What's in it for the ELDERLY ?

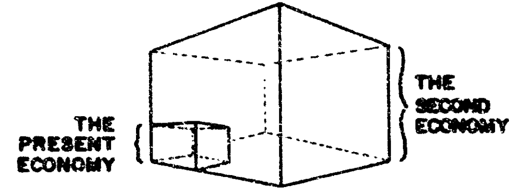
- An end to the creeping inflation that has been eroding their retirement dollars (pensions, annuities, savings etc.)

- An opportunity to retire with dignity on a private, adequate, dependable income which (unlike Social Security), continues whether one works full-time, part-time, or not at all.

- An end to the humiliation of being dependent on children or on welfare.

- A capital estate to pass on to one's heirs, thus assuring the elderly that their children will continue to give them some consideration, right down to the reading of the last will and testament.

What's in it for YOUTH ?



- A challenge to build the SECOND ECONOMY - one that will do for the non-capital-owning 90% what the present economy does for the capital-owning 10%.

- This will require a doubling and re-doubling of our present industrial capacity, with economic growth rates of several times our present 3% per year.

- This in turn will create severe labor shortages. We will need all the talents of all our young people for at least a generation or more.

- It can be the most demanding and rewarding era thus far in America's history.

665

What's in it for the IMPOVERISHED ?

- A second income from dividends that's adequate to live on, one that's several times bigger than Social Security or Unemployment Insurance or local relief handouts.

- A private income based on the productivity of capital, free from the stigma of welfare or charity.

- A dependable income that continues whether one is able to find and keep a job or not.

- A capital estate to pass on to one's heirs (perhaps the only thing of value the family was ever able to own).

What's in it for those who are already CAPITALISTS ?

- A stable economy (no more boom-bust cycles).
- A government policy dedicated to protecting private property (instead of socializing it).
- No more hoarding of earnings by corporations. (After reserves for depreciation and operation, they would have to pay out most of their net earnings to the owners - the shareholders.)
- No more double tax on the earnings of capital. (Corporate income tax would be repealed and personal income tax would be reduced because cost of government would be drastically reduced.)
- No more death taxes, to the extent that one's estate is distributed in gifts which do not make the recipients richer than $50,000 each. (Above $50,000 a graduated tax would apply.)

What's in it for FARMERS ?

- A stable economy (no more boom-bust cycles).
- An increased market because of increased consumer purchasing power.
- Improved farm prices because of increased consumer demand.
- An opportunity to acquire stock and have a <u>second income</u> from dividends, whether there's a job on the farm or not.
- An opportunity for the small farmer to get out of farming, if he wants to.
- Lower personal income taxes.
- Ultimately, the end of government control of agriculture.
- A capital estate (in addition to the farm) to pass on to one's heirs.

53-758 O - 80 -- No. 18 -- 43

What's in it for PUBLIC SECTOR WORKERS ?

(Civil Servants, Legislators, Teachers, Ministers, Writers, Artists etc.)

- A second income which can be as big as the typically low salaries paid to these professionals.

- Some freedom from the grinding necessity for subsistence toil; thus, greater freedom from anxiety and an opportunity to devote more time to the works of civilization.

- This should result in a vast increase in the precious goods of civilization - good government, philosophy, literature, religion, art and the like - which after all are finest creations of any culture.

What's in it for U.S. FOREIGN RELATIONS ?

A tremendous improvement in our position as leader of the Free World:

- As 50 million American families become owners of productive capital, they will begin to have second incomes from dividends.

- This increased purchasing power will accelerate industrial growth to several times its present rate of 3%. (Japan's is 12%)

- Increased industrial strength will give us increased military strength.

- Meanwhile, our expanding economy will show the whole world that CAPITALISM works better than COMMUNISM, when everyone has a chance to become a capitalist.

- This will win back the "neutral" nations.

- We can then export these ideas to the under-developed nations. They can use our SECOND INCOME PLAN to spread capital ownership among thousands of their own families and thus build purchasing power to consume while they build industrial power to produce. (Thus we can provide them with a far better alternative than socialism.)

B. Questions Most Often Asked About the Second Income Plan.*

1. Would the Second Income Plan cause inflation?

No, it is designed to avoid inflation. Its tendency would be to stabilize and eventually reduce prices, and permit competitive setting of wages without loss of income to the worker. It is the one-income economy we now have that is inherently inflationary. Remember that the familiar devices we use to artificially create employment -- public works not sought for their own sake, but for the employment they create, agricultural and industrial subsidies, production of military overkill, crash space race programs, production of goods to give away to foreign nations -- all produce non-economic goods; that is, goods that create purchasing power within our economy but that add no consumer goods and services within the economy to absorb such purchasing power.

Similarly, each time wage costs are increased in order, by one means or another, to distribute more income (welfare) to workers without increasing (in fact usually decreasing) their work-input into the economy, the cost of the product is increased. But neither its quantity nor quality is comparably improved. This too is inflationary. This is, in fact, what inflation is -- the creation of purchasing power not offset by simultaneous creation of useful goods and services. Thus, ten million dollars worth of savings or credit "invested" in building space missiles, for example, is permanently inflationary unless counteracted by increased taxes. The same ten million used to build a furniture factory or to expand an airline may have a temporary inflationary effect initially only until the new facility produces sufficient net income to defray its costs of construction -- normally a matter of three or four years at most. Thereafter, for an indefinite period, as it pours goods or services into the economy, its effect would tend to be beneficially deflationary: the consumer's dollar would purchase more without depriving the consumer of his source of purchasing power.

Since the introduction of new plants into the economy as it expands is a continuous process, the long-term deflationary forces would more than offset the short-term inflationary forces. Such a Second Income Economy would be free of the bloating of prices with costs that represent welfare, rather than productive input.

Even the initial and temporary inflationary tendency can be eliminated by the government's reducing its make-work subsidies by a portion of the amount invested in new capital.

*Copyright 1966
Louis O. Kelso and Patricia Hetter

2. Isn't the Second Income Plan socialistic?

Hardly. The Second Income Plan builds ownership of the means of production into individuals as their private property. It then protects the right of each individual to receive all the wealth his property produces. This is a wide departure from what is popularly called "socialism" -- where the capital is owned by the state and a broad income is sought through employment of one or more workers in every family and wages are set by the political apparatus. Since both the government's capital costs (usually reckoned by analogy to competitive economies) and the often artificially high labor costs are passed on to the consumer, the prices of goods and services are high. Incentive to produce (an important part of which is the acquisitive instinct or instinct to own capital) is low.

By placing a main source of economic power in an industrial economy (namely, the ownership of capital) in the government bureaucracy where it is combined with their political power, the socialist economy tends toward totalitarianism. A Second Income Economy, on the other hand, would put all economic power in individual hands and would bring about its wide diffusion. Thus it would tend to be a power-diffused, hence free, society.

So far in history, there has never been an economy in which every household owned a viable share of productive property, and this is the ideal of the Second Income Plan.

3. Would not the financing of business expansion primarily by sale of newly issued stock to new or small stockholders dilute the equity of existing stockholders?

No economic dilution would be involved. If General Motors, for example, expands its productive capacity 20% and finances this new capital by sale of new stock at market price to its employees or other buyers under Second Income financing, the equity of the existing stockholders is not diminished in the slightest. Each new share of stock issued results in investment of the proceeds in new productive plant and equipment. The pre-existing stockholders own exactly what they did before the expansion -- namely, all the General Motors equity that existed

up to the date of the new stock issue. For every dollar of new stock, a dollar's worth of new productive capital has been added.

There is, however, a dilution of voting power, and this is a dilution that is intended. The great corporations of America, effectively owned by 2 million families, have a narrow voting control. The same corporations--vastly expanded and owned by 65 million families-- would have a broad voting control. That is precisely what ought to be. Certainly from management's standpoint, the more broadly ownership is diffused, the better.

The Second Income Plan breaks up the monopoly access to new capital formation now enjoyed by existing capital owners. But when you stop to think about it, why should those who own the economy's existing assets automatically acquire ownership of all future assets forever and ever? Why shouldn't private and individual ownership of the means of production be as widely diffused as the power to vote? The Second Income Plan is intended to protect existing ownership against dilution. Indeed, by tightening up the laws of private property, it is designed to reduce dilution suffered by existing stockholders. But it is also intended to create tens of millions of new stockholding families as it brings about the building of the Second Economy.

4. Is there really enough corporate stock to provide every American family with a second income from dividends?

There would be, given 25 years or so in which to do the job. The Second Income Plan does not propose governmental redistribution of any of the existing stock ownership. Quite the contrary. The protection of both present and future private property in capital ownership is the essence of the plan. We are proposing that only newly issued stock be made available under the plan. This would be new capital created by industry as it expands its productive facilities to provide more goods and services to families with second incomes to spend. Currently, new capital formation in the American economy is taking place at a rate of about $70 billion a year. Based on $20 billion a year of this yearly increment, this is enough new capital to allocate about $20,000 worth to each of one million families per year. After an initial start-up period of about 5 years, during which the first new capital estates would be paying off their acquisition costs, one million families annually could leave the welfare rolls, each producing a legitimate income of $4,000 or more per year through its productive capital. Within a second 5-year period, 5 million families per year could similarly benefit. Hence, within 10 years, half of all American families would acquire a capital estate.

5. Where does the money come from to buy the stock?

You borrow it from a bank on a promissory (non-recourse) note, secured by pledging the stock itself. The bank can, if the rate of growth warrants, "discount" your note by turning it over to its Federal Reserve Bank in exchange for cash equal to the note's face value less the discount. The money to pay the bank comes directly from the Federal Reserve; it is new money issued against your promissory note. Except for the purpose involved, this banking procedure is conventional; nothing new has been added. It is a rational system for monetizing carefully controlled new capital formation -- the chief source of the goods and services that money buys. It would be the first rational monetary system in history.

6. Who decides what stocks you get?

You do, within the limits of what is available among "qualified" stocks at the time you buy. It would depend on which corporations were seeking funds for expansion at that time. It is proposed that a monetary regulatory agency (Capital Diffusion Insurance Corporation), under proper statutory authorization, establish a qualification procedure whereby a corporation seeking to qualify its shares for financed purchase by new stockholders under the Second Income Plan could, by conventional means, establish the financial feasibility of the proposed expansion. When "qualified", the shares could be offered by the investment banking house for sale to new stock buyers who borrow funds through the banking system or from other lending sources.

The financing bank would insist that the portfolio of stocks be suitably diversified.

7. What happens if, after you buy stock, you find that someone else's stock is doing a lot better?

Almost every stockholder finds himself in this situation at one time or another. The Second Income Plan can, after all, only offer equality of economic opportunity, not equality of income or exemption from ordinary investment risks. However, the very fact that corporations have qualified for insured loans on their stock would be important assurance that they were sound. Diversification offers further protection from the risk of faring too badly in comparison with other financed capitalists.

When you select stocks for purchase under your second, third and fourth capital-financing loan, you can use your experience to upgrade your holdings if you have not chosen too well the first time around.

8. If families are allowed to buy capital without first working and saving for it, won't it corrupt them?

Not unless you believe that every well-to-do family that has inherited all or some of its wealth is thereby corrupted. A list of families who did not work and save their way to capital ownership would have to include the families of most of America's founding fathers, many of our presidents, and disproportionately many of our most distinguished artists, scholars, writers, statesmen, public servants and business leaders. The fact is that it is almost impossible for a man to contribute significantly to the work of civilization until he has provided his family with a minimum income that relieves him from having to toil for their living.

Furthermore, the families do "save" to pay for their stock. The stocks produce dividends. Instead of spending these dividends, the family plows them back to pay off the loan. It is only as the stock is paid for that they begin to use the dividends as a "second income". This procedure is exactly the same as that followed by business throughout the industrial era. Businessmen have always "borrowed" money to invest in productive capital, and then let the earnings of the new capital pay off the loan. This is how our first families became first families. And what's proper for the first families of America is proper for all families, isn't it?

9. If a poor family winds up owning some $20,000 worth of stock, won't it squander it?

A few might. But even as to profligates, the privilege of running through a capital estate should not be confined to those who already have one.

But most new Second Income families will treasure their new capital estate and will husband it and hang onto it for dear life, just as a family a century ago would fight to the death to retain possession of its farm under the Homestead Act; just as our peasant ancestors went hungry rather than eat the last of their herds or flocks, and just as the most primitive agricultural tribes hoarded their seed corn throughout winter even though many of them starved. The belief that the average man does not have the wisdom to preserve capital and the ability to use it constructively is not borne out by history. Moreover, inexperienced families can be taught a great deal about how to manage their capital estates during the time it takes for the dividends to pay off the loan. This would be a place where unions could make an invaluable educational contribution; so could benevolent societies, civic groups and bank trust departments.

A thoughtful economist, after studying the Second Income Plan, expressed the opposite concern, and with some reason. He suggested that when the average citizen finds that the acquisition of productive capital by himself in quantities sufficient to provide a significant income is actually feasible, it will arouse in him, as it has so many times in history, a sharpened acquisitive instinct, and he may then seek to save so much of his income that his consumption may suffer. Here again, education must come to the rescue. The proper use and enjoyment of wealth is one of our least understood subjects.

10. Aren't you overestimating the earnings of mature corporation? If earnings are really 20% of invested capital, why are dividends today only about 5%

A 5% yield on invested capital is about the best that can be expected today. But this figure does not represent the stockholder's real equity in corporate earnings. The corporate income tax at the federal level alone takes 45% of earnings at source and this level may return again to its recent higher levels. The [illegible]

corporate income tax removes another 4 to 5%. Even prior to this, an incalculable part of the wealth produced by capital has been redistributed to employees through such devices as non-competitively determined or administered wages and welfare benefits. Add to this the earnings withheld by the corporation itself to finance expansion -- often as much as half of what remains after taxes. A myriad of accounting practices, too, are employed to conceal much of the productivity of capital. So do such tax practices as excessive depreciation allowances and investment credits.

As things are now, the stockholder does not receive more than a fraction of the wealth his capital actually produces. Under the Second Income Plan, the full 20% or even higher yield would be paid out on stocks financed under the plan's approved techniques. Note that this does not mean that all stocks will be subject to the full dividend payout principle -- stocks bought and sold in the conventional market would be unaffected by the Second Income Plan.

The annual survey of industry profits contained in the April issue of National City Bank's Monthly Economic Letter has shown for years that the average net profit before taxes of more than 1,200 U.S. corporations exceeds 20%, notwithstanding the universally used devices to conceal profits.

11. Won't the Second Income Plan lead to more government interference instead of less?

No, the government acts only as a superviser of the credit system (which it is now) and as a referee to see that every American family gets a fair chance to buy and pay for a share of American industry. Once the plan gets under way, present government involvement in business and personal affairs could be cut way back. The source of most government interference today is the need to redistribute income and to artificially create unnecessary work on a massive scale in order to keep the economy from collapsing. From this need springs such things as make-work programs, subsidies, [illegible] income taxes, etc. Needless to say, the government would not have to fight an anti-poverty war when there are no more impoverished families.

Of course, the present situation did not come into existence overnight and we cannot change it over night. However, we can change the tendency of events. The goal of the Second Income

Plan is to build privately-owned economic security into each family rather than welfare into the society. Economically independent families mean economically independent villages, towns and cities. Such communities can manage their own affairs and provide for their own needs democratically at the local level. They do not have to risk impairment of their liberties in return for government benefits. A government does not have to do for its citizens those things the citizens can do for themselves. Hence, the tendency of the Second Income Plan is toward less government, less government interference and less taxation. It most emphatically does not mean, however, a return to laissez faire. The government must umpire the game, but the Second Income Plan will provide the rules, and the economically independent citizen with an affluent second income is the goal.

12. <u>If everybody gets an income from capital, who will do unpleasant work in the economy?</u>

First of all, let us remember that the immediate result of the Second Income Plan will be genuine full employment, i.e., jobs actually necessary to produce goods and services for people rather than non-economic space hardware and war goods. Then let us remember that even at growth rates double and triple the present 3 to 4%, the Second Economy (to be owned by those not owning assets in the existing economy) will take some years to build. Thus, for a few years -- frankly no one can predict just how many -- second incomes from capital ownership will supplement labor incomes, not replace them, for the majority of families. Thus, the answer to the question of who will do the necessary work in the economy for the next generation or so is: many more of us than are working now.

As technological advance eliminates the need for human labor in the economy (and this it will continue to do whether we adopt the Second Income Plan or not), incomes from capital will gradually become primary sources of income instead of secondary. The economy will always need some labor, no matter how advanced the technology. But no one can predict just what labor's work will consist of after the Second Economy is built. Whether work will be fascinating or boring, delightful or disagreeable, require geniuses or morons -- no one can say. The question as asked assumes that the work required two generations or so from now will be disagreeable, and that persons having incomes from capital will not be motivated to perform it. But the facts may be just the opposite. One thing is certain. With plenty of purchasing power

around, the price of any work for which there is need in the economy will rise to the point where the work will be done. The question cannot be definitively answered today, and twenty years from now perhaps it won't even be asked.

13. If mature corporations finance their growth through future savings, won't this destroy investment opportunities for those who have accumulated savings?

Those who already own a capital estate may invest their excess in new capital formation, in the financing of the Second Income Plan for others, and in enterprises that either do not utilize Second Income Plan financing or do not qualify for it. These latter types of enterprise generally involve a higher investment risk than do mature corporations; they also yield larger rewards to the successful investor. Inasmuch as the social justification for accumulated savings has always been that their owners put them at risk in order to add to the productive assets of the economy, owners of substantial capital estates should not object to carrying out their self-proclaimed social duty. Moreover, the building of the Second Economy will open up hundreds of times more investment opportunities than exist today, opportunities for creative and profitable employment of capital. In the one-income economy, there is normally more capital available for investment than places to invest it -- a frustrating situation for the capital owner. (And one reason why existing stocks are bid up far beyond the level justified by actual dividend return.) We must keep in mind too that Second Income Plan financing is only an alternative method of finance. It is not meant to supplant the conventional techniques based on past savings, but to supplement them, in order to make capital ownership possible for families without savings.

14. What effect would the Second Income Plan have on the stock market?

Gradually, stock prices would develop a direct relation to income and the continual churning of existing outstanding stock

would be reduced. Stocks would ultimately be bought primarily for their income yield, rather than in anticipation of speculative profits or for the purpose of avoiding normal income tax rates.

The total volume of stocks outstanding would be multiplied dozens and dozens of times as the proportion of new capital formation financed by issuance of new stock rises from 4% as at present to -- ideally -- 100%. The normal and non-speculative market in stocks would thus vastly exceed in volume the most speculative and unhealthy booms of today's stock market.

15. How does the Second Income Plan differ from the Guaranteed Income proposed by the Ad Hoc Committee on the Triple Revolution?

There is virtually no similarity -- only differences. The Second Income Plan is designed to enable every household to buy a viable share of the thing that produces affluence -- productive capital -- as its private property, to own, enjoy, increase and pass on to its heirs. The Guaranteed Income is simply a super-redistributive measure that makes each household's economic welfare dependent on political and bureaucratic decisions. The Second Income Plan would diffuse economic power throughout all households in the society, thus building an economic foundation for political democracy and securing the rights and liberty of the individual. The Guaranteed Income proposal necessarily fuses in the hands of politicians economic power with political power, thereby tending to create a totalitarian system hostile to the rights of the individual. It is impossible for a citizen to retain his civil rights when others have the power to determine his material needs.

The Second Income Plan offers detailed and specific measures for bringing about tremendous economic growth -- a Second Economy -- which will be capable of producing for the many the high level of affluence now enjoyed by only the upper 10% of families in the existing economy. Thus the Second Income Plan offers a blueprint for enlarging the economy's productive capacity in ways which build the power to consume simultaneously with the power to produce. It stimulates the economic motivation of the individual.

The Guaranteed Income merely subdivides the wealth produced by the existing economy -- already too small to produce real affluence for the non-capital owning majority. Its basic mechanism is political redistribution of the wealth produced by capital. This

weakens economic motivation and destroys the institution of private property and makes it unavailable to the many.

Lastly, the Second Income Plan encourages responsible government and the integrity of elected office holders. Imagine how our political institutions would degenerate if the main campaign issue became the size of the guaranteed annual income to be offered by the winning candidate or party!

16. How do we decide which American families will become financed capitalists first?

Since the first aim of the Second Income Plan is to provide equal economic opportunity to all Americans, logic and justice would demand that the first financed capitalists be households now totally or partially excluded from economic participation. Families whose breadwinners have been disemployed by automation, especially those men and women who have spent long years in the work force. Elderly persons who have never earned enough from their labor to retire in comfort and dignity. Ministers, school teachers and members of the civil service. Policemen and firemen and other municipal employees who have served a specified number of years in their posts. Working mothers of dependent children. Not everyone can go through a door at the same time, nor by the same token can everyone become a capitalist at once. The question of priority will have to be decided politically. But the financed capitalist door is strictly a one-way thoroughfare -- those families who pass through are on their way to material well-being and independence. It is also a door which grows wider and wider. As policy becomes more and more oriented toward the objectives of the Second Income Plan, and as families with second incomes increase, economic expansion will create more and more productive capital to be bought and paid for by new capital owners.

C. <u>Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy</u>.

Note: This section was written by Mr. Kelso in August 1968 to explain why the input-outtake logic of double-entry bookkeeping was equally applicable to the economy as a whole. It is addressed primarily to persons seeking to understand the underlying logic of Two-Factor Theory and the Second Income Plan. It is equally addressed to those seeking to understand why our present economic strategies have failed.

L = Labor or Human input into production, i.e., the time, control (or skill) and energy of humans engaged in producing goods or services, measured in dollars, for a given time period.

N = Input into production by the nonhuman factor (land, structures, and machines) measured in dollars, for the same given time period.

W = Market value of real wealth, i.e., goods and services, produced in a given time period.

Then, in an economic system constructed on the logic of double-entry bookkeeping (i.e., the logic of two-factor theory) L + N = .

PL = Purchasing power received by labor in the form of wages, salary, bonuses, commissions, or other compensation as the result of its input into production of goods and services (control [or skill] and energy for a period of time).

PN = Purchasing power received by the owners of the nonhuman factor as compensation for the use (input) of their land, structures or machines in the production of useful goods and services for a given period of time.

Then: PL + PN = W.

Now:

C = Dollar value of capital goods produced during the time period.

X = Dollar value of consumer goods and services produced during the time period.

So: PL + PN = C + X

and

C + X = W

for things equal to the same thing are equal to each other.

But:

PN increases as C increases, for as the purchasing power arising from production is invested in new capital formation, the ownership of which accretes to the owners of previously existing capital goods as a direct result of financing new capital formation out of past savings, the productive power of these owners expands. Unless their consumption expands proportionately, the rate of increase of their productive power over their consumption expenditures accelerates with time.

Since:

PL + PN = W,

PN increases relative to PL as C increases.

So a rigid linkage between the ownership of the non-human factor at the beginning of the time period and the ownership of the non-human factor added (through C) during the time period, necessarily results in a diminition of PL in relation to W as PN increases.

The relationship between C and X is important. C, the value of capital goods produced during the period, is a derived demand. Capital goods (land, structures and machines) are not directly consumable by humans. It is the human need for consumer goods and services alone that ultimately gives value (through market demand) to capital goods. If the purchasing power of the fixed group of

owners of the nonhuman factor increases constantly, but their consumption of consumer goods, which would contribute to the value of the nonhuman factor does not increase in proportion to the increase in PN, a serious imbalance arises. PL diminishes in relation to W, and surpluses of consumer goods and services and underutilization of capital goods, or the excess funds seeking investment over opportunity for such investment of PN arises.

-- Poverty of the non-owners of capital goods, the workers and the unemployed, arises.

-- Depression of market value of capital goods, and the lack of investment opportunity for PN (a recession or depression) occurs.

Furthermore:

-- Underproduction, because of lack of market demand arises.

-- Poverty flourishes.

Clearly:

Technological change, which results in an accelerating reduction of PL and increase in PN, both in relation to W, cannot continue unless the number of families and individuals who are able to make only labor input diminishes, and the number of capital owning families and individuals increases at an accelerating rate.

33-758 O - 69 -- No. 19 -- 44

If, as the families and individuals who make up PL either move from the class of owners only of labor power, and either become owners of viable holdings of capital, or both remain employed and acquire significant capital ownership, and thereby receive Second Incomes, then technological change, which shifts the population out of the exclusively-labor-dependent class, and fosters leisure, can advance without restraint.

Similarly, poverty (the inadequacy of purchasing power of families and individuals where adequate supplies of such goods and services could be brought into existence) which arises automatically in a double-entry bookkeeping society from diminishing L, can be attacked at its source by transferring the families and individuals in the L class into the N class. Ideally, the rate of transfer from L class to N class [or to simultaneous membership in both the N class and the L class] would be identical with the rate of shift in productive input from N to L through technological change. Thus the growing <u>general</u> affluence and leisure of the masses would synchronize with -- and would be a direct function of, the rate of technological advance, and would not be impeded by institutional hangups.

This means that C, the investment in capital goods, could increase as rapidly as the physical factors would permit, for as C increased, the individuals in the PL class would shift to, or would simultaneously also become members of the PN class. . . .

X would increase up to the level of affluence desired by the population as a whole.

C would increase as rapidly as the increase in the desire for consumer affluence increased, since the demand for C is derived from the demand for X.

The effect of financing new capital formation out of PN as compared with the effect of financing it out of pure credit.

Since PL + PN = W

and

C + X = W,

the greater X is in relation to C, the greater the level of general affluence. This is true because C cannot be produced, under free market conditions, in excess of the demand for it derived from demand for consumer goods, and the physical capacity of individuals for consumer goods and services is finite and cannot be indefinately increased.

If new capital formation is financed out of PN, then, since the capital-owning class is small at the outset, and does not significantly increase, because of the institutional arrangements that cause the present owners of capital to acquire ownership of all newly formed capital, X cannot legitimately increase with the advance of technological change. Only PN will increase, and the propensity and desire to increase C will be limited to the excess of funds

seeking investment in the non-human factor. A tendency to use such funds to drive up the market value of existing assets will arise, leading to stock market speculation and the like. But increase in C is limited by the lack of demand derived from increase in X.

To some extent, the loaning of funds by the owners of the non-human factor to the owners of labor (the non-capital-owning masses who have only their labor to contribute to production) which is a dual attempt to close the purchasing power gap and to employ for profit their excess purchasing power, will postpone the recession or depression and severe readjustment of values through market value changes, as will increasingly severe measures of political redistribution in an attempt to correct the purchasing power gap.

But it is elementary that such attempts, to the extent they involve the loaning of purchasing power by the high income owners of the non-human factor to the financially underpowered and non-capital-owning masses, while postponing the readjustment, will also increase its severity. For the consumption capability of a particular family is diminished by the aggregate effect of compound interest where borrowing takes place in order to increase consumption. Aggregate real power to consume useful goods and services is diminished by the amount of compound interest paid. For example, twenty-five year or longer

financing periods for financing of home ownership may double or even treble the amount of dollars paid for a home. The time of enjoyment of consumption is influenced favorably to the consumer, but the absolute supply of consumer purchasing power, which determines the health of trade and the degree of general affluence, will be greatly diminished by this practice. It extends the earning power of excess funds of the owners of concentrated capital holdings, but in absolute terms it actually reduces the real standard of living of those dependent on consumer finance.

Attempts to close the purchasing power gap through consumer credit also assure the eventual deflation of value of capital assets, since their value is derived from the market demand for things produced by capital goods, i.e., consumer goods and services. Clearly, the delaying action of consumer finance is not a solution to the problem of how general affluence and general leisure can be attained by the masses at the maximum rate _physically_ possible.

On the other hand, the financing of new capital formation out of credit -- pure credit _where such credit is made available to the non-owners of capital_, and the owners of sub-viable capital holdings -- has quite different effects within the economy. New capital formation, at least, in the dominant and more productive

. . .

part of the economy, does not occur unless potential derived demand for it will be adequate to enable it to pay for itself within a short time -- usually three to five years. So such financing of new capital formation through pure credit mechanisms will not diminish X but in fact, with some time delay, will relentlessly increase X and will also increase the purchasing power to consume X by reason of increasing the number of persons in the PN class. At the same time, such pure credit financing of new capital formation, if properly regulated, need not cause unemployment of funds held by the owners of concentrated capital holdings (PN), since pure credit need not be used until available financial savings have first been used for this purpose under the techniques of the Second Income Plan. This process may also force such financial savings into higher risk and more innovative investments.

Such change will permit expansion of production and the broadening of the consumption of affluence to the full limits of technological, labor, and resource capability, since the previously non-capital-owning families whose incomes are thereby enhanced through the Second Income derived from capital ownership abound in unsatisfied needs and desires, and will expand their purchases of consumer goods out of current income in their quest for the enjoyment of affluence.

It should be noted, too, that if political constraints or business policy constraints bring about the financing of new capital formation through pure credit in ways that generate the ownership of productive capital on the part of those who previously owned no capital, or held negligible amounts of it, and this results in excess PN in the hands of the owners of concentrated capital holdings, they will inevitably seek to employ their excess PN in financing of new capital formation under Second Income Plan techniques for the purpose of broadening the capital ownership base by offering to loan such funds at rates competitive with those available through the banking system [ultimately controlled by the discount rate of the central bank] for the use of pure credit for the same purpose.

Thus excess PN in the hands of the owners of concentrated capital holdings can generally be profitably employed, though probably at rates lower than would be available if the combined efforts of government to redistribute purchasing power from the apparent owners of capital to the non-owners of capital and the use of high-interest consumer loans in a futile effort to close the purchasing power gap were, in effect, subsidizing the return on otherwise-surplus financial savings.

Such use of governmental and business policy

restraints in order to validate a business strategy by which management takes the initiative to expand the economic power of the population of the economy to consume synchronously with expansion of the physical power of the economy to produce would amount to nothing less than the minimum use of intelligent economic system design to conform to the double-entry bookkeeping logic of the market economy.

From another aspect, such constraints would amount only to that imperceptible curtailment of individual liberty required to keep senselessly greedy individuals from injuring their fellowman without benefit to themselves other than to feed unproductive avarice.

Such restraints, in short, are an application of the principle of limitation, which is one of the three foundation stones of economic justice. See The Capitalist Manifesto, by Kelso and Adler, Random House, 1958, Chapter 5, pp. 66-69.

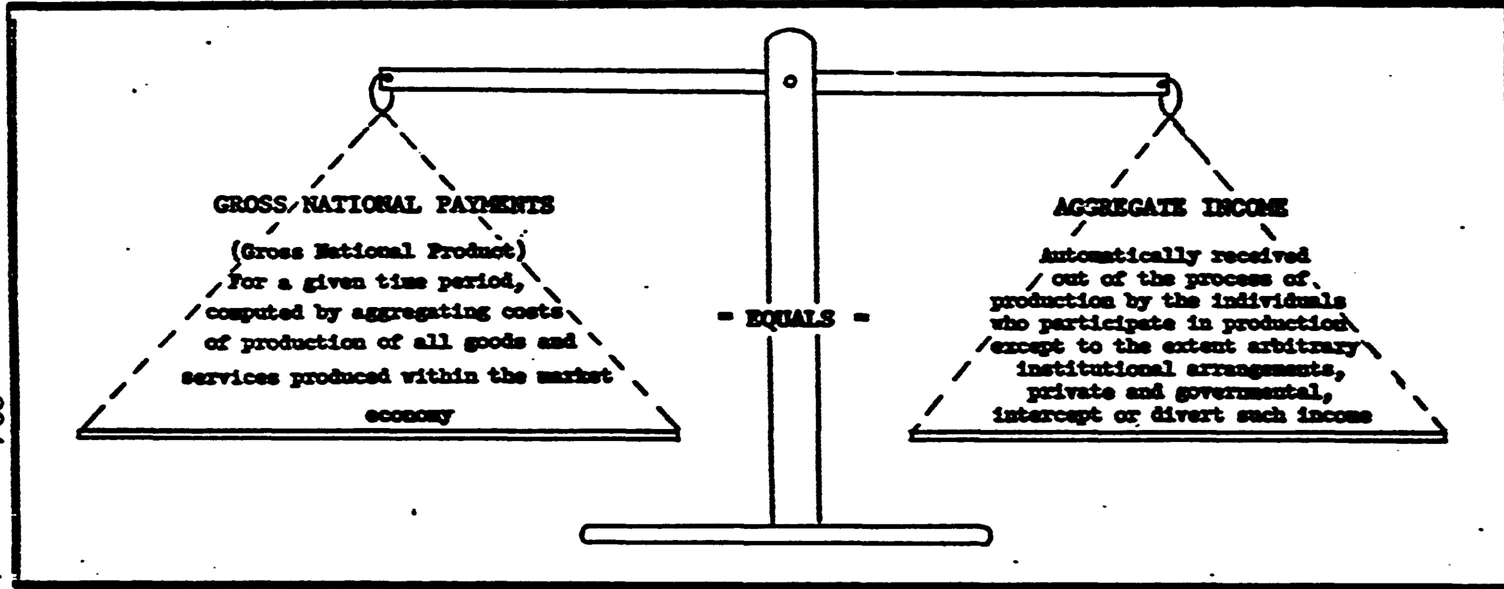
As the employment of two-factor theory in the umpiring of economic activity reduces the tendency of PN to accumulate in excessive quantities, the new policy being to build viable capital holdings of reasonable size in all families rather than to permit the accumulation of grotesque quantities of financial savings by individuals or families whose economic power to produce long since

has exceeded their physical capacity or desire to consume, the PN seeking employment in the process of financing new capital formation will diminish and the use of pure credit for this purpose will become dominant as the goal of universal capitalism, every family and individual owning a viable capital estate, is achieved. Thereafter, it appears that the policy implications of the choice between financing of new capital formation through past savings or through pure credit would turn largely on factors other than national economic policy.

Louis O. Kelso

SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMIC THEORY

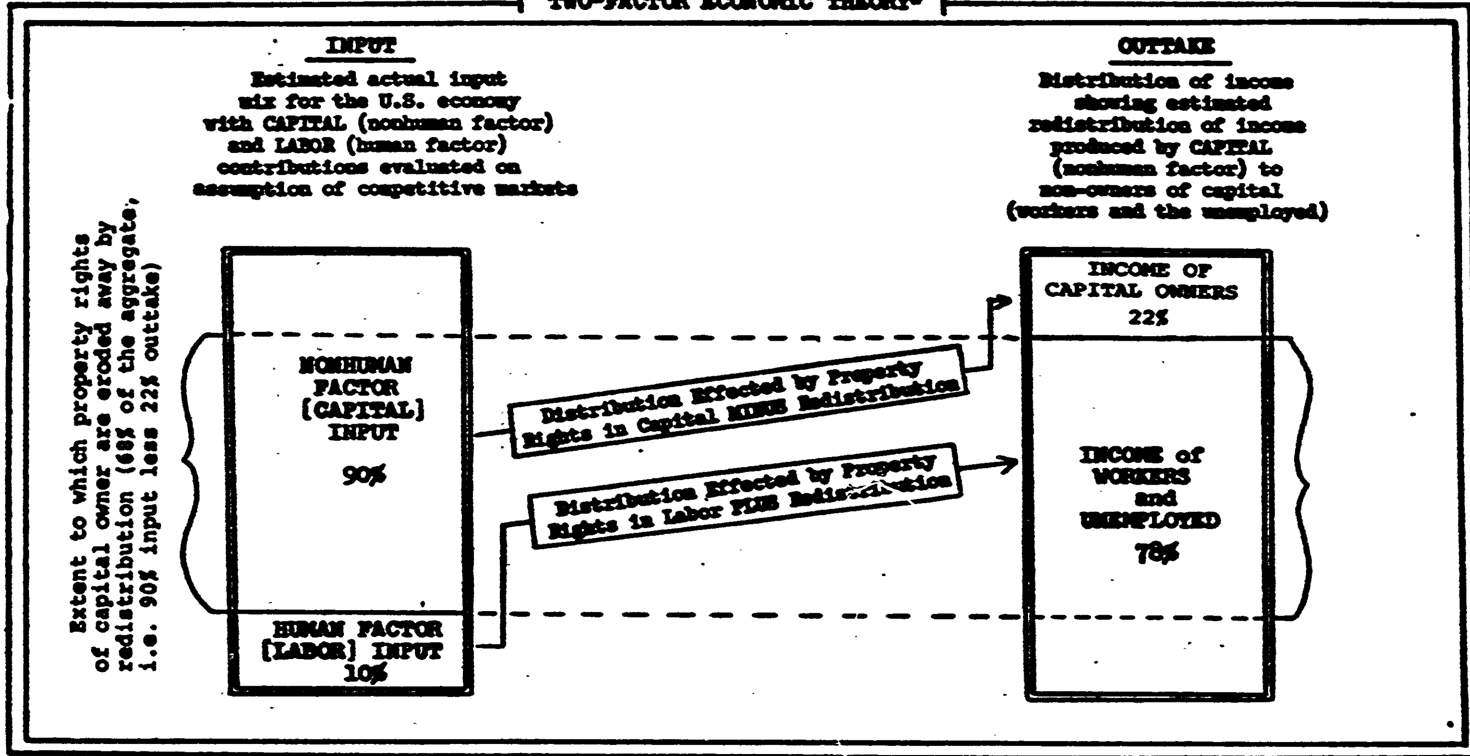
(For every dollar spent, somebody gets a dollar in economic value)



This chart is intended to illustrate Say's Law interpreted through Two-Factor economic theory, i.e., the assumption that each of the two physical factors of production (the human factor and the nonhuman factor) produces wealth or income in the same physical, economic, political, and ethical senses. Say's Law confirms the identity in a market economy between the market value of goods and services produced in a given time period and the aggregate purchasing power created out of the process of production and arising in the hands of the participants in production. "Property right" in a factor of production is the right to receive the entire income or wealth produced by the thing owned (labor power owned by the worker, or physical capital or equity in physical capital owned by the capital owner), evaluated through the mechanism of competitive markets. "Redistribution" from the owners of capital to the non-owners of capital is effected by a wide variety of means, including coercive bargaining of wages, discriminatory taxation (like the corporate income tax which falls only on the wealth produced by capital), payments for nonwork, etc.

Copyright 1967 - Louis O. Kelso and Patricia Hetter

REDISTRIBUTION OF INCOME FROM CAPITAL OWNERS TO NON-CAPITAL OWNERS IN THE U.S. ECONOMY EXPLAINED THROUGH TWO-FACTOR ECONOMIC THEORY*



* Copyright 1967 - Louis O. Kelso and Patricia Hetter.

This chart is intended to illustrate Say's Law interpreted through Two-Factor economic theory, i.e., the assumption that each of the two physical factors of production (the human factor and the nonhuman factor) produces wealth or income in the same physical, economic, political, and ethical senses. Say's Law confirms the identity in a market economy between the market value of goods and services produced in a given time period and the aggregate purchasing power created out of the process of production and arising in the hands of the participants in production.

"Property right" in a factor of production is the right to receive the entire income or wealth produced by the thing owned (labor power owned by the worker, or physical capital or equity in physical capital owned by the capital owner), evaluated through the mechanism of competitive markets.

"Redistribution" from the owners of capital to the nonowners of capital is effected by a wide variety of means, including coercive bargaining of wages, discriminatory taxation (like the corporate income tax which falls only on the wealth produced by capital); payment for nonwork. etc.

V. RECOMMENDED TAX REFORMS

If we grant the desirability of the goal both of achieving legitimate full employment in the production humanly useful goods and services, and enabling a rapidly expanding proportion of the families of the economy to acquire reasonable-sized holdings of productive capital, than it becomes possible to design a program of tax reform designed to achieve these goals. Specifically, the objective would be to use governmental tax guidance to create millions of new capital-owning families with second incomes from the largest corporations, in the course of stimulating the building of a second economy: a building task that amounts to at least twenty-five years of the most intensive full employment. Such a continuous expansion, if it is to be free from the oppressive accumulation of consumer debt, welfare-push inflation, and governmental redistribution of income, can only be supported by raising the economic productiveness of the underproductive through enabling them to acquire ownership of productive capital.

Such a program of tax reform might consider the following:

(1) Qualified Stock Bonus Trusts.

The provisions of the Internal Revenue Code (Section 401) and applicable regulations relating to stock bonus trusts should be liberalized to encourage U.S. corporations that today account for some 80% of the production of goods and services to build equity ownership into their employees. Such liberalization should:

* Increase the present limits of deductibility of corporate contributions to qualified stock bonus trusts from 15% of covered payroll to 30% of covered payroll, independently of deductions for contributions to qualified pension trusts.
* Make dividends payable into such trusts deductible by the corporation as interest presently is;
* Permit a pass-through of dividends to employees without deferment where the trust has fully paid for its stock;
* Broaden the provisions of the Code and applicable regulations to permit joint multi-employer stock bonus trusts, similar to the provisions for joint multi-employer profit-sharing trusts, except that the joint stock bonus trusts would permit the distribution of benefits in diversified stocks of the several participating employers.

(2) <u>Bank Escrows for Members of General Public</u>.

Internal Revenue Code should be modified to permit private escrows to be established with banks to finance the purchase of newly issued stock by low-income individuals through non-recourse financing, with dividends being made tax-deductible by the paying corporation, provided a specified high proportion of corporate net income is paid out in dividends, and exempting such dividends from personal income

taxation on the buyer until the stock is fully paid for. (See section IV. A.)

(3) <u>Contributions to Qualified Employee Trusts Deductible from Income, Gift, and Estate Taxes</u>.

Contributions by individuals to any qualified profit-sharing plan or stock bonus trust should be afforded the same treatment as contributions presently made to qualified charitable foundations. Thus individuals, whether connected with a particular corporation or not, would be given income, gift and estate tax deductions for contributions which tend to build new capital ownership into those who otherwise are capital-less. The rich would thus be motivated to make capital owners out of the propertyless, rather than continue to disconnect their capital accumulations from the ownership of human beings.

(4) <u>Gifts to Qualified Individuals Deductible from Income, Gift, and Estate Taxes</u>.

The wealthy should be provided the same deductions under income, gift and estate tax laws for gifts of income-bearing property or securities to individuals as they are presently entitled for gifts to qualified charitable foundations, so long as the recipient, after the gift, has an estate of no more than a specified value -- say $50,000 or $75,000 -- after which a graduated tax would apply.

(5) <u>New General Purpose Foundations Discouraged</u>.

The Internal Revenue Code should discourage the creation of new general purpose foundations, which tend to prevent

acquisition of increased productive power through capital ownership by the poor. The Code should give maximum encouragement to the use by existing general purpose foundations in following the lead of Ford Foundation, as announced September 29, 1968, to use a portion of its portfolio assets for loans to employee Second Income Trusts to enable employees to acquire ownership of productive capital without diminishing their take-home pay.

BIBLIOGRAPHY
on
Two-Factor Economics

(The Theory of Universal Capitalism and the Second Income Plan)

Conventional economic concepts, from Adam Smith through J. M. Keynes, and the governmental and business institutions based upon them, assume that the performance of labor is the sole or primary method of legitimating individual income; that capital instruments increase "labor productivity" and that the goal of an economic system is to keep labor employed.

The real world of industrial production, however, operates on opposite assumptions: It is constructed on the reality of the full productive equality of the two factors of production: the human factor (labor) and the non-human factor (capital in all of its forms, including land, structures and machines). The theory of Universal Capitalism and the Second Income Plan are concerned with the proper structuring of an economic system in the two-factor economic world, and the updating of pre-industrial mores and ethical precepts to conform to the technical facts of an economy in which capital instruments produce most of the goods and services.

BOOKS

THE CAPITALIST MANIFESTO, by Louis O. Kelso and Mortimer J. Adler (Random House, New York, 1958). Also available in French, Spanish, Greek and Japanese.

THE NEW CAPITALISTS, by Louis O. Kelso and Mortimer J. Adler, (Random House, New York, 1961). Also available in Japanese.

TWO-FACTOR THEORY: THE ECONOMICS OF REALITY* by Louis O. Kelso and Patricia Hetter (Random House, New York, 1968; paperback edition: Vintage Books, 1968).
*Title changed after first printing from "How to Turn Eighty Million Workers into Capitalists on Borrowed Money."

BROCHURE

A brochure describing the goals and activities of the Institute for the Study of Economic Systems is available from the Institute's Washington office: 2027 Massachusetts Avenue, Washington D.C. 20036.

33-758 O - 69 -- No. 19 -- 45

FILM

THE SECOND INCOME PLAN, the action program for implementing two-factor theory (universal capitalism), is described in a 60-minute stripfilm with recorded narration, designed for showing on the Dukane micromatic stripfilm projector (available for rental in all Western Hemisphere cities). The stripfilm is available for $25 from the Institute for the Study of Economic Systems, One Maritime Plaza, San Francisco, California 94111.

ARTICLES

"The Case for the Capitalist Welfare State," by Louis O. Kelso, Report No. 10, August, 1962, Institute of Economic Studies, Araneta University, Manila, Philippines.

"Karl Marx: The Almost Capitalist" by Louis O. Kelso, AMERICAN BAR ASSOCIATION JOURNAL, March 1957, Vol. 43, No. 3.

"Corporate Benevolence or Welfare Redistribution?" by Louis O. Kelso, THE BUSINESS LAWYER, January 1960, Vol. VV, No. 2.

"Labor's Great Mistake: The Struggle for the Toil State" by Louis O. Kelso, AMERICAN BAR ASSOCIATION JOURNAL, February 1960.

"Welfare State - American Style" by Louis O. Kelso, CHALLENGE, The Magazine of Economic Affairs, New York University, October 1963.

"Poverty and Profits" by Hostetler, Kelso, Long, Oates, The Editors, HARVARD BUSINESS REVIEW, September-October 1964.

"Cooperatives and the Economic Power to Consume" by Louis O. Kelso, THE COOPERATIVE ACCOUNTANT, Winter 1964, Vol. XVII, No. 4. (Published by The National Society of Accountants for Cooperatives.)

"Uprooting World Poverty: A Job for Business" by Louis O. Kelso and Patricia Hetter, BUSINESS HORIZONS, Fall 1964. (Reprinted in MERCURIO, Anno VIII #8, August 1965, Rome, Italy; FAR EASTERN ECONOMIC REVIEW, Vol. L #1, October 1965, Hong Kong; and winner of the First Place 1964 McKinsey Award for significant business writing.)

"Beyond Full Employment" by Louis O. Kelso, TITLE NEWS, Journal of the American Land Title Association, November 1964.

"Poverty's Other Exit" by Louis O. Kelso, NORTH DAKOTA LAW REVIEW, January 1964, Vol. 41, #2.

"Are Machines Supposed to Make Work?" by Louis O. Kelso and Patricia Hetter, CHALLENGE, April 1965.

"Why Not Featherbedding?" a satire by Louis O. Kelso, CHALLENGE, September-October 1966. (Reprinted in AMERICAN CONTROVERSY: READINGS AND RHETORIC by Dempsey and McFarland (Scott, Foresman and Company, 1968.)

"General Affluence for Canadians via The Second Income Plan" by Louis O. Kelso, EXECUTIVE Magazine, Don Mills, Ontario January 1967.

"Equality of Economic Opportunity through Capital Ownership" by Louis O. Kelso and Patricia Hetter, SOCIAL POLICIES FOR AMERICA IN THE SEVENTIES, Edited by Robert Theobald (Doubleday & Co., New York, 1968). (Excerpts from this essay are reprinted in the April 1968 issue of CURRENT.)

"Eliminating the Purchasing Power Gap through Two-Factor Theory and the Second Income Plan" by Louis O. Kelso and Patricia Hetter, INCOME MAINTENANCE PROGRAMS, Hearings... Joint Economic Committee, 90th Congress, Second Session, Volume II, pp. 633-652 (Government Printing Office 1968).

"The Second Income Plan: A Contrast," by Louis O. Kelso and Patricia Hetter, NEW GENERATION, Fall 1968. (Theme of the issue: Community self-determination: the bill and the debate.)

"Income Maintenance through Two-Factor Theory and the Second Income Plan," by Louis O. Kelso. (Statement prepared for and presented to the President's Commission on Income Maintenance Programs, Los Angeles Hearings, May 23, 1969.)

ADDITIONAL READING

BOOKS

MORAL MAN AND IMMORAL SOCIETY, by Reinhold Niebuhr (Charles Scribner's Sons, New York, 1932).

THE CHILDREN OF LIGHT AND THE CHILDREN OF DARKNESS, by Reinhold Niebuhr (Charles Scribner's Sons, New York, 1944).

LEISURE - THE BASIS OF CULTURE, by Josef Pieper (Pantheon Books New York, 1962).

OF TIME, WORK, AND LEISURE, by Sebastian de Grazia (Twentieth Century Fund, New York, 1962).

UNDERSTANDING MEDIA: THE EXTENSIONS OF MAN, by Marshall McLuhan (McGraw-Hill Book Company, New York, 1964; paperback by Signet Books, New York.)

ECONOMIC NATIONALISM AND CAPITALISM FOR ALL IN A DIRECTED ECONOMY, by Dr. Salvador Araneta (Araneta University Press, Rizal, Philippines, 1965.)

LA REFORME PANCAPITALISTE, by Marcel Loichot (Robert Laffont, Paris, 1966).

REPORT FROM IRON MOUNTAIN ON THE POSSIBILITY AND DESIRABILITY OF PEACE, with Introductory Material by Leonard C. Lewin (The Dial Press, New York, 1967).

POLITICAL REALIGNMENT - A CHALLENGE TO THOUGHTFUL CANADIANS, by Hon. E. C. Manning (McClelland and Stewart Ltd., Toronto 1967).

BLACK CAPITALISM, by Theodore L. Cross (Atheneum, New York 1969).

THE NEW CLASS: AN ANALYSIS OF THE COMMUNIST SYSTEM, by Milovan Djilas (Frederick A. Praeger, New York, 1957).

ARTICLES

"When Work Won't Earn" by Jack H. Doupe, Editor; "Three Men Pushing Us All to Become Wealthy" by Anthony J. Patterson; and "Affluence for All Canadians" by Winnett Boyd and Jon W. Kieran, all from the May 1967 issue of CANADA MONTH (Montreal).

"The American Economy: Power and Paradox" by Dr. Norman A. Bailey, THE YALE REVIEW, Summer 1966.

"Personal Thoughts" by Winnett Boyd, a Series of Seven Papers on the Canadian Prospect.

"CORE'S Program: Building a 'Second Economy'" by Floyd B. McKissick, NEW GENERATION, Spring 1968.

"Ownership and Income" Policy Statement of the National Catholic Rural Life Conference, INCOME MAINTENANCE PROGRAMS, Hearings...Joint Economic Committee, 90th Congress Second Session, Vol. II, pp. 653-657 (Government Printing Office 1968.)

"Economic Development Thru Capital Diffusion" Report No. 5, Institute of Economic Studies and Social Action, Araneta University, Manila, Philippines.

"The Crawfordville Story" by Norman G. Kurland and Norman A. Bailey, THE COLUMBIA FORUM, Fall 1968.

"The Relevance of Capital" by Abram T. Collier, President of New England Mutual Life Insurance Company. (Copies available from the Communication Department, New England Mutual Life, 501 Boylston Street, Boston, Massachusetts 02117.)

"A New Look at Taxation," an address by Frank S. Capon, Financial Vice President of DuPont of Canada Limited, to the Canadian Chamber of Commerce, October 2, 1968.

"The Keynes Mutiny," by James T. McCausland, FINANCE, August 1969.

INSTITUTE FOR THE STUDY
OF ECONOMIC SYSTEMS

2027 Massachusetts Avenue, N.W.
Washington, D. C. 20036
(202) 667-5800

One Maritime Plaza
San Francisco, California 94111
(415) 397-4600

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D.C.

Statement in Regard to the Provisions of the Tax Reform Act of 1969 (H.R. 13270) Relating to the Holding Period for Livestock (Sec. 212(b)); Gain from Disposition of Property Used in Farming (Sec. 211); and Depreciation Recapture of Purchased Livestock (Sec. 212)

STATEMENT OF:

KENNETH M. PLAISTED
General Counsel

NATIONAL BOARD OF FUR FARM
ORGANIZATIONS, INC.

152 West Wisconsin Avenue
Milwaukee, Wisconsin

Mr. Chairman, Members of the Committee:

My name is Kenneth M. Plaisted. I am the General Counsel for the National Board of Fur Farm Organizations, Inc., a Minnesota Co-operative, with offices located at 152 West Wisconsin Avenue, Milwaukee, Wisconsin. Our association is comprised of the 52 state, regional and marketing organizations the approximate 3,500 members of which are farmers engaged in the raising of domestic mink.

Our purpose in presenting this statement is to urge this Committee to review in depth the provisions of the Tax Reform Act of 1969 that affect (1) the holding period for livestock for capital gain tax purposes, (2) the treatment of the gain from the disposition of property used in farming, and (3) the proposed recapture of depreciation of purchased livestock. These are all areas of the Act which, if adopted, will result in placing new and unfair additional tax burdens on the nation's mink farmers who are already confronted with increased production costs and, as the members of this Committee are well aware, Mr. Chairman, with the problem of competing with heavy import competition and without the benefit of any regulation of mink imports in any form whatsoever.

The Change in the Required Holding Period for Livestock to Qualify for Capital Gain tax treatment would result in Gross Inequities When Applied to Mink Farmers

Under present law the gain from the sale of breeder mink, or the pelts taken from breeder mink, qualifies for capital gain treatment if the animal has been held by the farmer for 1 year or more. The proposed bill now before your Committee would increase the holding period to the extent that the animal must be held for at least 1 year _after_ the animal would have first been used for breeding purposes. In practice, when applied to breeder mink, this would actually increase the holding period for an additional 12 months.

The mink animal is born in May, used as a breeder (male and female) the following March and, if the animal is to be culled from the breeder herd, is then pelted in late November of the same year when the pelt is in its prime condition and when the mink would be approximately 17 months old. Present law permits the capital gain tax treatment of the proceeds of the pelts taken from the breeder animal when the mink has been held by the farmer for more than 1 year. The proposed bill would deny the farmer capital gain treatment on those animals culled from his breeder herd after only 1 year's use for the reason that from the time the animal was first used as a breeder (in March) to the time the animal was pelted (in November) would cover a period of only approximately 8 months. Therefore, if

the mink farmer wanted to be in a position to treat the proceeds from the sale of his pelts from his first year breeders as capital gain, he would be required to carry these mink breeder animals over to the next pelting season (November) which would be another 12 months. This, of course, would not be economically feasible due to the high cost of feeding and caring for the animal during this additional one-year period and at the end of which period there would have been no increase in the value of the pelt to be taken from the breeder mink.

Not all breeder mink are culled from the herd after one season's use as a breeder. Some of the animals are used for 2 or 3 years for such purposes. In many mink herds, however, depending upon the type of mink raised by the farmer, a substantial number of the mink in the breeder herd are pelted after only 1 breeding season. This is true particularly in herds comprised of the so-called light color types. In fact, if the mink farmer has a progressive breeding improvement program, the quality of the fur of the young mink should equal or excel that of its parents and the farmers would then retain the kit (young mink) for use as a breeder the following year and pelt the adult animal.

The enactment of Section 212(b) of the bill in its present form as applied to breeder mink would defeat the legislative purpose of the Congress in its adoption of the present wording of Section 1231(b) of the Code. A review of the reports

of the legislative committees[1/] which accompanied the enactment of Section 117(j) (now Section 1231(b)) clearly indicates that the adoption of Section 117(j) was intended to provide tax relief and thus be an incentive to farmers to turn over their breeder herds for improvement purposes and that the improvement in breeder herds should result in subsequent higher farm profits and, therefore, a more desirable economic condition within the farm economy.

As was stated previously, this Committee is well aware of the competition our members are confronted with as a result of the large quantities of mink pelts being improted into the United States. One reason that our domestic mink farmers have been able to stay in business at all is due to their constant herd improvement programs which result in higher quality fur pelts. For the reasons we discussed earlier, an effective herd improvement program requires a relatively high turnover of the breeder herd after the first breeding year, in particular with the lighter color types of mink. In the past our members have not been penalized, tax-wise, for these programs to improve their herds. The enactment of Section 212(b) of the bill as presently worded would remove any tax incentive for herd improvement and penalize the progressive mink farmer

---

1/ H. Rep. No. 586, 82d Cong., 1st Sess., p. 32; S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41-42.

who was striving to upgrade his herd and keep ahead of the quality of the foreign imports which, in the last analysis, is his only hope of survival.

The reasons for the proposed extension of the holding period for livestock as set forth in the House Report[2] on this bill are not persuasive and have no application whatsoever to the operation of a mink farm. The intended change is apparently designed to correct a few isolated instances where wealthy non-farm taxpayers have invested heavily in certain types of livestock for tax-motivated investment purposes only. This specific proposed change, we respectfully submit, is an overkill and can only result in economic hardship to the farmer and defeat the basic intent of the Congress when it originally enacted Section 117(j) in 1951.

We believe that the present wording of Section 1231(b) of the Code should remain the law on the subject of the holding period for breeder livestock. In the event, however, that Congress decides to amend the section as proposed in Section 212(b) of the bill in order to correct what it may consider to be certain abuses involving other types of livestock, a further provision should be included in such amendment so that livestock used as breeders on mink farms would qualify for capital gains tax treatment if the animal had been held by the taxpayer for 1 year or more which is the present law.

2/ H. Rep. No. 91-413, 91st Cong., 1st Sess. (Part 1), p. 70.

Proposed Changes Relating to Recapture of Depreciation on Purchased Livestock and the Disposition on the Sale of Property Used in Farming will add to the Tax Burdens of the Farmer

The bill before your Committee also proposes to change the existing tax law affecting the recapture depreciation on purchased livestock and the treatment of the gain from the disposition of property used in farming.

The House Report on the bill states that the present depreciation recapture rules as applied to most properties are not applicable to farm livestock and that the House Committee could see no reason why livestock should be treated any differently than other types of properties used in a trade or business.[3/] The Report further states the reasons the bill provides for a change in the treatment of the gain on the disposition of farm property is that the farm accounting rules now applicable to farmers have allowed certain "high-income taxpayers" who farm as a sideline to obtain tax losses to offset their other business income.[4/]

The reason why many of the provisions of the tax law relating to farming, and particularly livestock, are different from those related to other trades or businesses, we believe, is relatively simple. Congress has always recognized that in the raising of any type of livestock there are certain

---

3/ H. Rep. No. 91-413, 91st Cong., 1st Sess. (Part 1), p. 68.

4/ Ibid., pp. 62-63.

inherent risks which are not present in the carrying on of other businesses. The farmer is at the mercy of all of the elements of nature in the course of raising his livestock whatever the type of livestock may be. Because of these risks taken by the farmer, he has been afforded tax allowances with regard to depreciation and certain costs of raising his animals in the reporting of his income from the sale of livestock. These risks which we have mentioned are still present in every field of agriculture. The elements of nature still affect the breeding habits of all farm livestock, including mink. Any defect in a breeder animal is not discerned until after it has been used as a breeder and the female has produced its young. The farmer may, therefore, have a substantial investment in a breeder animal who will turn out to be completely unproductive. This is hardly the case when a piece of machinery breaks down in a factory and where the defect can be immediately discovered and corrected.

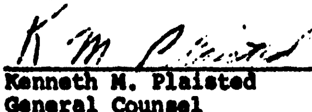
For these and other reasons, we believe there are sound justifiable reasons for affording the farmer certain tax treatment on the sale of his breeder livestock and the options of using certain accounting methods that are not necessarily afforded other businesses.

Conclusion

The changes in those areas of the tax law which are the subject of this statement, as proposed in the bill (H.R. 13270), are apparently designed to correct certain abuses by taxpayers in the high income brackets who carry on limited farming activities. In practice, however, as is often the case with tax "reform" legislation, it will be the small and medium sized farmers who will bear the burden of additional taxes, if this legislation is adopted in its present form. We earnestly urge this Committee, Mr. Chairman, to explore other ways to correct the alleged farm tax abuses referred to in the Report of the House.

The domestic mink industry in the United States is fighting for its very survival at this moment under a government policy that is apparently committed to free trade. During the past 2-year period, one-half of our members have been forced out of business. During this same period our domestic production has declined from 6-1/2 million pelts to 5 million pelts. The market today is at the lowest point in the history of the mink farming business. Tax reform may well be needed in many areas, but we plead with this Committee to thoroughly review the proposed reforms and to take action by eliminating those "reforms" in the bill that will increase the tax burden of the domestic mink farmer.

Respectfully submitted,



Kenneth M. Plaisted
General Counsel

October 1, 1969

O