ENERGY WINDFALL PROFITS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

SECTION 110 OF S. 2589
ENERGY WINDFALL PROFITS

JANUARY 22 AND 23, 1974

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ENERGY WINDFALL PROFITS

TUESDAY, JANUARY 22, 1974

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

The committee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Talmadge, Ribicoff, Nelson, Mondale, Gravel, Dole, and Packwood.

The CHAIRMAN. The committee will come to order. I would like to ask that the witnesses whom I have asked to appear this morning take a seat at the witness stand together so that they can all appear in a panel.

Mr. Mortimer Caplin, Mr. John Nolan, Mr. Johnnie Walters, Mr. Randolph Thrower, Mr. Joel Barlow who will be representing Mr. Edwin Cohen this morning, Mr. Jerome Kurtz, and Mr. Barron Grier, if you would find a place here at the table, we will then have the opportunity for each of you to make his statement. After you have all made your statements, we will ask the questions that would appear appropriate. The witnesses can answer both based on who thinks he knows the answer to the question, or Senators may wish to direct their questions to particular witnesses.

Today we begin a 2-day round of hearings on a proposal which is currently before the Senate which attempts to tax excess or windfall profits in the energy sector.

I support legislation to prevent energy companies from taking unfair advantage of the current crisis to make excessive profits. But we must be sure to draft an excess profits tax proposal in such a way that we will get more energy, not less. I have expressed my doubts that the proposed tax pending before the Senate is workable and soundly conceived. And the proposal before the Senate has never received the benefit of 1 single day of testimony, by one witness, in either House.

It was not contained in the Senate version of the Emergency Energy Act, but was added to the bill in a House committee which does not have jurisdiction over taxation and has not had experience with the complexities of any excess profits tax law.

The expert witnesses who will appear before us today and tomorrow will address themselves to the following points:

One, what problems do you anticipate would arise in the administration of such a windfall profits tax, including areas such as development of regulations, rulings, and litigation?

Two, if such a tax were enacted, what kind of advice would you give energy corporations with respect to the planning of their operations, including proposed capital investments for the purpose of expanding their energy reserves and supplies?

I have received a letter from the Honorable William Simon which indicates that the excess profits tax proposal pending before the Senate is totally unworkable and will lead to endless litigation. But, more importantly, it will discourage energy production in the next year, at a time when it is very much needed.

It would be a real pity if the Congress votes for a proposal which would worsen rather than improve our energy position. Before the Senate votes on this proposal, I want my colleagues to have the benefit of the information provided by the experts who will appear before this committee today and tomorrow, so that Senators will be voting in full knowledge of the likely effect of the proposal.

At this point, I will incorporate in the record section 110 of the conference report on S. 2589, dealing with excess profits, Secretary Simon's letter on the proposal, and the committee's press release announcing these hearings.

[The material referred to follows:]

PRESS RELEASE

FOR IMMEDIATE RELEASE
January 18, 1974

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 Dirksen Senate Office Bldg.

CHAIRMAN RUSSELL B. LONG ANNOUNCES HEARING ON PROPOSED WINDFALL PROFITS TAX PROVISION

Honorable Russell B. Long, (D., La.), Chairman of the Senate Finance Committee today announced that hearings on a proposed windfall profits tax provision will be held on Tuesday and Wednesday, January 22 and 23, 1974, in Room 2221 Dirksen Senate Office Building at 10:00 A. M. The hearing will focus on the provisions of the proposed windfall profits tax set forth below.

The Chairman stated the purpose of this hearing is to assist the Committee in analyzing the feasibility of administering and interpreting the provisions of this proposed tax and to learn whether there are any serious problems of taxpayer compliance under such a proposal.

Particular attention will be devoted to an evaluation of the definition of windfall profits contained in this proposal, which is essentially the same as the definition of windfall profits in S. 2589.

The witnesses who will appear before the Committee have been requested to address themselves to the following points.

1. What problems do you anticipate would arise in the administration of such a "windfall" profits tax, including areas such as development of regulations, rulings, and litigation?

2. Based on enactment of such a tax, what kind of advice would you give energy corporations with respect to the planning of their operations, including proposed capital investments for the purpose of expanding their energy reserves and supplies?

PROPOSED WINDFALL PROFITS TAX

(a) Imposition of Tax. -- In addition to other taxes imposed by this subtitle, there is hereby imposed a "windfall profits" tax on the taxable income of every energy corporation for each taxable year ending after December 31, 1973. In computing such tax a credit shall be allowed for the taxes imposed on such corporations under section 11 with respect to the income subject to the addition to tax imposed herein.

(b) Definition of Income Subject to Windfall Profits Tax. -- The addition to tax imposed under subsection (a) shall be equal to 85 percent of the amount by which the profits of any energy corporation for the taxable year derived from the sale of any energy products/determined by the Secretary or his delegate to be in excess of the lesser of --

(1) a reasonable profit with respect to the particular seller as determined by the Secretary or his delegate upon consideration of --

(A) the reasonableness of its costs and profits with particular regard to volume of production;

(B) the net worth, with particular regard to the amount and source of capital employed;

(C) the extent of risk assumed;

(D) the efficiency and productivity, particularly with regard to cost reduction techniques and economics of operation; and

(E) other factors the consideration of which the public interest and fair and equitable dealing may require which may be established and published by the Secretary or his delegate; or

(2) the greater of --

(A) the average profit obtained by sellers of energy products during the calendar years 1967 through 1971; or

(B) the average profit obtained by the particular seller of energy products during such calendar years.

(c) Except as provided in subsection (b), for the purposes of this section, the term "windfall profits" means profit in excess of the average profit obtained by all sellers for such products during the calendar years 1967 through 1971.

A number of witnesses who have been involved in the administration of the tax laws in connection with their positions as high Treasury officials have been invited to appear and comment on this issue. The following witnesses have indicated, on short notice, they will appear.

Tuesday, January 22, 1974

Mortimer Caplan, former Commissioner of Internal Revenue Service

Charles W. Davis, former Chief Counsel of Internal Revenue Service

John E. Nolan, former Assistant Secretary of the Treasury

Johnnie Walters, former Commissioner of Internal Revenue Service

Wednesday, January 23, 1974

Honorable William E. Simon, Deputy Secretary of Treasury and Administrator, Federal Energy Office

Sheldon S. Cohen, former Chief Counsel and former Commissioner, Internal Revenue Service

Crane Hauser, former Chief Counsel, Internal Revenue Service

Jerome Kurtz, former Tax Legislative Counsel, Treasury Department

Mitchell Rogovin, former Chief Counsel, Internal Revenue Service

K. Martin Worthy, former Chief Counsel, Internal Revenue Service

The Chairman stated: "If, after further consideration, the Senate in its wisdom decides to accord the Committee adequate time, prior to acting on the Conference Report on S. 2589, the Committee will hold broad hearings which will be open to all witnesses desiring to testify on the subject of the windfall profits tax proposal set forth above and on other windfall profits proposals." The Chairman further stated that the witnesses invited to testify at this time were selected solely on the basis of their prior experience in holding high positions in the Treasury Department with responsibility for administration of the tax laws under various Administrations, both Democratic and Republican.

EXCERPT FROM:

93D CONGRESS 1st Session } SENATE { REPORT No. 93-663

ENERGY EMERGENCY ACT

DECEMBER 20, 1973.—Ordered to be printed

Mr. JACKSON, from the committee of conference, submitted the following

CONFERENCE REPORT

[To accompany S. 2589]

* * * * * * *

SEC. 110. PROHIBITION ON WINDFALL PROFITS—PRICE GOUGING.

(a)(1) The President shall exercise his authority under the Emergency Petroleum Allocation Act of 1973 and under the Economic Stabilization Act of 1970 so as to specify prices for sales of petroleum products produced in or imported into the United States, which avoid windfall profits by sellers.

(2) Any interested person, who has reason to believe that any price (specified under any of the authorities referred to in paragraph (1) of this subsection) of petroleum products permits a seller thereof any windfall profits, may petition the Renegotiation Board (created by

section 107(a) of the Renegotiation Act of 1951 and hereinafter in this subsection referred to as the "Board") for a determination under subparagraph (A) or (B) or paragraph (3).

(3)(A) Upon petition of any interested person, the Board may by rule determine, after opportunity for oral presentation of views, data, and arguments, whether the price (specified under any of the authorities referred to in paragraph (1)) of petroleum product permits sellers thereof to receive windfall profits. Upon a final determination of the Board that such price permits windfall profits to be so received, it shall specify a price for such sales which will not permit such profits to be received by such sellers. After such a final determination, no higher price may be specified (under any of the authorities specified in pragraph (1)) except with the approval of the Board.

(B) Upon petition of any interested person and notwithstanding any proceeding or determination under subparagraph (A), the Board may determine whether the price charged by a particular seller of any petroleum product permitted such seller to receive windfall profits. If, on the basis of such petition, the Board has reason to believe that such price has permitted such seller to receive windfall profits, it may order such seller to take such actions (including the escrowing of funds) as it may deem appropriate to assure that sufficient funds will be available for the refund of windfall profits in the event there is a final determination by the Board under this subparagraph that such seller has received windfall profits. Prior to a final determination under this subparagraph, such seller shall be afforded a hearing in accordance with the procedures required by section 554 of title 5, United States Code. Upon a final determination of the Board that such price permitted such seller to receive windfall profits, the Board shall order such seller to refund an amount equal to such windfall profits to the persons who have purchased from such seller at prices which resulted in such windfall profits. If such persons are not reasonably ascertainable, the Board shall order the sellers for the purpose of refunding such profits, to reduce the price for future sales, to create a fund against which previous purchasers of such item may file a claim under rules which shall be prescribed by the Board, or to take such other action as the Board may deem appropriate.

(C) Notwithstanding section 108 of the Renegotiation Act of 1951 and section 211 of the Economic Stabilization Act of 1970, any final determination under subparagraph (A) or (B) shall be subject to judicial review in accordance with sections 701 through 706 of title 5, United States Code.

(4)(A) The Board may provide, in its discretion under regulations prescribed by the Board, for such consolidation as may be necessary or appropriate to carry out the purposes of this subsection.

(B) The Board may make such rules, regulations, and orders as it deems necessary or appropirate to carry out its functions under this subsection.

(5) The determination and approval authority of the Board under this paragraph may not be delegated or redelegated pursuant to section 107(d) of the Renegotiation Act of 1951 to any agency of the Government other than an agency established by the Board.

(6) For the purposes of subparagraph (B) of paragraph (3), the term "windfall profits" means that profit (during an appropriate accounting period as determined by the Board) derived from the sale of any petroleum product determined by the Board to be in excess of the lesser of—

(A) a reasonable profit with respect to the particular seller as determined by the Board upon consideration of—

(i) the reasonableness of its costs and profits with particular regard to volume of production;

(ii) the net worth, with particular regard to the amount and source of capital employed;

(iii) the extent of risk assumed;

(iv) the efficiency and productivity, particularly with regard to cost reduction techniques and economies of operation; and

(v) other factors the consideration of which the public interest and fair and equitable dealing may require which may be established and published by the Board; or

(B) the greater of—

(i) the average profit obtained by sellers for such products during the calendar years 1967 through 1971; or

(ii) the average profit obtained by the particular seller for such products during such calendar years.

(7) Except as provided in paragraph (6), for the purposes of this subsection, the term "windfall profits" means profit in excess of the average profit obtained by all sellers for such products during the calendar years 1967 through 1971.

(8) For the purposes of this subsection, the term "interested person" includes the United States, any State, and the District of Columbia.

(9) This subsection shall not apply to the first sale of crude oil described in subsection (c)(2) of this section (relating to stripper wells).

(10) This section shall take effect on January 1, 1975, and shall apply to profits attributable to any price (specified under any of the authorities referred to in paragraph (1) of this subsection) of crude oil, residual fuel oil, and refined petroleum products in effect after December 31, 1973.

(b) Notwithstanding any other provision of law, administrative proceedings before the Board under this section shall be governed by subchapter II of chapter 5 of title 5, United States Code, and such proceedings shall be reviewed in accordance with chapter 7 of such title.

* * * * * * *

PROHIBITION OF WINDFALL PROFITS—PRICE GOUGING

Senate bill

No provision.

House amendment

Section 117 would amend section 4 of the Emergency Petroleum Allocation Act of 1973 by adding a new subsection to prevent price gouging with respect to sales of crude oil, residual fuel oil, refined petroleum products, and *coal*, including sales of diesel fuel to motor common carriers. The amendment would direct the President to use authority under the Act and under the Economic Stabilization Act of 1970, to specify prices for sales of crude oil, refined petroleum products, residual fuel oil, produced in or imported into the United States, which avoid windfall profits by sellers.

Any interested person who had reason to believe that established prices allowed windfall profits could petition the Renegotiation Board for a determination by rule of the existence of such profits and for their recovery. The seller would be afforded a hearing in accordance with the procedures required by section 554 of title 5, United States Code. Upon final determination that such price permitted windfall profits, the Board would order the seller to refund an equivalent amount to those affected purchasers reasonably ascertainable. The Board could order a reduction in price for future sales of such item or take other appropriate action. The Board's final determination is subject to judicial review.

The term "windfall profits" would be specifically defined in paragraphs (6) and (7). Such profits would refer only to profits earned during the period beginning with the enactment of the Act and ending on the date of its expiration. Actions to determine or recover windfall profits must be brought within one year of the Act's expiration.

Conference substitute

Section 110 of the conference substitute is the same as the House amendment, except that—

(1) The section is no longer an amendment to the Emergency Petroleum Allocation Act.

(2) A new subsection 110(a)(10) has been added which provides that no provision of this section 110 in its entirety shall take effect prior to January 1, 1975. When section 110 does take effect on January 1, 1975, it shall apply to profits attributable to prices charged after December 31, 1973 for crude, residual oil and refined petroleum products.

(3) A new and separate section 129 has been added to the conference substitute which requires the President to set prices for crude oil, residual fuel oil and refined petroleum products which avoid windfall profits. That term "windfall profits" is separately defined in that subsection to mean profits which are excessive or unreasonable, taking into consideration normal profit levels. The new section 129 shall be in effect only until December 31, 1974.

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

January 21, 1974

Dear Mr. Chairman:

Last December the Administration proposed that Congress consider a proposal for an Emergency Windfall Profits Tax to deal with excess or windfall profits resulting from escalating crude oil prices. The proposal is designed to deal effectively with the problem which exists; it is coordinated with a total energy program; and it is workable. The Committee on Ways and Means is expected to begin consideration of the proposal shortly. We strongly urge that you give the proposal, and related energy proposals, your careful attention as soon as possible.

While prompt action against windfall profits is essential, it is equally essential that it be done in a way consistent with the larger goal of attaining early independence from foreign energy supplies. In this connection, we believe that the windfall profits proposal contained in Sec. 110 of the Conference Report dated December 20, 1973, on the Energy Emergency Act would be ineffective and unworkable and could seriously prolong our quest for energy independence.

Sec. 110 is based on traditional excess profits tax concepts, which means that the government has to determine how much profit is "too much" profit. That kind of determination involves the selection of base periods and acceptable profit levels or rates of return from historical profit information. That in turn requires a determination that some rate or amount of profit was "normal" for affected taxpayers during the historical period chosen. In fact, the assumption of normality is false and most of the complexities of excess profits taxes have come from trying to adjust the tax for the abnormalities which always exist. I have attached as an appendix a brief discussion of excess profits taxes, which describes some of the complexities involved.

In prior excess profits tax laws, the complicated guides for determining the amount of excess profits have consumed pages and pages of the statute books. Sec. 110, on the other hand, vaguely expresses the test for excess profits in terms of "reasonable profits," "average profits" and "windfall profits." An administrator of those provisions would, accordingly, have no workable guide for making decisions. Furthermore, the administrator selected for this awesome task is the Renegotiation Board. This Board was designed for the entirely different and limited purpose of reviewing profits from certain types of contracts. While its personnel are able and conscientious, the Board is ill-equipped from the standpoint of concept, size and expertise to deal with a matter of this scope and complexity. Consider, if you

will, that excess profits tax controversies numbered over 50,000 and are still going on 20 years after the tax expired, and that the Internal Revenue Service was the only party with standing to complain about the profit levels of a taxpayer. Compare that situation with the private and individual relief provisions embodied in Sec. 110, under which anyone intrested could invoke the entire redetermination procedure of prices already administratively approved. The potential volume of cases which could arise is staggering to contemplate.

We agree that action should be taken with respect to windfall profits but we believe that Sec. 110 provides an unsatisfactory way to go about it. It would be administratively unworkable and it would create such great uncertainties as to what price the Renegotiation Board or a court might several months or years from now determine to be fair, that intelligent investors would be discouraed from making the investments which will be necessary if oil supplies are to be increased. Billions of dollars of investment are needed to increase energy supplies, and total uncertainty as to the profitability of that investment will surely discourage it. And if additional supplies are not forthcoming, prices can only escalate further as consumers bid up the prices for the existing supplies.

The Emergency Windfall Profits Tax provides a much more careful and satisfactory solution since it:

. Focuses directly on the problem by taking away the windfall part of the price increase in crude oil.

. Phases out over the period over which supplies will be increased, thus not discouraging the needed new investment to obtain additional supplies.

. Falls on the producer, not the consumer, since it merely takes away unexpected profit rather than adds costs which must decrease expected profit or be passed on.

. Is simple to administer--it involves no complex calculations, no complex returns and no complex concept.

At this critical time we must be sure that any solution devised for windfall profits does not work at cross purposes with the goal to achieve independence from foreign supplies. Further, it is a difficult and highly technical task to design a tax or other mechanism to deal fairly and efficiently with "excess" or "windfall" profits. It would be most unfortunate to proceed without heed to the lessons learned from our extensive experience with similar taxes.

We urge that Congress consider this problem as quickly as is possible, consistent with a technically satisfactory solution. We would welcome the opportunity to discuss in detail with you and your staff the operation of the Emergency Windfall Profits Tax and the problems inherent in Sec. 110, as outlined above.

I am sending a copy of this letter also to Senator Jackson, in his capacity as Chairman of the Interior Committee.

Sincerely yours,

William E. Simon

The Honorable
Russell B. Long
Chairman, Finance Committee
United States Senate
Washington, D. C. 20510

EXCESS PROFITS TAXES

While prior excess profits taxes differed significantly, they contained the common elements of (i) a determination of profit in excess of some base amount, (ii) the application of a high rate of tax to the excess amount and (iii) complex exceptions designed to alleviate the penal nature of the high tax rate in situations in which the general rule determination of excess profits yielded an inequitable result. The following problems existed in prior excess profits tax laws:

. Determination of base period and fair rate of return. No period can be selected which was a normal period for all taxpayers. That is to say, during any taxable year or years selected, some taxpayers' rates of return on investment or profits will be higher or lower than others for many extraneous reasons, such as strikes, floods, etc. Two basic methods have been used to determine a normal profit for the base period. One method is to compute a rate of return on invested capital during the base period, treat that as a normal profit rate, and impose a tax on any profits realized in excess of that rate. The other is to treat the absolute amount of profits realized during the base period as normal profits and impose a tax on any profits realized in excess of that amount. Combinations of the two basic methods have also been used. The assumption of normality of any historical rate of profits or any absolute amount of profits for a particular taxpayer for a particular period is subject to challenge because of the infinite variations in taxpayer's situations. For example, during whatever base period is selected, some taxpayers' businesses were contracting, some expanding; some used heavy amounts of equity capital, some relied heavily on debt; some engaged in heavy research and development expenses and others maximized earnings by postponing research and development expenses, and on and on.

. Exceptions for abnormalties. Because of the problems referred to above and others, complex machinery has always been required to adjust the inevitable inequities arising from the selection of base periods and the calculation of base period profits. Administrative boards and courts become entangled for years over these questions. The World War II and Korean War excess profits tax cases spawned over 54,000 applications for over $6 1/2 billion of relief because of claimed abnormalties in the computation of excess profits. Thousands of lawsuits, the last of which has not yet been decided, required large expenditures of time and manpower for both government and taxpayer in complex economic arguments over how much was too much profit.

. Incentive for wasteful expenditures. Since the tax is conventionally imposed at a high rate and only on net profits, it has the effect of causing expenditures which would not otherwise be made and which are wasteful. For example, the corporate taxpayer at a 48% income tax rate must use 52 cents of its own money for every $1.00 expended.

However, if the marginal tax rate is raised to 85% by the addition of an excess profits tax, only 15 cents of every $1.00 of excess profits spent by the taxpayer comes from its pocket--the other 85 cents will be taken in taxes if not spent. Experience teaches that this leads to wasteful practices and inefficiencies which increase or maintain product prices to consumers without creating corresponding benefits to society.

Applying an excess profits tax only to the net profit of oil production would be even more difficult, for the following reasons:

. Increased coverage. The expected windfalls will accrue to all owners of oil, who include thousands of individuals, trusts, estates, specially taxed corporations such as insurance companies, and other corporations not generally associated by the public with oil companies. Accordingly, the windfall tax must apply to all owners of oil, not just to large oil companies, if it is to be effective. The World War II and Korean War excess profits taxes have applied only to corporate taxpayers. It is safe to say that as complex to administer as prior taxes have been, an excess profits tax affecting thousands of noncorporate taxpayers would be greatly more complex.

. Determination of excess profits. It would be necessary to determine the excess profits from oil production alone if the tax were to be confined to the windfall. Complex allocations of income and expense would have to be made. In the case of the numerous individuals, estates and trusts who keep minimum formal records, the allocation problem would be even more sizeable.

. Taxable income management. Taxable income management through wasteful expenditures would be easier to achieve for oil producers since their incomes are reduced currently through the deduction of most of the costs of new wells and percentage depletion. Wasteful drilling practices and wasteful expenditures for overhead items could reduce the impact of the tax to a large extent without corresponding benefits to society from productive new wells or research.

The CHAIRMAN. I believe it would be appropriate to invite Mr. Mortimer Caplin, former Commissioner of Internal Revenue, to testify first, and I will then call upon the other witnesses to testify. After they have all made their statements, I would suggest we then ask whatever questions the committee members would care to address to the witnesses.

Mr. Caplin?

STATEMENT OF MORTIMER CAPLIN, FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE

Mr. CAPLIN. Thank you, Mr. Chairman, members of the committee, I am Mortimer Caplin, a partner in the Washington law firm of Caplin & Drysdale. I appreciate the committee's invitation to participate this morning on the proposed "windfall profits" tax.

Preliminarily, I would like to say that the proposal adopts a simplistic approach to an extremely complex problem. It employs a series of broad and generally defined terms, delegating to the Secretary of the Treasury, unusually wide discretion to fill in the statutory gaps.

Not only are the responsibilities assigned to him enormous, but he would need a staff with an exceptionally high degree of economic, financial, and business skills to discharge his obligations.

The proposed bill encompasses varied and uncoordinated categories of sellers of energy products, each with its own industry problems and pricing considerations. In seeking to separate normal or reasonable profits from excess of windfall profits, the proposal uses as one of its norms "the average profit obtained by sellers of energy products during the calendar years 1967 through 1971." This refers to the average of the industry. Yet no attempt is made, to differentiate among the sellers or to categorize them into cohesive or relevant groupings.

Nor does the proposed bill extent to all elements of the energy industry; for it apparently ignores corporations selling supplies to energy corporations—suppliers of rigs, drill pipes, completion pipes, machinery, and the like. Shortages in these supplies have been widely publicized along with reports of extensive importation, hoarding, and exorbitant prices.

Finally, we find no provision for relief in cases of hardship or inequity. In our prior experience with an excess profits tax during World Wars I and II, and during the Korean war, some form of relief provision was found essential, despite the difficulties encountered in deciding particular cases. Nevertheless, abnormalities frequently do occur due to some maladjustmen during the base-period norm—the beginning of a new business, or an amalgamation, or some dislocation, et cetera. A safety-valve relief provision is essential when a penalty tax with an effective 85-percent rate is imposed.

In brief, we have before us an excess profits tax, whether we call it a windfall tax or any other name. It is an extremely difficult tax to administer and one that we have used only in times of war. Our experience with this type of tax demonstrates that it is erratic and inequitable in application; for no workable formula has yet been found to separate normal or reasonable or fair and just profits from excess profits.

Further, because of its extremely high rates, extravagance and waste often occurs asserting inflationary pressures at a time when economy

and efficiency should be encouraged. Management of a company usually finds itself dealing with two baskets of earnings: One, that is not subject to the penalty tax and worth considerably more; and the other, subject to the tax and of lessor consequence.

There is a high premium on allocating charges against the high tax fund—travel and entertainment, high salaries, extra repairs, extra maintenance. Consequently, an inordinate amont of time and effort is spent on tax-oriented decisions, and tax minimization and tax avoidance plans abound.

Aside from the cosmetic or psychological appeal of its name, it is a type of tax that I would not recommend unless there was no viable alternative.

As a footnote, I would like to add that if the Congress should decide to adopt the philosophy of the proposed bill, consideration should be given to amending the definition of "windfall profits" in paragraph (b) so that it would be the excess of the "greater of", rather than the "lesser of", the following: (1) "a reasonable profit" of the particular seller; (2) the average industry profit during 1967–71; or (3) the average profit of the particular seller during this base period.

Such a change would significantly ease the administrative task, for the mathematical industy and individual averages during the base period would be the normal test, with the flexible reasonable profit standard being applicable only when the energy corporation's profit exceeded base-period averages.

On the other hand, under the present draft of the statute, an energy corporation would be required to subject its earnings to the reasonable profit test even when its performance was below the 1967–71 averages.

This would impose a very great burden on energy corporations each year. It would require them to test their profit against three standards each year, even when it was below base-period averages, and would create continuing uncertainty in determining whether the 85-percent penalty tax would be applicable.

By using the proposed "greater of" approach, the reasonable profit criterion would function as an exception. It would be in the nature of a relief provision and, then, only in the event that base-period averages were exceeded. Unless it were found that there was exceptional profiteering during 1967–71, Congress might well be willing to accept base-period averages as the customary norm.

Problems in Administration

Now the first specific question raised by the committee relates to administering a windfall profits tax, including the development of regulations and rulings and the potential of litigation.

In the first instance, extensive data, research and study would be required in any effort to develop workable regulations and rulings. The statute cuts a broad swath across American industry and administrators would need full understanding of the operations of a wide variety of energy corporations.

In determining a reasonable profit of a particular seller, consideration would have to be given to—and I use the statutory phrases—"the reasonableness of its cost and profits, with particular regard to the amount and source of capital employed," the "extent of risk assumed," the "efficiency and productivity, particularly with regard to cost reduc-

tion techniques and economics of operation," and "other factors the consideration of which the public interest and fair and equitable dealing may require."

What an awe-inspiring responsibility. Whereas today we have an energy administrator, tomorrow under this proposal the Commissioner of Internal Revenue would become an "energy industry czar."

Judgmental decisions will be necessitated at almost each step involved in interpreting this statute, whether by regulation or ruling or on audit by an IRS revenue agent. Under the loose standards contained in the statute, the drafting of clearcut administrative guidelines would be difficult to achieve.

Accordingly, an inordinate amount of time, effort, and money would be required both by energy corporations and the Government in preparing rules and regulations, as well as in day-to-day compliance with the statute.

Also, a broad mix of economists, accountants and lawyers would have a heyday. They would be needed both by the Government and the taxpayer on a continuing basis. Disputes over interpretation would seem inevitable; and the probability of numerous administrative controversies and judicial appeals seem very high.

Problems in Giving Advice

The second question of the committee relates to the kind of advice in this setting that a lawyer could give energy corporations in planning their operations or in making capital investments to expand reserves and supplies.

As a corollary to my first answer, it is apparent that continuous uncertainty would exist in interpreting the law. Planning current as well as future activities, would be hampered because of the statutory vagueness and ambiguities, and lawyers would have an extremely difficult task in advising clients.

In raising capital, investing in new plants and equipment, or in expanding operations, similar obstacles would be encountered in estimating the rate of net return and the advisability of going forward with projects. All of the general concepts discussed before—the flexible concepts as well as the mathematical averages of 1967–71 for sellers of energy and for the energy corporation itself—would have to be considered.

In each instance, judgments would then have to be made on the possible existence of "windfall profits" and the prudence of making commitments in the face of a threat of such a high tax. Differences of interpretation and potential controversy and litigation would always be lurking in the background.

Until final regulations were adopted, lawyers would tend to proceed with extreme caution and would normally prefer to give only tentative advice. And, even with final regulations, the statute would not lend itself to clear-cut decisions and advice, and the advice to clients would in all probability have to contain numerous qualifications.

In these circumstances, management would undoubtedly proceed with extreme caution in making final investment decisions.

Now, in conclusion, I would like to make these comments, Mr. Chairman.

SUGGESTIONS FOR STUDY AND ALTERNATIVE APPROACHES

Numerous economists have opined that the higher the price paid for energy, the more likely we will see increased production from U.S. sources. In view of the current shortfall in satisfying our needs, price increases will undoubtedly have to occur before the United States is independent of foreign energy sources.

At the same time, "windfall profit," "unconscionable profit," "price gouging," or "exploitation"—or whatever the term—is universally abhorred in this country. Most everyone wants to satisfy our energy requirements under a system that is fair to the consumer and fair to the producer and distributor. Similarly, there is concern that lower income groups not be asked to bear a disproportionate burden of price increases.

To achieve these goals, a balance must be reached to prevent runaway prices on the one hand, and to provide adequate incentives for investment and risktaking on the other. If we use our tax laws to achieve these purposes, a tradeoff will have to be made, given the present mood of Congress: that is, some additional tax costs to sellers in exchange for an increase in energy prices. The remaining questions are: "How much?" and "In what form?"

For reasons discussed before, the proposed "windfall profits" tax is not a suitable solution. It is erratic and inequitable in application, and complex and costly to manage.

An alternative approach is called for, either through different, new methods of taxation, or perhaps through modification, reduction, or total elimination of existing tax benefits, available today to the various elements of the energy industry.

In making its decision, Congress clearly will want to procure and consider accurate data on energy inventories, production, costs, reserves, sources of supply, and quantities sold. Undue haste could lead to unwise layering of the Internal Revenue Code, with additional complexity. While, in contrast, a carefully considered alternative may achieve a well-balanced solution to the energy needs of the Nation and in doing so may make an important contribution toward strengthening our tax laws.

Thank you, I would be very happy to answer any questions you have.

The CHAIRMAN. Thank you very much.

For those who appeared while Mr. Caplin was making his statement, I would like to explain that I have suggested that the former Commissioners of Internal Revenue and those who have similar expertise, former Treasury counsels, should all present their statements and at that time committee members may ask the questions they would like to ask.

I think I should explain that there is this difference between the proposal to which the witnesses were asked to testify, and the proposal that is in section 110 of the Emergency Energy Act. Section 110 is a 100-percent renegotiation measure. It has exactly the same concepts of excess profits word-for-word, except that it would require the Renegotiation Board to collect from anyone making what would appear to be an excess profit 100 percent, not 85 percent.

We asked that the tax experts testify to an 85-percent excess profits tax because we have never had a 100-percent excess profits tax. But the measure actually before the Senate has the same effect, as far

as the producer is concerned, as a 100-percent excess profits tax, and I think that that should be made clear for the record.

It was felt that one who has had the responsibility of collecting the taxes could better testify to a proposal if it was formulated as a tax proposal, with the Secretary of Treasury having the responsibility of collecting it, rather than as a renegotiation proposal with the Renegotiation Board having the responsibility of getting the money.

I will now ask that Mr. John Noland, who served very loyally and faithfully for many years in the Treasury, and gave much valuable advice to this committee during his years there, give us the benefit of his views on the excess profits tax-type proposal.

STATEMENT OF JOHN S. NOLAN, FORMER ASSISTANT SECRETARY OF THE TREASURY

Mr. NOLAN. Thank you, Mr. Chairman, members of the committee.

While it is possible to develop a reasonable windfall or excess profits tax applicable to energy companies which preserves and even increases the incentive for development of new energy sources, the form of tax under consideration today is wholly unsatisfactory. Similarly, the recapture of windfall profits by the renegotiation process, as contemplated by section 117 of S. 2589, the proposed Energy Emergency Act, would be an equally poor system. These particular proposals are probably unconstitutional because of their uncertain application. They would greatly discourage new capital investment in energy development because of the extraordinary uncertainty that they would create. Finally, they are totally unadministrable, either through our tax administration structure or the renegotiation process.

The proposed windfall profits tax would be imposed on the "profits" of any "energy corporation" for the taxable year derived from the sale of any "energy products" to the extent that such "profits" exceed the lesser of either a "reasonable profit' to be determined by the Internal Revenue Service on consideration of certain specified general factors or standards, such as "the extent of risk assumed; or alternatively, the average profit from sales of energy products in the base period 1967 through 1971 of either all sellers of such products or of the taxpayer, whichever such base period experience is higher. No statutory definitions of the critical factors, such as "energy corporation," "energy product," the standards in determining reasonable profits such as "the extent of risk assumed" are provided in the proposed tax provisions, nor were they provided in section 117 of S. 2589.

The statutory factors or standards pursuant to which the Internal Revenue Service must determine the extent to which the energy corporation's profit is a "reasonable profit" are all as broad and undefined as the one I listed.

Such a tax would call for income determinations by product lines, since the products of energy corporations extend far beyond the usual concept of "energy products," particularly in petrochemicals and chemical and plastic products. Our tax system has never been required to determine taxable income by product lines, and it cannot readily be done. Few, if any, companies would have product accounting which would provide profit data according to product lines which coincide with the concept of "energy products."

Product accounting requires proper "intracompany" pricing between one division and another, as where the oil refining division sells refined products as raw materials to the chemical division, a determination which is extremely difficult to make, and is beyond the present scope of our section 482 "intercompany" pricing provisions.

Since the proposed tax would require such determinations for the past period 1967–71, both on an industrywide basis and for each particular taxpayer, as well as for future years, and since such data could not be developed, the tax in this form would not be administrable.

The tax is determined by reference to "profits," rather than "taxable income," which is the base of our entire Federal income tax system. Concepts such as "energy corporations" and "energy products" cannot be left to the discretion of the administrators. In these times when all major corporations are conglomerates to some degree, and when the range of products of American producers is so extraordinarily broad and diverse, Congress must make the policy decisions as to the scope of the tax.

One need only recall the extraordinary controversy and litigation surrounding the Treasury Department's effort to adopt the ADR depreciation system in 1971, interpreting the statutory concept "a reasonable allowance for the exhaustion, wear and tear * * * of property," to foresee the impossibility of the Treasury Department or the Renegotiation Board resolving these policy decisions.

Finally, the amount of a tax cannot be determined by the Internal Revenue Service on the basis of considerations as vague and indeterminate as the factors or standards specified in this proposed statute. Taken directly from the Renegotiation Act of 1951, the application of these factors has been described by one of the country's leading renegotiation experts as involving "wholly a matter of judgment" because of the absence of measurable, objective standards. The precise amount of a tax liability cannot be left to the judgment of the Internal Revenue Service. We have never had such a concept in our tax system. The areas in which a measure of discretion or judgment has been committed to the Internal Revenue Service on interstitial questions, such as the reasonableness of intercompany pricing between related entities under section 482, have traditionally caused the greatest difficulty in our tax system. They produce endless controversy and litigation.

Against this background, several conclusions may be drawn. If implemented through the renegotiation process, such a system would probably be unconstitutional. The renegotiation statutes have traditionally provided for recapture of excessive profits on contracts with the Government, principally defense-related. They have not applied to affect dealings wholly between private parties. Their constitutionality was upheld on the basis of the war powers of Congress. Where the Government's interest is far less direct, as where the transactions are wholly between private parties, the proposed system would involve an unconstitutional delegatioin of congressional power, or a taking of property without due process of law, because of the vagueness of the statutory standards and concepts.

Similarly, as a taxing statute, the proposal would be unconstitutional for the same reasons.

Beyond the constitutional difficulties, the proposal is unsound in either form because of the adverse effects it would have on capital

investment in development of new energy resources. The uncertainties it would create as to profits which could be retained, and thus rate of return on new investment, would prevent such investment from being made.

Corporations are free to invest the shareholders' fund only in projects that promise a higher rate of return than other available alternatives, and no intelligent investment decisions could be made when the rate of return could not be estimated in advance.

Finally, it appears that the years 1967–71 in the petroleum industry may have been a period in which crude oil supplies and refining capacity exceeded that needed to meet the demand for refined oil products, thus leading to a relatively low rate of return on invested capital. From a policy standpoint, it would be extremely unwise to limit profits by reference to such a standard when what is needed is massive new investment in energy development, involving a higher-than-average risk factor.

Adjustments in the measuring rod, and perhaps additional incentives for development, are necessary. The plowback concept for use of profits for these purposes, which has been under study at Treasury for several years, offers promising possibilities.

Finally, the recordkeeping and administrative problems of determination of income by product lines and determination of excessive profits by a judgment process would be intolerable. Neither the energy industry nor the Internal Revenue Service could function efficiently under such a system.

Answering the committee's specific question, then, it is my opinion that either the proposed windfall profits tax in question or the renegotiation process of S. 2589 would engender extraordinary litigation—to a degree that neither system could be administered.

The Internal Revenue Service, or the Renegotiation Board, would be incapable of drawing the necessary regulations and rulings for application of such a system. I would feel obligated to counsel my clients to challenge in court the constitutionality of either of these statutes; to challenge in court the validity of regulations and rulings interpreting their scope and attempting to amplify the statutory factors; and to challenge in court any precise determination of windfall profits.

I would advise my clients that no reliable estimates of profitability or rate of return on investment for new capital expenditures could be made, at least for a number of years until the application of the statute in operation could be determined.

In my judgment, this would greatly inhibit new capital investment for the purpose of expanding energy reserves, particularly in such vital projects as recovery of oil reserves from tar sands and oil shale, gasification of coal, use of thermal and steam energy resources, and similar projects.

As I stated at the outset, this is not to say that we cannot devise a workable tax for recapturing excessive profits of energy companies, consistent with efficient new investment in development of energy resources. We have the experience of excess profits taxes in World War I, World War II, and the Korean emergency.

It is possible, by proper statutory definition, to limit such a tax to income of energy companies, and in doing so, to preserve and enhance incentives for new risk-taking investment.

Such a system must provide for measurement of "reasonable" profits by reference to several specific alternatives. One of these would be a base period of normal earnings, reflecting specific adjustments for abnormal business conditions, for excess capacity in relation to demand, for the effect of business cyclical factors, and for the effect on earnings of the particular taxpayer of expansion, such as mergers and other acquisitions, and contraction—corporate divisions—during the base period. Another alternative must be to measure reasonable profits by reference to a rate of return on invested capital properly drawn to reflect the degree of risk of various kinds of energy-related investment and development. The rates of return could be taken from the taxpayer's own experience or from industrywide rates provided in the statute, whichever is higher, after adjustment in each case to insure adequate profitability to encourage new investment.

The excess, if any, of income during the taxable year in question, derived from the normal concept of taxable income under our Federal income tax subject to appropriate, specific adjustments, may than be determined. Adjustments to income for the year in question for abnormal business conditions and expansion and contraction of the taxpayer, similar to adjustments of the type made for the base period, would also be made. If the taxpayer uses base period earnings as the standard for determining excess profits, adequate deductions or credits, possibly subject to a plowback requirement, could be provided to insure new investment.

Thus, as I have said, a system could be devised, but it requires the care and expertise that only this committee and the House Ways and Means Committee can bring to it after adequate public hearing and opportunity for extensive work by the staff of such committees and the Joint Committee on Internal Revenue Taxation.

Thank you very much.

The CHAIRMAN. Thank you very much.

Next we will call on Mr. Johnnie Walters, who served during the Nixon administration with distinction as Commissioner of Internal Revenue.

This is the first time I have had the opportunity to see you, Mr. Walters, since we on the Joint Tax Committee investigated what happened to the enemies list, and I am pleased to congratulate you that you refused to do anything whatever about it. I think it is to your credit and Secretary Shultz's credit that you insisted on administering the Internal Revenue Service in a completely nonpolitical fashion, although you had been urged to depart from that type of good administration.

We would be pleased to hear your views about this excess profits tax matter now.

STATEMENT OF JOHNNIE WALTERS, FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE

Mr. WALTERS. Thank you very much, Mr. Chairman.

Mr. Chairman, and members of this distinguished committee, I appreciate the opportunity of appearing to consider with you and my colleagues here some of the problems involved in the proposed windfall profits taxes.

All of us today are concerned with the energy crisis, and it appears that most Americans are making great effort to cooperate. At any time demand outstrips supply, of course, there are going to be efforts to make profits, and usually there are some around who will take advantage of those opportunities. If the shortage happens to be a luxury, then we do not have to worry about it. But if it is a necessity for all Americans, such as energy, then we do have a problem.

No one today is willing for those who deal in energy to profit unduly because of the energy shortages. Several Members of Congress, as well as the President and others, have advanced proposals to prevent that. It is good that this particular committee is embarking upon a study of the proposal to impose a severe tax, up to 85 percent, on windfall profits. In doing so, however, the committee no doubt will and should weigh the advantages against the disadvantages of such a tax.

We have been asked to comment particularly about the problems of administering the tax. You already have heard many of those problems, and I will not read all of this statement. I will try to summarize portions of it.

One particular problem that has not been mentioned specifically, but is of intense concern to me, and I am sure it is to this committee, is the adverse impact that this particular tax or anything like it would have on the overall compliance capability of the Internal Revenue Service. Any former Commissioner is acutely aware of the intense need, even the necessity, for greater compliance capability. The Service simply does not have adequate resources to administer and enforce our present internal revenue laws. Enactment of this proposal will make this bad situation much worse.

Increasingly, those of us concerned with administering our laws have been concerned about the compliance capability in our voluntary self-assessment system. Any diversion of compliance capability hurts the system on an overall basis.

Unquestionably, enactment of a windfall profits tax will create a host of critical problems and questions, many of which have already been mentioned. The problem of developing adequate regulations and rulings is immense. The problem of selecting and training specialists to audit and investigate compliance with the new tax provisions will be great. While it is true that those who have worked in former excess profits tax areas have some knowledge of the field and some guidelines, nevertheless, they will tell us that the problems of administration are immense.

While only a relative few revenue agents and special agents might be diverted to the windfall profits areas, any diversion weakens the already inadequate compliance program. And, needless to say, the welfare of the Nation depends on the soundness of our overall self-assessment tax system.

Mention already has been made of the litigation problems. I do not believe we can estimate too highly what this will do, because those who are subject to a windfall profits tax definitely will litigate. And we will not only have litigation, we will have multiplicity of litigation.

Our judicial system already is burdened so much that we cannot resolve tax questions in a prompt way. This committee knows that it takes years and years to get the ultimate judicial answer to tax ques-

tions. This is a problem area. Enactment of a windfall profits tax will intensify this problem.

There are many questions which have already been mentioned that this legislation would raise: What is an energy corporation; what is a reasonable profit; and other questions. In addition, we already have some corporations that might be considered energy corporations subject to Government review, so that their rates are allowed only to permit a reasonable profit. Are such corporations, if they are considered energy corporations, now to be subjected to a second Government review to determine what profit they should make? This hardly seems necessary, and it certainly adds to the delay and the problems of administration and judicial makeup.

Only in the simplest cases will the questions be easy of determination. For instance, where a corporation derives profit from sale of energy products and profit from some other product or products, it may be difficult, or even impossible, to ascertain just what the profits are from energy products. While the accounting profession has developed the specialty of cost accounting, the profession does not acclaim that specialty as a science. At best it is an art, and certainly not one on which we should base an 85-percent tax.

These subjective questions will give us difficult problems. Would this tax apply only to energy corporations? What about individuals who sell energy products? Does the tax apply to a corporation that generates and uses its own energy with no sales to others? Does the question of reasonable profits raise a constitutional question? It may.

It seems to me it would be shortsighted indeed to impose this new tax expecting and requiring administration of the new law without considering the problems as they relate to the problems the Internal Revenue Service already struggles with in administering our overall tax system.

In addition to these problems, it seems that there are some goal problems. Just what are we aiming at? It seems clear today that we ought to be finding and developing new and greater sources of energy; in other words, encouraging development, exploration, and research. A windfall profits tax certainly will not do that. Instead, it will discourage investment of dollars, effort, and time.

Those who otherwise might make significant investments to improve and increase our energy supplies without doubt will be dissuaded to some extent by this tax. Even if a corporation is willing to do what maybe patriotism suggests, and that is live with a nonwindfall profit, the necessity to justify every action will have a chilling effect. Unquestionably, this will delay needed action, just the opposite of the Nation's critical need.

Further, enactment of a windfall profits tax at this particular time indicates a serious distrust of energy corporations. This hardly compliments either our self-assessment system or those corporations. Our tax system is based on trust. That being so, maybe we ought to give everyone an opportunity to discharge his or its responsibility as a trusted citizen. The result just might be healthy.

To protect consumers against price gouging might make political sense; but to do so by saddling America with a burdensome, complex tax aimed at anticipated price gouging may make economic nonsense. We can hardly afford many more continuing economic burdens.

Now, as to what we may expect lawyers and others to do, and energy corporations to do, with such a tax, it seems to me that we can expect two basic approaches if this tax is enacted. In the long run, lawyers and others will advise and clients will delay to the extent feasible any action requiring significant investments necessary to meet and resolve the energy crisis pending expiration of the windfall profits tax.

And in the short run, these corporations will bill and charge conservatively in order to avoid not only the windfall profits tax but also the adverse public reaction which will come if they are accused of profiteering. This means that investors will keep their funds out of the very corporations needing them to meet the energy crisis, and the ongoing strength of those energy corporations will be weakened.

Thus, both the shortrun and the longrun effect of this proposed tax are counter to what the Nation needs; that is, a great enthusiastic charge to discover and develop new and greater energy sources for the decades ahead.

May I recommend to the committee also, if you have not noted it already, an editorial in the January Fortune at page 65.

The CHAIRMAN. That will appear in the record at this point, and I will see that copies are made available to each member.

[The article and Mr. Walter's prepared statement follow:]

[From Fortune magazine, January 1974]

EDITORIAL: THE ENERGY CRUNCH AND NATIONAL LEADERSHIP

> Scenario: Hijackers seize a crowded airliner in mid-Atlantic. As worlwide attention turns to this drama, it becomes known that the plane had taken off with so little fuel that it might not have been able to reach its destination anyway, without extraordinary skill on the part of the crew—and maybe a brisk, fortuitous tail wind. The situation would not be greatly improved if the hijackers meekly sat down, fastened their seat belts, and gave up their weapons. Nevertheless, since the more important question of how the plane came to take off without enough fuel might lead to a complicated discussion, everyone fixes his attention on the hijacking.

This little melodrama bears an uncomfortable resemblance to the way the U.S. has reacted to the energy shortage. Again and again, the shortage is said to be "caused" by the Arab embargo on oil shipments, an attribution that delights the more fanatical Arab leaders and gets a lot of other people off the hook. But the bitter truth is that for many years the U.S. (along with the rest of the world) has been increasing energy use so rapidly that the danger of a shortfall in supply was becoming more and more imminent. If the Arabs hadn't acted, the supply-demand balance might have been upset by a strike or a long cold spell. It would be more realistic to say that the Arab action had "uncovered" a deep-seated defect.

Not that the danger had been deliberately concealed. Over several years, President Nixon had called attention to it in a series of official statements. Thousands of people in businesses directly involved in energy supply (e.g., oil, gas, coal, electric utilities) had been emitting warnings; but these were often brushed off as self-serving. In September, 1972, a Fortune article called "The Energy 'Joyride' Is Over" summed up informed opinion this way: "Technology and good sense can stretch our resources—but only a big breakthrough can bring back cheap fuel and power."

Meanwhile, certain extremely vocal environmentalists, warning of a calamitous exhaustion of resources, urged zero (or negative) economic growth. Such doomsday preachments, ill-founded in fact, distracted attention from the development of feasible policies.

Despite all the warnings, both sensible and hysterical, U.S. public opinion was so unprepared that it wildly overreacted to the Arab embargo. The stock market tumbled, government was thrown into disarray, and millions of Ameri-

cans were filled with dread that a major depression was just around the corner. That lack of confidence itself could cause a depression, just as a lack of oil could. Moreover, the overreaction in U.S. public opinion threatened to distort and weaken U.S. foreign policy not only toward the Middle East but all over the world.

TOO MANY CZARS SPOIL THE BORSCH

Both the U.S. energy shortage itself and the even more dangerous public reaction to its belated publicity could have been minimized by more effective national leadership. The term "national leadership" is usually taken to refer exclusively or mainly to the federal government, personified by the President. This forty-year-old overemphasis on the presidency makes less and less sense. U.S. society today has so many "power centers"—including individuals as citizens, workers, or consumers—that we delude ourselves when we speak as if "the White House" by itself can effectively decide large national policy questions. Leadership in today's U.S. involves not only the making of official decisions, but a broad public flow of information, discussion, and persuasion.

But in this vast context of national decision making, the presidency does have an essential role which was not well performed during the years when the energy crunch was developing. While Nixon repeatedly *said* the problem was urgent, he did not by his actions convey either to the Congress or the public a real sense of urgency. On page 76 of this issue, FORTUNE reviews the Administration's backing and filling on energy questions, its weird shifts of delegated responsibility from one energy "czar" to another without ever forming a solid Administration consensus about the nature and gravity of the problem, much less what was to be done about it. Former Governor John Love, the penultimate energy czar, complained when he abdicated that during his five months' tenure he had not been able to get the President's attention. If the President didn't have his mind on the energy crunch, it was hardly surprising that he failed to convey to the country a sense of its urgency.

IT CAN'T BE BLAMED ON YOU-KNOW-WHAT

Watergate, no doubt, was a heavily distracting factor. But it would be a mistake to assume that, but for Watergate, the federal government would have adequately played its part in mobilizing the national will toward an effective energy policy. Because energy pervades all aspects of the national life, it is perhaps inevitable that some sixty separate government agencies deal with one or another aspect of the energy problem. The disgrace is that there has been so little communication and coordination among them: to this day figures on energy supply or demand derived from one Washington agency are being disputed or doubted by some other Washington agency. This confusion among official sources of information is one reason why a significant part of the public still thinks that all the talk of an energy crunch is a mere public-relations ploy by oil companies and other interests looking for special favors.

Valid criticisms of the President and the executive branch should not obscure deficiencies elsewhere in that huge body of public and private persons that constitutes the "national leadership." Even if the President had really been on the energy ball, Congress, always eager to avoid responsibility for unpopular decisions, might have stalled as it did on the Alaska pipeline and other urgently needed legislation. Businessmen might have continued to fight one another for specific advantages in the application of energy policy rather than addressing themselves as a community to the broad problem posed by rising energy demands. Journalism, more at home with a crisis-in-being than with the complex programs needed to stave off a crisis, might not have fulfilled the function of carrying information and serious discussion to the people. Even in the midst of the crisis, scores of reporters concentrate on interviewing gas-station operators and truck drivers. The colorful vehemence with which these news sources express their anger is unquestionably part of the story, but it doesn't contribute much to understanding or solving the problem.

Defects in the public discussion, which is the arena where "national leadership" really functions, are especially apparent in the debate about gasoline rationing. Any intelligent consideration of rationing needs to rest upon an informational base, from which fairly firm estimates of future supply and demand can be made. Such a base is still lacking.

It is clear that refineries, either voluntarily or by law, will have to alter their product mix, sacrificing gasoline to residuals that will be needed for

heating and for industrial energy. But the estimates of the gasoline shortage range from less than 5 percent to more than 30 percent. At the lower figure, there's a reasonable hope that voluntary restraint on the part of motorists would cut the demand enough. At the higher figure, the hope becomes dim.

In mid-December, William Simon, the current energy czar, officially announced that gasoline refining runs would be cut to 75 percent of their present level. This turned out to be a miscalculation. The actual level he wanted to attain turned out to be 95 percent. The frightening error went uncorrected for hours, a sure sign of the statistical confusion in the government and the media.

WHEN PROTECTION IMPOVERISHES

Last month a Fortune editorial argued that a price rise, which is the normal market response to a shortage, would not only limit demand but would also tend over the long run to increase supply. But proposals along this line are met by the strenuous "social justice" objection that they would work a hardship on those consumers least able to pay and would increase, at least temporarily, the profits of oil companies.

This kind of thinking has for years affected the way the national leadership deals with energy policy. To protect the consumer and limit profits, the federal government has for over ten years held down the wellhead price of natural gas to the point where exploration for new sources of gas in the U.S. almost ceased. Not surprisingly, the demand for cheap natural gas rose faster than that for any other energy source. Other public policies, including the meat-ax approach to environmental problems, have inhibited the development of nuclear energy and of processes that use coal.

If the same kind of leadership logic shapes a policy of holding gasoline prices near present levels while rationing gasoline, that would almost guarantee the indefinite continuance of a shortage. To meet the expected U.S. oil requirements of 1980 the industry will need billions of dollars of new investment, which it isn't going to get if profits are held down.

THE PEOPLE AREN'T STUPID

President Nixon has opposed gasoline rationing on the ground that an army of bureaucrats would be required to enforce it. If that were the only difficulty, the U.S. could afford a couple of such armies. But the deeper trouble is in writing a rationing law that would make any kind of sense or equity in today's patterns of gasoline usage—patterns that vary so widely from family to family, depending on such factors as distance between home and work.

Instead of assuming, as our national policy has done, that cheap energy is always preferable, prices should be allowed to push upward. Part of the additional revenue should go into profits and part of it should be taxed away to support government-sponsored research on new energy sources and to help pay the social and environmental costs of a high level of energy use. Such indirect social costs have always been underestimated in the U.S.—one reason that we had much lower energy prices than other nations.

The American people, who form an essential part of the policy-making process, are not invincibly stupid. If public officials, businesmen, and journalists really settle down to explaining the facts and the choices involved in energy policy, the citizenry is quite capable of understanding that unduly cheap energy will dry up energy supply and discourage invention and investment while it fosters wasteful use. It is not unreasonable to suppose, for instance, that Americans can be persuaded that spending tax dollars on mass transit makes more sense than building additional superhighways.

In the years ahead the U.S. will need to lift its policy-making process to a much more effective level if we are not to totter from crisis to crisis. Obviously, this point applies not only to energy policy but to a wide range of choices that will be made more wisely if we do not wait until danger is upon us.

PREPARED STATEMENT OF JOHNNIE M. WALTERS, FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE

Mr. Chairman and members of this distinguished Committee, I appreciate and thank you for the opportunity of appearing to consider with you some aspects of the legislation dealing with the energy crisis. In particular, we this morning are concerned with the proposal to tax "windfall" profits.

Everyone today is concerned with the energy crisis and it appears that most Americans are cooperating in efforts to meet the crisis. At any time demand outstrips supply there are opportunities to profit, and usually there are some ready and willing to take advantage of the opportunities. When the short supply is of a luxury, we need not concern ourselves with the profiteering. However, energy is not a luxury; it is a necessity, although admittedly until recently we probably have used it luxuriously.

No one today is willing for those who deal in energy to profit unduly because of the energy shortages. Several Members of Congress, as well as the President and others, have advanced various proposals to prevent that. It is good for the Finance Committee to study the proposal to impose a severe tax—85%—on "windfall" profits. In doing so, the Committee no doubt will weigh the advantages against the disadvantages and problems of such a tax.

ADMINISTRATIVE PROBLEMS

This Committee, of course, is quite knowledgeable with respect to our tax system and how it operates. Thus, the Committee already is aware of problems in the administration of the tax system generally.

The initial and quite serious problem that will come with a "windfall" profits tax is a further weakening of the compliance capability of the Internal Revenue Service. Any former Commissioner is acutely aware of the intense need—even necessity—for greater compliance capability. The Service simply does not have adequate resources to administer and enforce our internal revenue laws. Enactment of this proposal will make this bad situation worse.

Those of us who have been directly involved with the administration of the tax system, as well as this Committee and other committees of Congress, increasingly have been concerned with the long-term impact of inadequate compliance capability on our voluntary self-assessment system. For instance, the diversion of compliance capability (e.g., Economic Stabilization Program Energy Crisis) from the primary function and responsibility of the Internal Revenue Service (collecting revenue) or the watering-down of that capability through additional taxes or tax functions definitely should be of major concern to the Committee.

Unquestionably, enactment of a "windfall" profits tax will create a host of critical problems and questions. As the Committee knows, the Service has not been able to develop and issue regulations and rulings under existing tax law as needed. Enactment of the "windfall" profits tax would create a need for a whole new batch of regulations and rulings. Since this new tax is of an emergency nature, the need would be immediate. This means diversion from regular work, i.e., regulations and rulings in the income tax area, and therefore greater delay in handling that work.

In addition to the early problem of developing and issuing regulations and rulings, the Service will have to select and train specialists to audit and investigate compliance with the new tax provisions. While to some extent the provisions relate to rules governing taxable income, they also will depart markedly because of the nature of the proposed tax. Those individuals who recall work with the World War II or other excess profits taxes will vouch for the difficulty of administration. For instance, with respect to the proposed tax, it will not be easy to determine "a reasonable profit."

While only a relative few revenue agents and special agents might be diverted to the "windfall" profits areas, any diversion weakens an already inadequate compliance program. And, needless to say, the welfare of the Nation depends on the soundness of our self-assessment income tax system.

LITIGATION PROBLEMS

Further, we can rest assured that persons affected by the emergency legislation will litigate issues involving a "windfall" profits tax. One of the major problems today is the delay in resolving tax issues. As the Committee knows, it takes years and years to secure final judicial resolution of tax issues. We need improvement in this problem area—not an increase of the problem, which is bound to come with this or any other new and complex tax provision.

There will be many issues to debate in the legislation. As indicated earlier, what is "a reasonable profit"? What are reasonable costs? And who can determine satisfactorily the true efficiency of an energy corporation at any time, and particularly during a period of crisis? What constitutes an "energy corporation"? And should all "energy corporations" be subject to the "windfall" profits

tax? Some utilities that may be considered "energy corporations" already are operating subject to government review allowing only reasonable rates of return. Still another government review hardly seems necessary to avoid "windfall" profits by such utilities. Any multiplicity of governmental review in this respect certainly will lead to factual and jurisdictional battles at the administrative and judicial levels.

The determination of "windfall" profits in many cases will not be easy. In fact, only in the simplest of cases will it be easy. For instance, where an "energy corporation" derives some income from sale of energy products and some from production or sale or other products, it may be difficult, or even impossible, to ascertain what profits, if any, should be subjected to the "windfall" profits tax. While the accounting profession has developed the specialty of cost accounting, the profession does not acclaim the specialty as a science. At best it is an art, and certainly not one on which to base an 85% tax!

The kinds of subjective questions the proposed tax will raise (reasonable profit, extent of risk, efficiency, etc.) can only result in serious problems of administration and litigation. Does the provision apply *only* with respect to energy *corporations*? If so, it would generate a great stampede to dump energy and energy products into the hands of individuals—something not particularly attractive on an orderly business basis. And does the provision apply where the corporation generates and uses energy or energy products, without sales to others? And does the restriction of profits to "reasonable profits" raise a constitutional question? It may.

By noting these problems, we do not intend to say whether Congress should or should not impose the tax as a means of preventing undue profiteering during a period of crisis. That is an entirely different question—one for the Congress to answer. Our purpose is to invite the attention of the Committee to significant problems which will come with the proposed new tax. It would be shortsighted indeed to impose this new tax expecting and requiring the Service to administer it without considering the problems as they relate to problems the Service already struggles with in administering our tax system.

GOAL PROBLEMS

In addition to the administrative and litigation problems, enactment of a "windfall" profits tax presents other serious problems. It seems clear today that we ought to be finding and developing new and greater sources of energy, in other words, encouraging development, exploration, and research. A "windfall" profits tax certainly will not do this. Instead, it will discourage investment of dollars, effort, and time. Those who otherwise might make significant investments to improve our energy supplies without doubt will be dissuaded to some extent by the "windfall" profits tax. Even if an energy corporation is willing to do what patriotism suggests, i.e., live with non-windfall profits, the necessity to justify actions will have a chilling effect on corporations. Unquestionably, this will delay needed action—just the opposite of the Nation's critical need.

To impose a "windfall" profits tax at this time indicates a serious distrust of energy corporations. This hardly compliments either our self-assessment tax system or those corporations. Our tax system is based on trust. That being so, maybe we ought to give everyone an opportunity to discharge his or its responsibility as a trusted citizen. The result just might be healthy.

There must be a better way to serve America better than by a "windfall" profits tax that surely will shackle us in efforts to recover from this crisis. This suggests that the Congress should not act in haste. To protect consumers against price gouging may make political sense; but to do by saddling America with a burdensome and complex tax aimed at *anticipated* price gouging may make economic nonsense. In serious matters, we should move seriously. Maybe we should consider the overall long-run effect of a "windfall" profits tax as compared to some alternatives for achieving long-run goals. We can hardly afford many more continuing economic burdens.

EXPECTATIONS

With a "windfall" profits tax, we can expect two basic approaches by those subject to the tax:

(1) *Longrun.*—To the extent feasible delay actions requiring investments necessary to meet and resolve the energy crisis until the "windfall" profits tax expires.

(2) *Shortrun.*—Bill and charge conservatively in order to avoid the "windfall" profits tax in order to avoid controversy and to avoid adverse public relations. (This means investors will keep their funds out of the very corporations needing them to meet and solve the crisis, i.e., the energy corporations, and the on-going strength of energy corporations will be weakened.)

Thus, both the short-run and the long-run effect of a "windfall" profits tax are counter to what the Nation needs, i.e., a great enthusiastic charge to discover and develop new and greater energy sources for the decades ahead.

The CHAIRMAN. Next we will call upon Mr. Randolph Thrower, who served with distinction as the Commissioner of the Internal Revenue Service during the previous years of this administration.

Mr. Thrower, we are pleased to have you back with us.

STATEMENT OF RANDOLPH THROWER, FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE

Mr. THROWER. Thank you, Mr. Chairman. It is a pleasure to be back.

Members of the committee, my name is Randolph W. Thrower, an attorney, with offices in Atlanta, Ga., and Washington, D.C.

This statement is given in response to a request received from Chairman Long over the past weekend. Thus I hardly need to qualify my remarks with the acknowledgment that a subject as complex as the one before you would deserve a great deal more study than I have been able to give it. Problems of the design and administration of an excess profits tax provision are not unfamiliar to Federal tax administrators. I think that all would agree that it would be folly to impose another excess profits tax without taking into account and benefiting from the extensive experience of the past.

Frankly, from the standpoint of administrability, I see almost insuperable difficulties in the proposal as presently designed. Although the proposal to tax excess profits attributable to the energy crisis has inherent within it complexities not known under previous excess profits tax provisions, these presumably are surmountable but, in my judgment, a great deal more work will be required to obtain an operable act. If this is not done, you can be assured that an almost intolerable burden will be placed first on the taxpayer, seller, and administrator and then on the courts.

My first reservation arises from a failure to state the public interest to be served and the general standards to be followed which would be useful as a guide in interpreting the legislation. It is not enough to say that one can assume what are the objectives of such legislation. An attempt to develop a generalized statement to aid the administrator should suffice to show that one is needed.

As to the coverage of the provisions, the provisions of the act should be as clear as reasonably possible in identifying the taxpayers who are to be covered and the transactions to be taken into account.

The draft in the press release refers only to "every energy corporation," but section 110 of S. 2589 and the conference committee report presumably would cover corporations and individuals alike, extending from sales by those who originally extract oil from the ground to ultimate sales by retailers. The application of excess profits taxes to individuals encountered difficulties under the World War I provisions and was avoided in the World War II and Korean war provisions by limiting them to corporations only. A limitation to corporations alone, while simplifying, might tend to stimulate investors to select unin-

corporated ventures rather than corporate ventures. Yet, the inclusion of individual investors will make all the more difficult a problem of determining what is a "normal profit" and what is "excessive."

Neither the proposed section 110 of S. 2589 nor the proposed excess profits tax bill relates to total profits of a seller but only to profits arising from particular transactions. This will impose a special burden of administration not previously encountered under excess profits tax provisions.

Some exclusions should be provided for in order to eliminate many small retailers and others having an insubstantial volume of transactions of the covered products.

Section 110 would apparently cover profits on sales abroad of products produced or refined in the United States, and vice versa, but this needs clarification.

In any event, the extent of the coverage needs to be carefully considered in order to design an administrable act.

The formula for determining what is "excessive" is, of course, at the heart of such a provision, whether it be an excess profits tax provision or a renegotiation provision. It is a problem of determining by formula what is normal; that is, what would have been earned in the absence of the emergency, and then taxing—under an excess profits tax provision—or recovering—under a renegotiation provision—profit that is in excess of that.

The formula provided in S. 2589, or section 110, and incorporated in the excess profits tax provision in the press release would seem deficient in several respects, including the following.

First, it is unprecedented in establishing profits of a base period as a maximum standard for current profits. It authorizes the administrator, by referring to a number of vague generalities, to reduce the standard of normalcy provided by the base period. Excess profits tax provisions traditionally have established the base period as a minimum standard, with a possible upward adjustment due to equitable considerations peculiar to the taxpayer or the segment of his particular industry. The factors listed in paragraph (b) (1) of the proposed windfall profit tax in the press release are of the type which should be referred to as a justification, in the public interest or in the interest of treating equitably the taxpayer or seller, for increasing the base period standard rather than reducing it.

Two, the proposed formula is vague and uncertain in referring to "average profit" of the base period. Does this mean average profit in terms of absolute dollars? This would be determinable for a single operator but not for the entire industry, which has a wide range in the size of sellers. Does it then refer to a margin of profit as related to gross sales or units produced or sold, or does it refer to return on investment? If all measures are referred to, which would control, the one most favorable to the taxpayer or the least favorable one?

It should also be clarified as to whether these provisions refer to profits as reported to stockholders, as determined for Federal income tax purposes, or as determined by some common standard chosen by the Treasury Department.

There is no way under our system of justice to design provisions of the sort under consideration without the inevitability of extended administrative controversy and litigation. The most that can be hoped for is a design that basically is sufficiently equitable and technically is

adequately drafted to permit the act to be reasonably administered and to enable it to be reviewed and upheld by the courts.

We were asked to comment upon the kind of advice which we would give "energy corporations with respect to the planning of their operations, including proposed capital investments for the purpose of expanding their energy reserves and supplies." One must assume that the client has the choice whether or not to risk his investment in an area covered by the excess profits provisions. Additional investment will be determined by the return—perhaps, depending on the definition of "profits," including cash throwoff from percentage depletion—on marginal capital invested, not by the overall average return. The 85-percent tax rate may be too high to leave sufficient capital for reinvestment by petroleum producers.

Moreover, the use of base period profits as a maximum return, without regard to inflation, impact of the devaluation of the dollar, extent of new investment or marginal risks in the present emergency, combined with the vast uncertainties of the language, might constitute too great a disincentive to new investment. Ultimately, these are questions for economists rather than lawyers, but one would tend to advise a client to look elsewhere for investment opportunities.

Finally, the difficulties foreseen in the administration of the proposed excess profits tax pale into insignificance compared with the renegotiation provisions of section 110 of the conference report of the Emergency Energy Act. The excess profits tax would be applied in the first instance by the taxpayer in filing his return. Thereafter, it would be audited by the Internal Revenue Service. Unresolvable differences could end in litigation.

Under the renegotiation provisions, however, any purchaser of petroleum products could initiate an appeal directly to the Renegotiation Board with no screening processes whatsoever. The Board could be swamped. Its decisions would be subject to judicial review. It seems probable that issues raised in this manner would be tied up in litigation long after the present crisis had subsided, and little but confusion would have been contributed to the resolution of the crisis.

Thank you very much, Mr. Chairman.

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

And next we will hear from Mr. Joel Barlow, senior tax counsel of Covington & Burling. Mr. Barlow is appearing here in place of Mr. Edwin Cohen, who advised this committee for a number of years as Under Secretary of Treasury and helped us write the Tax Reform Act of 1969, though I am not sure whether he claims credit for that or not. If you don't like that bill, I think it is fair to say it would have been worse if he had not been there.

We are pleased to have you here, Mr. Barlow. I would think that anyone can hold his job as senior tax counsel in a law firm that has Ed Cohen has got to have credentials that deserve to be heard before this committee, so we would be pleased to have your statement.

STATEMENT OF EDWIN COHEN, FORMER UNDER SECRETARY OF THE TREASURY, PRESENTED BY JOEL BARLOW, SENIOR TAX COUNSEL, COVINGTON & BURLING

Mr. BARLOW. Thank you very much, Mr. Chairman. My name is Joel Barlow. As the chairman has said, I am a partner in the Washington

law firm of Covington & Burling. At the request of the committee, I am presenting the statement of Edwin Cohen, who is now a partner in our law firm, and who regrets that he cannot be here today.

I might add that I agree completely with the views expressed in his statement, and I shall be glad to respond to questions if there are questions asked of me.

I may say also that I was called in by the War Department in World War II to help draft the first Renegotiation Act, and I am greatly concerned about the wisdom and even the constitutionality of the renegotiation aspect of this windfall profits tax proposal; and even more so with the renegotiation aspect of section 110 of the conference report version of 2589, which would give the Renegotiation Board the administration or the participation in the administration of what amounts to a tax law.

Now, Mr. Cohen's statement.

I am pleased to submit to the committee, in response to its request to me and to other former officials of the Treasury Department and the Internal Revenue Service, brief comments regarding the proposed "windfall profits" tax on energy corporations, copy of which is attached to this statement.

The witnesses have been requested to comment on (1) problems that would arise in the administration of such a tax, including the development of regulations, rulings, and litigation, and (2) the kind of advice that could be given to energy corporations with respect to the planning of their operations, including proposed capital investments for the purpose of expanding their energy reserves and supplies.

Preliminarily, I would note that in my experience taxes on excess profits have presented some of the most—if not the most—complex and difficult problems in the field of Federal income taxation. When I came to the bar in 1936, there were cases still pending involving excess profits taxes that existed during World War I. Controversies under the World War II and Korean war excess profits taxes similarly left large sums in dispute and litigation continued for many years after they were terminated.

As contrasted with the brief windfall profits tax provision being considered by the committee today, the Korean war excess profits tax—which was drafted with care in the light of the experiences with the World Wars I and II taxes—contained 35 lengthy sections that were necessitated by the complexity of the subject matter. While the Korean war excess profits tax dealt with substantially all business corporations, whereas the proposed tax would deal only with sales of "energy products" by energy corporations, it would seem that most of the same problems would exist in this narrower segment; and they would be compounded by the necessity of determining separately the profits on energy products sold by corporations which are also engaged in the sale of other goods and services. I do not believe it feasible to give adequate guidance to administrative officials, taxpayers, or the courts on a subject of such complexity in a statute that is as brief and vague as the one proposed.

As a few illustrations of the difficulties involved in the proposed tax, I would call the committee's attention to the following:

1. The tax of 85 percent is imposed with respect to the "profits" of an energy corporation derived from the sale of energy products. It is unclear whether "profits" are to be determined by reference to financial

statement accounting in accordances with good accounting practice—as to which there is often disagreement—or in accordance with the different concept of "taxable income" as determined under the Internal Revenue Code. The Internal Revenue Service is accustomed to administering the "taxable income" concept, but modifications would be needed in judging windfall profits.

2. In the proposed statute it is not clear what treatment is to be given to important elements of profit determination for energy corporations such as depletion, intangible drilling expense, depreciation or the investment credit for equipment. These are important issues, and especially so for companies increasing their production during the basic period and in current years. In particular, the language of subsection (a) leaves the availability of the investment credit in some doubt, since that credit reduces the income tax under section 11 of the code and the latter tax would be allowed as a credit against the windfall profits tax.

3. It is uncertain whether the tax is to be applied to the profits of each energy corporation separately or whether it is to be applied to the consolidated profit of an affiliated group of such corporations. The literal language indicates that each corporation's tax is to be computed separately, but it would seem appropriate in determining windfall profits to permit intercompany transactions between affiliates to be disregarded.

4. No guidance is given as to the treatment of foreign income, either of branches or of subsidaries, nor as to the effect of income taxes paid to foreign governments. Double taxation may result; income taxes paid abroad on foreign income are allowed as a credit against the normal U.S. income tax under section 11 and the latter tax would be allowed as a credit against the windfall profits tax. Domestic effects may be confused by the treatment of foreign operations unless further careful though is given to that aspect in the proposed statute.

5. In comparing current profits with those of a previous base period, earlier excess profits taxes provided for an adjustment to be made in respect of increases or decreases in invested capital during and subsequent to the base period. Obviously, companies which have increased their investment in production capacity for energy products since the beginning of the base period should have their base period profits adjusted upwards, and downward adjustments would seem in order for those who have disposed of facilities or otherwise reduced such investments. Prior excess profits taxes included extensive provisions for adjustments related to increases or decreases in capital invested, mergers, consolidations, other reorganizations, liquidations, purchases and sales of businesses, and so forth. Moreover, allowances were made for catastrophes or interruptions of production or other abnormalities in the base period, for introduction of new products or services and other factors that may reasonably have accounted for increases in profits. Special rules were provided for new corporations that did not have a full base period experience. While some of these factors could be taken into account under the broad language of subsection (b) (1), unless it is so vague that it cannot be applied and interpreted properly, there is no provision for them in subsection (b) (2) (B).

6. The test of "reasonable profit" under subsection (b) (1) is derived from the Renegotiation Act of 1951 providing for renegotiation of

Government contracts. Its broad, generalized language, which in effect provides only subjective tests, has never before been applied to income taxation for administration by the Internal Revenue Service, and in my opinion it should not be. The difficulties of developing and applying such broad concepts and subjective tests have been demonstrated by experience under the Renegotiation Act. They would be grave indeed in the application of an 85 percent tax. The result could be an extended period of uncertainty and litigation.

Mr. Chairman, I would like to insert here the statement made by Senator Proxmire just this past year as to the vagueness and the difficulty of application of these Renegotiation Act standards. In the Congressional Record for June 30, 1973, Senator Proxmire, following a study of renegotiation by the General Accounting Office, made the following statement:

> The Board's rationale for the profit exemption exposes another serious shortcoming in the Renegotiation Act. There is no definition in the statute which permits the Board to determine with any degree of precision whether profits are excessive. Indeed, the Act provides a series of guidelines which are supposed to aid the Board in its determination. The guidelines, upon examination, turn out to be mostly a loose collection of subjective, non-quantifiable factors.

These are the factors that are included in section 110 and in the proposed draft we are considering today. Now, continuing with Senator Proxmire's statement:

> The factors include the contractor's efficiency, the reasonableness of costs and profits, the contractor's net worth, the extent of risk assumed, the nature and extent of contribution to the defense effort, the character of the business, and a final catch-all guideline consisting of such other factors, the consideration of which the public interest in fair and equitable dealing may require. It will be seen that all of these factors, with the exception of the determination of net worth, are highly subjective in nature. To say that the method employed by the Board in determining what is excess and what is not excess is imprecise, is putting it mildly. This shotgun approach to the definition of excessive profits is most unsatisfactory. It may have been necessary and the best that could be developed 20 years ago or more when renegotiation was relatively new. To continue renegotiation under such vague standards is unfair to both the contractors and the public. It is time to establish a more precise and objective definition of excessive profits. One might suppose that the determinations of excessive profits under such loose standards as exist today would vary so widely that no pattern reflecting adherence to any standard would be discernible. That is exactly the case today.

I end the quote.

7. The alternative test in subsection (b)(2)(A) of "the average profit obtained by sellers of energy products" in the years 1967–1971 would make the tax upon a company selling one energy product depend upon the base period profits of companies selling different energy products with different profit margins. Various factors could have produced different profit margins for different energy products; the profits of one product should not fairly be judged by reference to base period profits of different products, especially when sold by other companies. Moreover, it would be difficult, if not impossible, to obtain the properly comparable data, especially for a particular taxpayer to secure the data from competitors and defend his case. Among the problems in the proposed statute is whether "average profit" of other sellers would be determined for purposes of comparison with the taxpayer by its relationship to dollar sales, to invested capital or to a combination of the two.

These are but a few illustrations of the problems that would be involved in the administration of the proposed tax. Enactment of the tax in the proposed form would produce the most serious difficulties in the development of regulations and rulings in the absence of far more specific directives in the statute.

At least until appropriate guidelines had been developed and published, it would be most difficult to advise an energy corporation with respect to proposed capital investments—and I parenthetically would add, I think that is an understatement. Inabilities of the companies to ascertain the effect of capital investments under an 85 percent rate would seem to provide a serious deterrent to development of additional production and capacity, which is a prime objective in the energy program.

In a speech before the American Bar Association Section of Taxation in August 1969, I—meaning Mr. Cohen—suggested that the taxation of oil and gas operations be made dependent in part upon the plowback or reinvestment of profits into the discovery and development of new resources. I continue to believe that this would be a promising approach that warrants further review before adoption of the current proposal.

I would urge upon the committee that the Congress refrain from enacting such a vague statute with such a heavy rate without at least extensive consideration and a total revision and expansion of the language of the draft.

Thank you very much, Mr. Chairman.

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

Next we will call on Mr. Jerome Kurtz, who served us and advised us ably during the Johnson administration with regard to the many tax measures that we passed during those years, prosperous, sometimes troublesome years. And we welcome you as an old friend back before the committee, Mr. Kurtz. We would be pleased to have your statement.

STATEMENT OF JEROME KURTZ, FORMER TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Mr. KURTZ. Thank you, Mr. Chairman and members of the committee.

My name is Jerome Kurtz. I am now an attorney, practicing in Philadelphia. We have been asked to comment today on the administrative difficulties likely to be encountered if the proposed "windfall profits" tax on energy corporations were to become law, and I am pleased to respond.

Because these hearings were called on relatively short notice my testimony necessarily will highlight what are probably only some of the most obvious problems with the bill. The bill, in effect, proposes a tax of 85 percent on that part of the taxable income of an energy corporation equal to the amount by which the profits of such corporation from the sale of energy products is determined to exceed a certain base. That base is the lesser of a reasonable profit for that corporation or the greater of its own base period or an industry base period. Authority is specifically given to the Secretary of the Treasury to determine what is a reasonable profit with respect to the seller. The only

guidance given in making that determination are five separate factors, which the bill asks him to take into account.

These factors are the reasonableness of cost, net worth, risk, efficiency, productivity, and other factors which the Secretary may establish. No definition is given of average profit for purposes of determining either the taxpayer's average profit or the average profit of all sellers of energy products.

I would like to divide my comments into three basic areas of concern. First, a particular drafting problem with the bill as it now exists which it seems to me may make impossible its implementation in its present form because several aspects of the language of the bill are inconsistent with its apparent purpose; second, problems of implementing legislation drafted with the generality of this legislation, even assuming that the language problems to which I have referred are cleared up; and third, I would like to make a general comment on the use of an excess profits tax.

First, as to technical language problems. The bill defines the tax base, that is, the starting amount from which a reasonable profit is deducted, as taxable income. Taxable income, however, particularly in the energy field, does not reflect economic profit. In fact, some of our largest energy corporations have little or no taxable income, and it is not clear that they would have any even if their profits as reported to the public were to increase dramatically.

This results largely from congressional determinations to grant depletion deductions, deductions for intangible drilling costs, and a range of other deductions not restricted to the energy field, but which nevertheless can cause taxable income to be a misleading indication of whether a particular corporation has in fact made windfall or excess profits.

For example, guideline lives, accelerated depreciation, current deduction for research and development costs are a few of the items that differentiate taxable income from income reported to the public.

Clearly, a better base than taxable income would be needed if the tax is to accomplish its apparent purpose and fall evenhandedly on those benefiting from increased prices.

In determining excess profits, the bill refers to an amount in excess of average profits obtained by sellers of energy products during a base period. It seems to me to be obvious that the reference is intended to be a rate of profit, rather than to a dollar amount of profit. It makes no sense to compare the income earned by a particular corporation in 1974 with the average amount of earnings of a group which might include Texaco and your corner gasoline station. On that basis, a small producer or seller would be forever exempt from the tax. Moreover, any reference to amount of profits is unfair because it fails to take account of addition or reductions to investment, changes in product lines, or any other change in the corporate structures since the base period.

I would assume that these and perhaps other critical drafting problems could be corrected if the bill moved toward enactment. Obviously, the comparison of taxable income on the one hand and profits on the other will produce arbitrary results, since we are comparing dissimilar products.

I might say that if taxable income were not used, however, some other definition would be needed, and a substantial portion of the Internal Revenue Code is devoted to a definition of income. It would seem impossible to start from scratch defining a new term. However, even if a better base than taxable income were used, and even if the bill referred to rates rather than to amounts of profits, the implementation of a bill such as the one before us without substantial elaboration would present insurmountable administrative problems.

The basic problem comes from the fact that very broad regulatory authority is delegated to the Secretary of the Treasury, but that no meaningful guidance is given for the development of the needed regulations in many areas.

The absence of guidance raises two questions: First, whether any particular regulation which might be developed would be valid; and second, whether the delegation of authority by Congress is so broad as to be an invalid delegation of legislative authority, and therefore cause the whole act to be invalid. These questions would plague the courts for years as subtle factual variations are tested against the standard of congressional intent where such congressional intent is insufficiently expressed.

There would therefore probably be a long period of doubt concerning whether the legislation were valid. The issue would have to await resolution in case after case in the courts. In the meantime, taxpayers would take varying positions in determining whether to comply with the act, and if so, how to compute their windfall profits. The situation would persist even after regulations were adopted in final form with continuing litigation as to the validity of particular portions of the regulation. Until regulations were promulgated, the situation would be even worse, because given only the act for guidance, most taxpayers would be completely unable to compute the tax, and would certainly be unable to do any planning which involved the potential liability for the tax.

Even this situation might be tolerable if we were dealing with a low rate tax. But this tax, if it applied, is at an 85-percent rate. The higher the rate of tax the more certainty is required, because the inclination of taxpayers to cut corners is generally proportionate to the tax rate.

The task of developing regulations seems overwhelming. Perhaps a list of a few of the more obvious problems which must be solved in regulations may show why this is so.

The bill applies to energy corporations and to energy products, but there is no definition either of an energy corporation or of an energy product. I know of no other taxing statute which leaves to regulations the determination of the parties and the subjects to whom the tax applies. Does it apply to companies which have only a small part of their business in the energy field, or must it be predominantly in the energy field? Is a retail gasoline station an energy corporation? Is an energy product limited to fuel, or does it apply to related products which might also yield windfalls because of current changes in the energy field, for example, products related to the conservation of energy or to the exploration for energy?

The bill applies to profits from the sale of energy products. Does this mean sale as distinguished from mining or manufacturing? If that is so, that raises a distinction which is drawn in the depletion

area, and has caused enormous administrative problems requiring repeated hearings over a period of years to develop regulations.

Are royalty interests covered? Does it apply to foreign income as well as domestic? And if so, how does the foreign tax credit apply, if at all?

How can a Secretary of the Treasury decide these questions without further guidance?

Should the bill apply to a capital gain on the sale of a mineral property? And if not, fields of avoidance seem wide open.

If the Secretary must determine the rate of profits, how would he determine what that rate should be, or what the amount of investment is? Would he use historic costs or current values? Should different companies have different allowances depending on when they acquired their assets, since they might have varying cost bases?

If we compare current profits to base period, then all sorts of adjustments will have to be made as a result of additional investments, corporate acquisitions, deacquisitions, et cetera.

Suppose different firms have different methods of accounting for various items. Must such methods be standardized? In other words, what are profits? Are profits related to taxable income? And what about the treatment of special tax deductions? How can the Secretary determine what is a reasonable profit without saying more? What rate of return might be appropriate?

Most of these questions should be decided legislatively. At least, clear guidelines should be provided. The regulations process necessary to make these determinations would be endless, and the various pressures might prove irresistible to administrators.

I would like to make a general comment on the use of an energy excess profits tax. One problem with imposing an excess profits tax on many energy companies is that the Internal Revenue Code definition of taxable income which serves as a tax base under the act is unsatisfactory, resulting as it does, and as I have mentioned, in many major oil companies paying little or no U.S. tax while reporting substantial profits to shareholders. To impose an excess profits tax on top of that foundation is like trying to scoop water out of a sieve. If we expect to get anything we should first close some of the holes in the sieve.

These questions must necessarily be faced by the Secretary of the Treasury if this bill were to be enacted, in connection with the development of regulations defining profits.

It seems anomalous to me to consider an excess profits tax on corporations that may pay little or no regular income tax. If it is felt, as it seems to be, that energy companies are in a position to pay substantial taxes, and that because of price increases tax incentives are not necessary for the industry, then I suggest that consideration be given to repairing the income tax as it applies to some energy companies. Specifically the deduction for intangibles and percentage depletion allowances and the workings of the foreign tax credit ought to be reexamined.

The first two of these provisions have been justified by their proponents on the grounds that they were desired incentives to exploration. It may well be that new price levels for fuel provide more than enough incentive without tax relief. To grant tax incentives on the one hand and to impose an excess profits tax on the other seems to me analogous to pressing the accelerator and the brake at the same time.

Thank you.

The CHAIRMAN. Thank you very much for these statements.

[The prepared statement of Mr. Kurtz follows:]

PREPARED TESTIMONY OF JEROME KURTZ

My name is Jerome Kurtz. I am an attorney now practicing law in Philadelphia. We have been asked to comment today on the administrative difficulties likely to be encountered if the proposed windfall profits tax on energy corporations were to become law, and I am pleased to respond. Because these hearings were called on relatively short notice, my testimony necessarily will highlight what are probably only some of the more obvious problems.

This bill imposes a tax of 85% on that part of the taxable income of an energy corporation equal to the amount by which the profits of such corporation from the sale of energy products is determined to exceed a certain base. That base is the lesser of (a) a reasonable profit or (b) the greater of the average profit obtained by sellers of energy products during the years 1967 through 1971 or the particular seller's profit during such period.

Authority is specifically given to the Secretary of the Treasury to determine what is a reasonable profit of the seller. The only guidance given is that in making such determination five separate factors are to be taken into account. Those factors are reasonableness of cost, net worth, risk, efficiency and productivity, and other factors which the Secretary may establish.

No definition is given of average profit for purposes of determining either the taxpayer's average profit or the average profits of all sellers of energy products.

I will divide my comments into three basic areas of concern.

1. Particular drafting problems with the bill as it now exists which, it seems to me, may make impossible its implementation in its present form because several aspects of the language of the bill are inconsistent with its apparent purpose;

2. Problems of implementing legislation drafted with the generality of this legislation, even assuming that the language problems referred to above were to be corrected; and

3. General comments on the use of an excess profits tax in this situation.

I. TECHNICAL LANGUAGE PROBLEMS

A. The bill defines the tax base, *i.e.*, the starting amount from which a reasonable profit or the base period profit is deducted, as taxable income. Taxable income, however, particularly in the energy field, reflects neither economic nor accounting profit. In fact some of our largest energy corporations have little or no taxable income and it is not clear that they would have any even if their profits, as reported to the public, were to increase dramatically. This results largely from the fact that taxable income is determined after allowing deductions for intangible drilling costs and percentage depletion. Furthermore, there are a range of other deductions, not restricted to the energy field, but which nevertheless can cause taxable income to be a misleading indication of whether a particular corporation has in fact made windfall profits. Guideline lives, accelerated depreciation, and the current deduction of research and development costs are a few of them. Clearly, a better base than "taxable income" would be needed if the tax is to accomplish its apparent objective and fall even-handedly on those benefitting from increased fuel prices.

In determing excess profits, the bill refers to an *amount* in excess of the average profit obtained by sellers of energy products during a base period. Obviously, the reference is intended to be to a "rate of profit" rather than a dollar amount of profit. It makes no sense to compare the income earned in 1974 by a particular company with the average amount of earnings of a group which might include Texaco and your corner gas station. On that basis a small producer or seller would be forever exempt from the tax.

Moreover, any reference to amount of profits is unfair because it fails to take account of additions or reductions of investment or product lines or any other changes in corporate structure since the base period.

Obviously, the comparison of taxable income on the one hand and profits on the other will produce arbitrary results since we are comparing dissimilar products. I would assume that these and perhaps other critical drafting problems could be corrected if this bill were to be enacted.

I might say that if taxable income were not used, some other definition would be needed. Most of the Internal Revenue Code is devoted to a definition of income and it would seem impossible to start from scratch with a new definition of profits.

II. PROBLEMS OF GENERALITY

However, even if a better base than taxable income were to be used and even if the bill referred to rates rather than amounts of profit, the implementation of a bill like the one before us without substantial elaboration would present insurmountable administrative problems.

The basic problem is that very broad regulatory authority is delegated to the Secretary of the Treasury, but no meaningful guidance is given for the development of the needed regulations in many areas. The absence of guidance raises two questions. First, whether any particular regulations which might be developed are valid; and second, whether the delegation of authority by Congress is so broad as to be an invalid delegation of legislative authority. These questions would plague the courts for years as subtle factual variations are tested against the standard of congressional intent, where such congressional intent is insufficiently expressed. There would, therefore, probably be a long period of doubt concerning whether the legislations were valid. The issue would have to await resolution in case after case in the courts. In the meantime, taxpayers would take varying positions in determining whether to comply with the Act and if so how to compute their windfall profits. This situation would persist even after regulations were adopted in final form with continuing litigation on the validity of various sections of the regulations.

Until regulations were promulgated, most taxpayers, given only the Act for guidance, would be unable to compute their tax—and would certainly be unable to do any planning which involved the potential liability for the tax. Even this situation might be tolerable if we were dealing with a low rate tax, but this tax, if it applies, is at an 85% rate. The higher the rate of tax the more certainty is required because the inclination of taxpayers to cut corners is generally proportionate to the tax rate.

The task of developing regulations seems overwhelming. Perhaps a listing of a few of the more obvious problems which would have to be solved in regulations may show why this is so.

a. The bill applies to sales of "energy products" and to "energy corporations." But there is no definition either of an energy corporation or of an energy product. I know of no other taxing statute which leaves to regulations a determination of the parties and subjects to which the tax applies. Does it apply to companies which have only a small part of their business in the energy field? Or must the company be predominantly in the energy business? Is a retail gasoline station an energy corporation? Are energy products limited to fuels or are related products included which might also yield windfalls because of the current changes in the energy field—for example, products related to energy conservation or exploration.

The bill applies to profits from the sale of energy products. Does this mean sale as distinguished from mining and manufacturing? That distinction is drawn in the depletion area and has caused enormous administrative problems—requiring repeated hearings over a period of years to develop regulations. Are royalty interests covered? Does it apply to foreign income as well as domestic and if so how does the foreign tax credit apply, if at all? Should the bill apply to a capital gain on the sale of a mineral property? If not, avoidance possibilities seem open.

How can the Secretary of the Treasury decide these questions? What will be used for guidelines?

If the Secretary must determine "rate of profit" how would he determine what that rate should be or what the amount of investment is? Is it historic costs or current value? Should different companies have different allowances depending if they changed hands in recent years and therefore have higher cost basis for similar assets?

If current profits are to be compared to a base period, then all sorts of adjustments should be made to account for additional investment or corporate acquisitions, etc.

Suppose different firms have different methods of accounting for various items. Must such methods be standardized? In other words—what are profits? Are profits related to taxable income? What about special tax deductions? And how can the Secretary determine what is a "reasonable profit" without saying more. What rate of return is appropriate.

Most of these questions should be decided legislatively. At least clear guidelines should be provided. The regulations process necessary to make these determinations would be endless and the various pressures might well prove irresistible to administrators.

III. A GENERAL COMMENT ON AN ENERGY EXCESS PROFITS TAX

One problem with imposing an excess profits tax on many energy companies is that the Internal Revenue Code definition of taxable incomes which serves as a tax base under the Act is completely unsatisfactory, resulting as it does, in many major oil companies paying little or no U.S. tax while reporting substantial profits. To impose an excess profits tax on top of that foundation is like trying to scoop water with a sieve. If we expect to get anything, we should first close some of the holes in the sieve. Questions of income definition must necessarily be faced by the Secretary under the proposed bill in his effort to define profits.

It seems anomalous to me to consider an excess profits tax on corporations that pay little or no income tax. If it is felt, as it seems to be, that energy companies are in a position to pay substantial taxes and that because of price increases, tax incentives are not necessary for the industry, then I would suggest that consideration be given to repairing the income tax as it applies to some energy companies. Specifically, the deductions for intangibles and percentage depletion, and the working of the foreign tax credit ought all to be reexamined. The first two of these provisions have been justified by their proponents on the grounds that they are desired incentives to exploration. It may well be that the new price levels for fuel provide more than enough incentives without tax relief.

To grant tax incentives on the one hand and impose an excess profits tax on the other seems to me analogous to pressing the accelerator and the brakes at the same time.

The CHAIRMAN. I have a statement from Mr. C. Houser Crane, who was Chief Counsel to the Treasury under President Kennedy. He agrees generally with the position you take here. It is succinct, and I will put this in the record at a later point.[1]

Perhaps one of you might know of this situation: Last year when we were desperately short of pipe to drill more wells, there was a company selling pipe for oil wells, and that company had enough pipe to drill 300 wells. But the company would not sell any of that pipe during the latter part of last year, even though there were people all over the Nation who would have drilled the 300 wells in a hurry. The reason was that the company had already made as much profit as the price control laws would permit it to make, and therefore they felt that good business practice would require them to keep that pipe right where it was and to hold on until January 1 of this year before making any sales. Are any of you familiar with that? I know it happened because I read about it, and I am told everyone in Houston knows about it.

Now, as I read this proposal, most of the people against whom this would apply would be bound by the requirement of not being permitted to make any more profits than they made during the years 1967 through 1971, which were not regarded as good years in the oil industry. Since that time the cost of living has gone up very substantially, perhaps 20 percent or more. If profits just kept pace with the cost of living they would be about 20 percent higher, one would think. The price of everything, including oil, has gone up. Presumably, most producers, if they had just kept pace with the cost of living, would be making more than they made during that time.

Now, section 110 of this energy bill, as I construe this, would require the great majority of companies to be judged by that standard,

[1] See p. 117.

which would mean that if they just kept pace with the cost of living they would have to give back about 20 percent of their normal profits by the standards that are set forth in this bill.

Most places where I know that you could get a lot of additional energy in a hurry are places where the fields, have already been discovered. I know, for example, of one family group in Louisiana that owns a large amount of land. They have a lot of wells on it. They could get a tremendous amount of oil immediately by simply drilling right alongside the wells they already have. But even at a 50-percent tax rate that they would be paying now, they feel that there is not much point in drilling any more. The oil that is there belongs to them 100 percent. They can take it out whenever it is to their advantage to take it out. As I construe this bill, every additional barrel those people would produce would be a donation. They would not be permitted to keep one penny of the additional profits that they make.

Now, can anybody here tell me how you could advise them, as their lawyer or their business counsel, to produce more oil when they would just be giving the oil away for nothing?

[No response.]

The CHAIRMAN. Now, it would seem to me that bill poses a problem that would exist throughout this entire country. Anybody who has a single oil well and a large enough lease to drill a second would have to give away every nickel he made on the second oil well. Can anybody tell me how it would help to solve the energy crisis to fix it so that a person cannot make $1 by taking his oil out of the ground and selling it to help meet the energy crisis?

[No response.]

The CHAIRMAN. Well, that is part of the problem I see, which apparently was not discussed for a moment in this proposal.

Now, if we are permitted by the Senate enough time to look into this matter, I hope that Mr. Staggers, or whoever drafted this proposal, will come before us and defend it, because I do not understand how you are going to solve the energy crisis by fixing it so that the great majority of people in the energy business will have to give back every single dollar of profits they make by investing more money in trying to find more oil or more gas.

Now, if anyone can explain to me what or where the incentive is, I would like to see it. It would appear to me that it is a disincentive. And, furthermore, when you put a 100-percent tax on something, as the Renegotiation Act does, this means that the Government wants to discourage that kind of conduct, that it is antisocial. Are we to view it as antisocial for someone to produce more oil to invest more money to produce more oil or more gas in a time of energy crisis?

Can anybody here explain to me where that is going to help us in our situation to tell a person that he is subject to a 100-percent tax, which sounds like he is engaging in antisocial conduct, to be held up to opprobrium and scorn throughout the entire Nation.

Why should he produce that much oil? Would it not be simpler just not to produce that much, cut back, produce less, keep the oil in the ground, and thereby avoid being accused of antisocial conduct?

Can anyone give me any advice on that, though?

Mr. BARLOW. Senator Long.

The CHAIRMAN. Mr. Barlow.

Mr. BARLOW. You have an analogy for what you are saying under the actual operation of the Renegotiation Act today. Many companies that are very efficient, low-cost, high-profit companies do not take Government contracts, and they do not take Government subcontracts, because they know that when they go before the Renegotiation Board, if they are efficient and have high profits, they will be on the bed of Procrustes and be lopped off with the less efficient, high-cost, high-price marginal producers in terms of profit levels and return on investment.

I think it is an illusion for the Government to think that the Renegotiation Board in the administration of these vague standards that they now propose to put into this bill and section 110 really is saving money for the Government or saving any money at all in recapturing excess profits. What is happening is that Government procurement has had to spend billions of dollars additional because the companies, in large measure, except in time of war, who will take Government contracts and subcontracts that have commercial business are the less efficient companies that have to charge the highest prices because they have the highest costs. The cost of Government procurement just escalates, so that we are not recapturing excessive profits effectively except in time of war, when all business will take Government contracts and subcontracts without regard to the penalty, the 100-percent penalty that you are talking about.

The CHAIRMAN. Mr. Thrower?

Mr. THROWER. Mr. Senator, I would add that no seller subject to the 100-percent tax that you described having a substantial amount would acquiesce in that without extended litigation as to the meaning of these provisions and, if interpreted as you have stated them, as to their contitutionality.

Thus, I think it would have no impact during the period of the crisis and would be resolved through litigation only years after the crisis has terminated. I think that is an inevitable product of the renegotiation provisions of section 110.

The CHAIRMAN. Furthermore, I have been told that people are offered an opportunity to take a chance on drilling an oil well, they are many times advised not to invest in that wildcat well unless they are doing that on tax dollars. If they are drilling up Uncle Sam's money, it might be worth doing it, but if they are using their own money, they are advised against doing that. That is oftentimes the case of prospects that do not have enough geophysical probabilities about them to make it look like a good risk, but if a man is in the 70-percent tax bracket, he might be well advised to go ahead and take the chance. Or if he finds a lot of oil by taking a chance where he has 1 chance in 100 when he drills his well, it might be worth it. But I have had tax counsel and oil and gas people tell me that if you are spending your own money, you woud be a fool to drill that location.

Now, assuming that a man, as many producers do, has a location where, without drilling very deep, he can produce a lot of oil right alongside an existing oil well where he knows there is oil there. He has the option to drill that one where he will have to give back every penny of it if he makes any money, and he also has the option to go drill one of these tax deals where the chances are 99 out of 100 he will not find anything, but if he does find something, the Government would

have had all of the money anyway. And that being the case, he can run up a big expense which he can charge off against an excess profit.

Now, would this type of law cause one to pass by the situation where, at small expense and small investment of materials and labor, he could produce a lot of oil and, instead, drill the prospect that most people would advise you not to drill if that was your money?

Mr. CAPLIN. Well, Mr. Chairman, you have dramatically illustrated the conflicting policies that this committee has to consider. In one respect, you are trying to encourage greater production: You want discovery; you want exploration; you want risk taking. You want a certain amount of wildcatting to find new fields. You want development of new sources of energy.

To do that, we have not found a better way under our system of government than the profit motive. Sometimes Congress has helped that profit motive by providing an additional incentive by giving a tax benefit under a tax law. Reference was made to percentage depletion, intangible drilling costs, foreign tax credits, and the like.

Now, the economists today, however, tell us that if you really want more production, if you want more exploration, you have got to accept the price of a rise in the cost to the consumer, a rise in the cost all along the way, right at the well-head, right down through our whole distribution system. And yet there is great concern that if we lift the lid off prices, there is going to be great suffering. So where do we achieve this balance?

I think the consensus that you heard today is that this bill is not the way to do it, that it is such a major disincentive that you are going to throttle any desire to move forward and open up new fields.

The question is: What else should you do? And I think that would be a profitable line of inquiry within this group.

The CHAIRMAN. Well, now, let's look at this case: If a person came to the bank and said, I have a lease on offsetting wells in a proven field. I would like to borrow the money to drill 100 wells in that field in a hurry. I would like for you to lend the money, but I am advised by my counsel that I will have to give back every penny of profit I make.

Now, what would you advise the bank about making a loan in that case?

Mr. CAPLIN. I feel pretty confident that meeting would never take place. This man probably would not want to waste his own energy of walking down to the banker's office under the facts you described.

The CHAIRMAN. In other words, you do not think the bank would make the loan; and if you advised the bank to make the loan, your own position as counsel for that bank might be somewhat in jeopardy.

Would that be a fair statement?

Mr. CAPLIN. I think it would be an unlikely marriage—with no gain to be realized by the man who is going to make the investment, or to make the loan, in the first instance.

The CHAIRMAN. That is all the questions I will ask at this point. I have quite a few I would like to ask, but I am going to yield to other Senators.

Senator Ribicoff?

Senator RIBICOFF. Yes. Thank you, Mr. Chairman.

Gentlemen, you are all experts. You have all had a position of responsibility. It is becoming very obvious to the country, and I think it is obvious to me, that this Congress is going to move in one way or another against the major oil companies, either by an excess profits tax or some other tax. I would like to talk some general oil tax policy while we have you here.

In 1972, the latest year for which we have figures, here is what the following companies paid in Federal income tax: Exxon, 6.5 percent; Mobil, 1.3 percent; Standard of California, 2.05 percent; Texaco, 1.7 percent.

Now, the figures of all major oil companies are comparable. The corporate tax rate is 48 percent, but if the oil companies pay taxes at the same rate as other U.S. manufacturers, the oil companies' taxes to this country would go up $3 billion. Under these circumstances, how can you justify such preferential tax treatment?

Do you still think it is essential that we keep the oil depletion allowance, the foreign tax credit, and intangible drilling expenses on the books?

Anybody?

Mr. NOLAN. Senator Ribicoff there certainly is room to reexamine the level of the depletion allowance and the allowance for intangible drilling costs with respect to foreign production in view of the current situation. I do think, however, there is a great misunderstanding with respect to the foreign tax credit.

There are problems in the application of the foreign tax credit, particularly as to the extent to which foreign governments are actually charging amounts in the form of a tax which may in actuality in part be a royalty. That feature needs to be reexamined. But it is quite inappropriate to compare only U.S. income taxes paid with total book income after reducing those U.S. tax figures by the foreign tax credit to the extent that the credit represents a true tax levied by the foreign government. All income taxes paid, including foreign taxes, must be considered. The foreign tax credit is conceptually very sound and an essential part of our tax system, because it prevents double taxation of the same income, and it is appropriate to grant U.S. producers a credit against their U.S. tax for foreign taxes, which truly represent foreign taxes.

Senator RIBICOFF. Now, this is very interesting.

Let me read off to you the development of the treatment of Aramco taxes in their business in Saudi Arabia. I am going to read it slowly and have you gentlemen follow to see if you are correct or not, because this is going to be a major issue in this session of Congress.

Production costs treated as business expense. Royalty treated as business expense. Through rulings that you gentlemen have made over a period of years, the 1.6 percent royalty as against the 6.7 percent tax, you have lumped it basically under the treatment of these taxes. This is what the record shows. I think since 1949 the Internal Revenue has been treating royalty payments as taxes.

Mr. NOLAN. I do not think that is so.

Senator RIBICOFF. I think you will find it.

Mr. NOLAN. We certainly made an extensive effort at the Treasury Department in the years 1969 and 1970 to determine whether, in fact, we could ascertain how much of the royalty payments being paid to foreign governments were, in effect, being characterized as taxes

rather than royalty payments. We sought to disallow the foreign tax credit to that extent. We found that the oil companies were paying royalties treated only as a deduction in addition to foreign taxes treated as a credit, and that the foreign taxes were no higher than in some nonoil countries. We could not conclude that royalties were being paid as taxes.

Senator RIBICOFF. What you actually did, you took about one-tenth of the royalty payments and said it was nontaxable. It was very minuscule, very minuscule. Production costs and royalties are subtracted from posted price. Income tax of 55 percent is then computed on posted price minus royalty and production costs. This is a tax paid to Saudi Arabia.

The tax paid is treated as foreign tax credit and may be offset against foreign earnings, including earnings in third countries, refinery profits, let's say, in Europe. The net effect is that Exxon and others who own Aramco do not have to pay any U.S. taxes on their foreign earnings.

Now, I do not think there is any question about that, that over the last number of years major oil companies have had a sufficiently high foreign tax credits to offset their taxes on earnings abroad. I think you will find, if you go back to your colleagues in the Treasury Department, you will find that.

Now, in terms of equity, maybe this was not so bad when the posted price was $2.90 a barrel a year ago. Today, however, with posted price at $12 to $14 a barrel, the foreign tax credit goes from $2.8 billion to $10 billion to $12 billion.

Now, it is not clear that this increase in tax credit really makes any difference, because the companies already had tax credits in excess of its foreign tax liabilities in 1968. Even if the IRS or Congress were to disallow tax credits on all or most of the companies' taxes to producer governments, they could shelter their foreign income tax from U.S. taxes by operating abroad as subsidiaries, which they do, rather than as branches.

One device by which the companies use their foreign tax treatment to shelter domestic profits from U.S. taxes is by transfer pricing, by raising the prices at which they import their own oil. They reduce their book profits in U.S. refining, which is taxable in the United States, and increase foreign profits on which they pay no U.S. taxes.

In other words, this country is getting a first-class rooking from the major oil industries. This is why we are finding Mobil, Exxon, Standard, Texaco, pay 1 percent, 2 percent, 3 percent, when all other manufacturing companies in the United States pay up to 48 percent.

Now, what are we going to do in this country to bring a sense of equity? Is this not the real problem we have got here, instead of what you are testifying today?

Mr. CAPLIN. Senator, you have focused on the foreign area for the moment, and Mr. Nolan has given an account of the efforts made during 1969 and later years to try to really grapple with this posted price test. I can assure you that back in 1961 through 1968, the Internal Revenue Service and the Treasury had the same problem. The difficulties continued, notwithstanding all our investigative powers, in getting accurate data on the realities of the posted price or what it really meant. This question of allocation of proper pricing between

what would be regarded as arm's-length foreign profit versus U.S. profit raises difficult problems under section 482 of the code.

I share Mr. Nolan's views that legitimate use of the foreign tax credit for what we would regard as a legitimate foreign income tax has justification. But if you have something that is an artificial foreign tax, then you are absolutely right; it is being used as a shield to protect earnings in other countries and to minimize the overall tax costs.

Senator RIBICOFF. You see, what is bothering me—I understand what the chairman is talking about. The chairman talks about his neighbor in Louisiana, someone with 10, 20, 30 acres of land, the independent, the people with the stripper wells, but we are entering a phase that we are going to need about $1 trillion to develop alternate sources of energy in the United States.

Now, the objective should be to have these major companies use their large resources of capital and technology to do this developing in this country, not countries abroad. But if they are investing and drilling for oil at the cost of 4 cents to 12 cents a barrel, excluding the taxes, why should they invest in the United States, where the cost to them is $2.40 a barrel?

Whatever they are charged by the Arab countries in taxes or royalties they get a tax break on. So they take their large resources and use it abroad instead of in the United States, which only serves to increase our dependence on foreign oil. We have large reserves in the United States. At the present cost, these major oil companies can go to secondary and tertiary drilling. It is harder. Why should they go to secondary and tertiary drilling and do all of this work when they can get these gushers and get all of this oil at 4 cents to 12 cents a barrel?

What difference does it make to the major oil companies? They are worldwide multinationals. They are consortiums. They are cartels. They make their profits all over the world, so they develop their resources abroad, and the irony is that we American taxpayers through our tax laws are allowing them to make money and do this developing and use their capital in countries that embargo that oil to the United States.

Now, how stupid can the United States continue to be? It is one thing if we are going to give them a break, if we get some benefits, but now we get no benefit whatsoever. The flow of oil is cut off to the United States. The prices keep rising astronomically to the consumer, and the major oil companies are making their money and paying no taxes to the United States, and we, as deliberate Government policy, are giving them a tax break of about $3 billion a year.

How long should Congress or the President or the American people stand by for that type of an operation?

Mr. CAPLIN. Senator, there have been a number of suggestions on meeting that problem, and it might be interesting to get the views of the various panel members on it.

For example, there have been suggestions that in the foreign field there be no percentage depletion or intangible drilling cost allowances. Some have said, in addition to that, to cut the foreign tax credit in order to meet the problem of an artificial posted price. For example, only 50 percent of the normal tax credit might be made available. There are great varieties of approaches, but you would not want to shoot from the hip. You really should have statistical studies to know exactly what each particular change is going to cost the industry.

At some point it is going to be too high, and there will have to be some resolution by Congress of what is a reasonable way to determine a proper balance.

I think all of these data that we are looking for are obtainable, particularly if the Congress goes forward with the mandatory requirements on providing information from the various energy companies. This has to be done; but it should not be done emotionally. I think it has to be done rationally and with reason, and after studying the accumulated material, which should not take a long period of time to gather.

Senator RIBICOFF. It is there, but it is shocking to find that you cannot even get these figures from the U.S. Treasury. I think that Bob Best is here. We tried to get some of these figures to find out what was going on, and it is almost impossible to get from the U.S. Treasury what the foreign tax credits, intangible drilling costs, oil depletion allowance, are amounting to.

I am not asking even name the companies individually, to breach the laws on confidentiality or secrecy. But the U.S. Treasury did not even have the figures to give us. I think the last figures they had are for 1967. It is a shocking thing to find out there are no figures anywhere.

Mr. CAPLIN. I am surprised at that.

Senator RIBICOFF. Bob Best has tried for months to try to get these figures for me, and he has had no luck. The only figures we had were some work we did on the multinationals. We had some figures for 1970 on the amount of foreign tax credit. But to try to break these down has been almost an impossibility. There has really been an iron wall of secrecy, and I think the Government has been playing the oil companies' game to the disadvantage of the American people.

Now, you say do not do this emotionally, do this thoughtfully, do this calmly, do this constructively. But we have been so frustrated in this country to try to get the facts. Now you are in a situation where the most unpopular segment of the American society is the major oil companies. And all you have to do is go home. I do not think, with all due respect, you gentlemen in Washington have the slightest concept of the furor and the anger of this entire Nation. There is not a Senator or a Congressman that has not been home over the Christmas recess that does not feel this and feel the strength of this. And all you have to do yourself is get into a line and try to get $3 worth of gas, or 10 gallons of gas in your tank, and listen to your neighbors as they are in line, running all around the mulberry bush, trying to fill up their tanks, and you understand their anger.

I just came from the Permanent Investigation Subcommittee here, because I think what we are doing over there is inextricably bound up in what we are doing here in this committee.

You find that the major oil companies have 5.5 percent more petroleum products this year than they had last year, and yet there is supposed to be a shortage. You find that you have variable figures. You have Mr. Simon using figures that the American Petroleum Institute gives him. At the same time, the Customs Bureau's figures of imports are 19 million barrels more for November than American Petroleum Institute gives to Mr. Simon. Mr. Simon then makes policy on API figures, and these figures are completely in the hands of API.

Now, the American people, and I do not think the Senate of the United States, are going to stand by. Now the question comes: Will this

committee and the Ways and Means Committee do a thoughtful, considered job, based on equity, to make sure we develop all resources of energy, or is emotionalism going to come into play. And this is why we need the help and advice of yourselves. And I do not think, for the first time in American history, the major oil companies are going to be able to stand up against American public opinion, which is overwhelming.

Now you do not get answers from the oil companies, and you do not get answers from the Government. I think a lot of the answers are going to have to come out of the Finance Committee.

Senator DOLE. Mr. Chairman?

The CHAIRMAN. Senator Dole?

Senator DOLE. Well, I share some of the views of the Senator from Connecticut, but I do not find anything, at least in the present law, that says "major oil companies." Do I interpret it correctly? This would apply to anybody in the energy business?

Oil is produced in Kansas by many independents and others. I assume anybody in that business is subject to this? Is that correct?

Mr. THROWER. Senator, if these proposals are drafted, I think it would extend to a filling station operator, whatever the size would be.

Senator RIBICOFF. I am going beyond this.

I have got you gentlemen here, and if the gentleman would excuse me, when Senator Long tells me my time is up—I do not mind interruptions——

Senator DOLE. Well, if you do not mind, I have got to be at the White House in 10 minutes, I do not have to be but——

Senator RIBICOFF. You should. I think there is nothing—in addition to Watergate, the most important problem the President has got is the problem of energy. I would be delighted to yield.

Senator DOLE. All right. You know, a lot of people are hot these days, but not from enough fuel. They are hot for other reasons. And of course it is easy to kick around the major oil companies—and I have done a little of that out in Kansas—it is great sport, and most everyone agrees with me.

But we should be realistic. I have listened to those who have testified to the effect that the present provision in the energy bill would be satisfactory, would not provide any real revenue, and as I hear one of the witnesses, it would likely be in litigation until after the crisis—is that generally the case?

So we have had all of this rhetoric about windfall profits tax and how the oil companies run the Government, but as I read again the proposal, as I have listened to the testimony, I do not think it stops at the big seven. Someone suggested it would reach down to the service station.

We have an obligation in this committee to look rather closely and not be carried away in the panic of the moment, because what we might do is kill off an industry and have a greater adverse impact on the consumer than even the current situation.

Some of us have in mind some provision that will do justice in the area of windfall profits, but also provide an incentive for more exploration in this country.

Now the President and Congress have talked about Project Independence. I have a different view on the foreign tax credit, being from an oil-producing State. We may provide enough incentives that they may be drilling for oil in Connecticut.

Senator RIBICOFF. No, you will not. We do not want oil drilled in Connecticut. There is none there anyway, but we do not want oil wells in Connecticut. I will be glad to give them to you in Kansas and Louisiana.

Senator DOLE. Well if you are going to give them to us, then you have got to make it possible that those who explore for oil and gas can make a reasonable profit.

I guess my question is. Is there any precedent that anyone here knows of in the tax laws, which define "reasonable profit"?

Has the Government ever gone into the business of defining "reasonable profit"?

Mr. WALTERS. Senator Dole, I do not believe there is any such definition. And that is why some of us suggested that the use of a term like that may raise a serious constitutional question.

We do not know what it would be.

Senator DOLE. We think, frankly, there might be some windfall profits in the fertilizer industry. It is not just fuel that concerns Americans, it is everything else that has gone up in the past few months, based on the so-called energy crisis.

I am certainly willing that we adjust the profits. Would this cover fertilizer? Windfall profits in that industry? Or in baling wire?

Mr. BARLOW. It is impossible to determine from the wording of the statute before us.

Senator DOLE. Can I conclude, then, that the bill before us is totally unworkable?

Mr. BARLOW. Yes. Senator, on the point you are making—and I think the Senator from Connecticut would agree—there are other standards than the effective rate of tax that corporations pay, to determine the reasonableness of profits. And I think the figures show that during this (1967–72) base period the return on net worth and investment in the oil industry was less than the return on net worth and investment in industry generally.

When you set up vague, subjective standards, under a statute you cannot be sure what standard is going to be used particularly under this kind of a statute. There are many standards—the return on investment is one—that rebut the proposition that these companies have been making unusual profits and have not been paying their adequate share of taxes, because the rate of tax they pay, the effective rate, is so low.

There are too many vague tests, and that is one of the real problems with this statute.

Senator DOLE. Well it just seems to me that if we are going to address ourselves to excess profits, or windfall profits, it ought to be a broad inquiry. It ought to be more precise and carefully drawn than section 110 or any variation on section 110.

I think much of the price increase has been due to regulation. We have had propane triple in price in Kansas when, really, the price of production of propane is negligible compared to other products that come out of a barrel of crude oil.

But I get a little nervous when Mr. Kurtz suggests that maybe we should do away with intangible drilling costs and other provisions, because we see that as an incentive. But I agree with you that you cannot step on the gas and the brake at the same time.

Now if we have an energy crisis—I am not certain we have, I am still skeptical—but if we have one, can we apply the brakes as far as incentives are concerned, and, at the same time, encourage domestic exploration?

Mr. KURTZ. Well, Senator Dole, Senator Ribicoff has stated the difficulty the committee has in getting information, and I obviously have none compared to the information the committee has. However, in discussing incentives, and whether additional incentives are required, I think one thing we cannot lose sight of is price.

At a time when oil was selling at, say, $3 a barrel, which was not very long ago, we had a depletion deduction, which was worth 60 cents a barrel, or 30 cents in tax saving, which means in effect the company was subsidized, or had a tax relief that was worth 30 cents on top of the $3.

Now we are talking about a $5 price.

Senator DOLE. $10.

Mr. KURTZ. Or $10, we are talking about much higher prices. The question is, in the face of these market prices, whether the Government still ought to be granting those tax benefits—and that is without getting into the question of whether they were justified at the time they were enacted or not.

Even assuming they were, we are in a completely different price structure in the energy field, and I am not sure whether the price level today is not adequate to provide all of the incentive that is needed to find more fuel.

For example, the newspaper reports on the auction of the shale leases would indicate that the oil industry, or the energy industry, views the prospect of high prices staying in existence for some considerable period of time, to justify the substantial extraction costs involved in getting oil out of shale, whereas a few years ago, nobody wanted to attempt to do it.

In the face of that, I am not sure that we should not reexamine what the existing incentives are—and that goes to intangibles and depletion and perhaps in the area of foreign tax credit.

Senator DOLE. Well I have severe reservations on the foreign tax credit, but it seems to me that one way to avoid an excess profit would be for those who are now in refining and producing to lower their prices.

There has been some suggestion that prices ought to be frozen. Some feel that in certain areas they are much too high now. You are not going to have any profit.

If, somehow, the prices might be lowered, we would not be discussing windfall profits tax. But I think we have to be realistic and I am certain everyone on this committee is, but the industry is far broader than the seven major oil companies. It affects a great many States and it affects a great many jobs.

And one of the objectives when trying to deal with the crisis is to preserve jobs. Now the best way to destroy hundreds of thousands of jobs, is to somehow cripple the entire industry. I do not know how—how do you single out the majors and not touch anyone else?

Mr. CAPLIN. I think we have seen how difficult that is.

The excess profit tax, or this windfall tax we have before us, would apply to all aspects of the spectrum, the large and the small.

Senator DOLE. Would it apply to royalty owners who suddenly get a——

Mr. CAPLIN. It is very hard to tell from the text whether it would; but it could if they were incorporated.

Senator DOLE. Would it apply to stockholders?

Mr. CAPLIN. I do not think it would apply to stockholders. The tax applies to the entity, to the corporation itself. Some other approach has to be taken and I think the point made by Mr. Kurtz is a very good one—to consider whether or not there ought to be some lessening of the incentives as prices go up.

One very interesting proposal that has been made along those lines, which merits study, is to reduce the amount of percentage depletion as the price goes up. So if you use the $4 base, you would take your percentage depletion against that base. If the price went up $1 more you would reduce your base by $1; if the price went up $2 you would reduce your base by $2, and so forth—until at $8, there would be no further percentage depletion.

That has been one suggestion. It may just stimulate further thought along those lines.

Senator DOLE. I think that has some merit, and I also share Senator Ribicoff's view on the foreign tax credit, particularly the offset provision.

But as long as we provide the incentive, I do not think most of those I have talked with in the oil industry—and they are not major oil companies—are concerned. They are fearful now that perhaps the price of oil, even on stripper wells, might be getting out of hand. It is up to $10 a barrel and somebody might be stepping in, even though this section 110 did not apply to stripper wells, and say that is an arbitrarily high price. And it may be

Does anybody else have a comment?

Mr. WALTERS. Senator, I would like to comment, if I may, back to Senator Ribicoff's idea because I think this—and I might say, Senator, that I am an attorney in practice but I do not represent any oil company, unfortunately.

I think we have tended to malign the big oil companies. I think we ought to see some good they have done. They have given us a vast reservoir of cheap fuel.

Senator RIBICOFF. Just one interruption. That is one of the greatest tragedies that ever happened in this country because the major oil companies hooked the world on cheap oil and became the pushers, just like hooking them on heroin. During this period, we failed to develop the ultimate sources of energy in the United States to make ourselves an independent nation.

And the one good thing that will come out of what has happened in the last few months, is it will force the United States to become self-sufficient in energy, and that is one break.

Now I do not want to interrupt you, but we are on the second call for a rollcall vote.

Mr. WALTERS. May I make a quick point, then?

The CHAIRMAN. I would like to inform all Senators here that the five bells have rung, and we have only 7 minutes remaining to vote.

Now I am going to just miss the rollcall in order to get on with this hearing.

Mr. WALTERS. Mr. Chairman, may I complete what I was going to say, if I may?

The CHAIRMAN. Would you rather wait until the other Senators return, or do you want to say it now?

Mr. WALTERS. It does not matter.

The CHAIRMAN. It seems to me that Senator Ribicoff was touching on something where he and I agree, although he represents Connecticut which does not produce a barrel of oil, and I represent Louisiana which produces more than any State except Texas, and on a per capita basis, more than any State in this Nation.

What We ought to be trying to do here is to develop a domestic industry capable of meeting our energy requirements. I see quite a few heads nodding, including the gentlemen here. Because until we do, those people over there in Saudi Arabia or in Kuwait, or Nigeria, Venezuela, who have been organizing for years are going to make us pay everything the traffic will bear.

You cannot very well blame them, since they are in business to look after their countries. As Senator Talmadge said when he visited Japan and saw what they were doing to give those people a competitive advantage over the people of the United States. I do not blame the Japanese Government for helping the Japanese people get ahead of the United States; all I blame is the U.S. Government for failing to help our citizens compete with the Japanese and look after our interests.

Now if we are looking after our interests, we ought to recognize that they are not going to sell us that fuel a great deal cheaper than we can produce it for ourselves. And if we do not have our own capacity to meet our full requirements, we are going to pay for it just as we are paying right now because we do not have it.

We at one time had that capacity. We do not have it now. We are going to have to regain it. President Nixon has said that. I am pleased to see Senator Ribicoff said that. And the question is, is this so-called windfall tax measure something that would help us regain that capacity right here in the United States.

As far as I am concerned, they can do whatever they want to do about Aramco, since that is over in Arabia. They are boycotting us now anyhow, and we cannot get a barrel of oil out of there anyhow except maybe sneaking it out by night. But I have been saying that it is very foolish to allow Arabia to ship us that oil. We ought to have our own capacity here.

The question is, is this a measure that will help us do it? You gentlemen have told me that not only is the proposal an administrative monstrosity, but it moves in the wrong direction. It will be an impediment to every major producer in the United States to invest his money to get us more oil.

Now does anybody disagree with that?

Mr. CAPLIN. No. I think it is universal, at this table at least, that this is not a workable statute. It is not a wise statute.

We all recognize that there is a need for some mechanism to monitor the rising prices. But the question is—what is the proper approach? Some sort of compromise must be developed.

I do not know whether you, Senator, had any thoughts on that—in terms of what would be a satisfactory alternative measure.

The CHAIRMAN. Well, when we try to think about what we can do about a bad situation, I personally favor an excess profits tax. I favor putting more taxes on Aramco and on production in Saudi Arabia. I favored doing that, in a way, to give us some leverage to make them invest some of the profits they are making there in drilling for oil and providing energy here, rather than the other way around, as we have been doing for the last 20 years.

I prefer to make it more attractive to producers here and less attractive to producers over there. I did not favor encouraging the use of the profits they make in Aramco and in the North Sea to drill for oil and to provide for gas and to provide coal liquification plants, and to develop shale and to build atomic plants, whatever it took to make those nations self-sufficient; I do not favor having the laws that we have had that made it so much more attractive to do business over there than it is to do business here.

Let me ask you this. To what extent do we have the capability of regulating those foreign countries in the production of oil in those countries? Have some of you thought about that?

In other words, to what extent do we have the power, be it this Finance Committee with its taxing power or the power to pass a renegotiation law, or the Commerce Committee passing a regulatory law, to what extent can we really effectively tax and regulate and control in the long run the products that are made by our oil companies or others doing business in Saudi Arabia, Iraq, Iran, Libya, Nigeria, Venezuela, or other foreign countries? To what extent do we have the power to reach that?

Mr. THROWER. Senator, I would think that our own domestic tax policies would have a tremendous impact on what is done in oil throughout the world than to the present status of oil production within the world, and a complete control but a tremendous impact.

And, I would add, I think it might be said for the record and probably it has been evident, that there has been no collaboration or coordination among the members of this panel. I think that is so, and yet there has been a remarkable uniformity of expression to the effect that the proposals in S. 2589, the proposed section 110 and the proposed excess profits tax provision as drafted, would contribute nothing.

I think that this which has come from the panel here—would contribute nothing to the resolution of the problem and would not approach the thoughtful, considered job that Senator Ribicoff, yourself, and Senator Dole, and members of the panel have indicated would be constructive under present circumstances, and particularly with the critical problems of the crisis that we face.

The CHAIRMAN. Well, there is another item that comes into play. I just added up some published figures that have been made available by the Independent Petroleum Association of America. I am sure they are relying upon some source like the Chase Manhattan Bank or the Treasury or Commerce Departments that have made these studies. These figures they have published here show the average earnings over a period of time of companies of all manufacturers, compared to the U.S. oil companies. For the years 1952–71 on the average, the American oil companies made a 10.2 percent return, compared to 10.8 percent for the other companies.

These figures, I believe, are structured the way a bank would structure them where they are looking not at the depletion allowance of 22 percent, but at what the bank actually thought, from a banking point of view, you made in profits and what you are able to declare out in dividends. So the average for all manufacturing was above oil companies. I just added up the years that are spelled out in the Staggers tax law, or the Staggers renegotiation law, 1967–71, and divided by five, and I come out with this: That you have a profit of about 9 percent on the average for the U.S. oil companies, and you have an average profit of 10.9 percent, about 20 percent more, during that same period for all manufacturing companies.

Now most of these companies will be held to a dollar figure under the provisions of that law, if it can be administered at all, and if it is upheld by the courts. The cost of living has gone up by about 20 percent; or to put it the other way around, the value of the dollar has depreciated by about 20 percent.

So, based on a dollar figure, most of these people would be held to a rate of profit that would be about 7 percent. Now can you tell me what people would advise investors, whether to invest in energy or whether to invest in manufacturing or something else, if many other companies are permitted to make about 30 percent or more under no regulation at all, while the oil companies are held to about a 7 percent profit?

What do you think would be the attitude of people who would be urged to invest?

Mr. NOLAN. Senator, it is clear I think that investment decisions are made on the basis of rate of return and that the oil company is obligated to invest its funds only in projects that provide better returns than other alternatives. If the tax is structured in such a way as to perpetuate these low rates of return that existed in the 1967–71 base period, you are going to adversely affect investment.

It seems to me, therefore, that if indeed it appears that 1967–71 was a depressed period for the industry—and that is something for this committee to look at in considering excess profits taxes—how valid a period is that as a base of measurement?

If we find that it was a depressed period, in order to construct a fair and reasonable excess profits tax, we must adjust those figures for the depression that existed. The number one specification for any kind of a rational excess profits tax applicable to energy companies must be not to look solely at base period earning experience, but to look also to another standard of reasonable profits which would be a fair rate of return on invested capital, taking into account the degree of risk to which oil companies and other energy companies must necessarily be subject in their new investment. This may be a higher degree of risk than manufacturing companies must generally incur. Specific allowable rates of return may be provided in the law.

Mr. KURTZ. Senator, I suppose this would indicate one of the problems of trying to write regulations on what a reasonable return is. Certainly oil companies have risks in exploring for new oil, very substantial risks, nevertheless, as an industry it is probably a lower risk industry than many in the sense that the demand for fuel is fairly well fixed and it is probably subject to fewer fluctuations. As we are finding out, it is very difficult to reduce the demand for fuel.

So that, while 1967–71 may be a bad base period, and we ought to look to comparable returns today, I am not sure that the fact that oil returns may be below industry-wide averages is necessarily wrong. It depends on how much below, and what else is included in those averages, because you must take account of how the investing public views oil companies.

I think they tend to view them as a safer long run kind of an investment than say automobiles, where styles can change.

The CHAIRMAN. Well it would seem to me that we ought to draft some such tax legislation as the administration has suggested, in the windfall area. I welcome the advice of each one of you, and I hope very much that any additional thoughts you have in this area will be the basis of a memorandum that you will submit to us to give us your thoughts and your ideas after the conclusion of this hearing.

But I would hope very much that that proposal will be part of a package of measures that will help us to become self-sufficient in producing energy here, because I am convinced that until we do, we will never see the end of the kind of crisis that we have here. We will be always subject to it and will continue to have all of the sort of problems that we are experiencing today.

Now it is unfortunately true that the parliamentary situation in the Senate at this moment is such that it is not within the power of the Senate, or at least of this committee at least, to propose amendments at this point to the monstrosity that is pending before the Senate.

It seems to me that what we are going to have to do is to seek to either pospone that conference report, or to vote it down to give us an opportunity to offer some kind of amendments.

I would like you gentlemen to comment as to what you would advise people who seek your advice in this area. If the Congress follows this logic which has been suggested to me—I have had people say, well, yes, we know that this is unworkable. We know that the proposal is ridiculous. We know that it is just legislative demagoguery, but it does have its advantage that if we pass it and make it law, it will force the Congress to pass some sort of excess profits tax law.

Now, if you are advising someone who is thinking about investing his money in obtaining more oil or more gas or building refineries or providing suppliers, what would your reaction be to that situation?

Mr. GRIER. Mr. Chairman, what would the Renegotiation Board be doing in the interim?

The CHAIRMAN. Mr. Grier, since you asked the question, I can only assume that you would be buying aspirin tablets during the meanwhile while you wait for all of these things to pile on you, because the way I read the statute, it says that this triggers in January 1975 but it is retroactive back to January 1974, and I believe that when everybody, not just Internal Revenue Service, but everybody can bring these renegotiation cases, that if the Renegotiation Board worked on them from now until eternity, you would never settle all of those renegotiation cases that would be pending.

But could I have a response to the question I posed?

Mr. THROWER. Mr. Chairman, I feel confident that the people would not take too lightly a law of the United States if it became a law of the United States. It has to be faced as a law prevailing at the time, and if Congress should pass it, no one could be expected to read it as a real

fantasy and not expect it ever to be enforced. And I think investment decisions and other decisions would have to be made upon the assumption that this is, as it is, the law of the United States.

I do not want to be frivolous, but we were asked what would we suggest to our clients, if we had them, in industries affected by this legislation, and if I had them the first suggestion I would make is to increase very substantially your retainer, as we will be busy for years to come litigating over this monstrosity.

Mr. BARLOW. Mr. Chairman, the first thing to do is just file a suit to test the constitutionality of this kind of vague statute, and I think it is very vulnerable. The Supreme Court held that the Renegotiation Act was valid with these vague standards simply because of wartime powers and because the act put a provision in all contracts in which the contractors agreed to these vague standards. But it is another thing to put them in the tax statute, and I have great conviction that it would not be difficult to get the Supreme Court ultimately—look at the waste of time and the uncertainty in the meantime—to get the Supreme Court to declare this tax statute unconstitutional. It seems to me that basically what this legislation has to have is, since intangible drilling expense and depletion allowance are benefits—I do not look upon them as subsidies, because you have to tax different kinds of income differently and recognize the different risks—but if these are benefits, then at this time we have to recognize the problem of the accelerator and the brake. Then why do we not have basic plowback or reinvestment provisions in this statute, so that what you want, investment in the United States and not abroad, will be assured because the tax incentives will force investment in this country?

I cannot conceive of an effective statute that does not encourage immediate investment and expansion. The best way to go about it, it seems to me, is to direct the benefits under the statute in that direction.

The CHAIRMAN. Well, did it ever occur to you that if Congress is going to pass an act of this nature, this poorly advised, drafted in such haste, with so little confidence in the drafting and the initiating of this meaure, that investors might feel that if Congress is going to be this irresponsible and act in this much of a hysterical fashion, that you really cannot rely upon Congress being wise when it moves to amend it?

Mr. BARLOW. The executive branch will then be in the ascendancy once again.

Mr. NOLAN. Mr. Chairman, that is an afront also to the capacities of this committee and the House Ways and Means Committee. These committees have the finest staff in the Congress, and they are capable of developing a satisfactory form of tax to deal with this problem. Senator Gravel already has a bill presently pending in the Senate to which this committee is going to give consideration that is a promising start in this direction. It certainly deserves the most careful study. But to adopt a form of legislation that is admittedly insufficient, probably unconstitutional, and thoroughly unworkable seems to me to be the worst sort of way to legislate at this time.

The CHAIRMAN. Mr. Walters?

Mr. WALTERS. Mr. Chairman, let me be rather specific in answering your questions. I think if this law should be enacted that many, and certainly I would advise any client I had definitely against making

any investment which would subject him to this windfall profits tax except in the case of the greatest urgency where it was a necessity to retain a lease or some rights. I do not see how any attorney could advise any client to do anything that would subject him to this tax. I think it would be a very definite deterrent to development of greater energy resources.

The CHAIRMAN. Well, thank you very much, gentlemen.

Since we have not heard from him yet, I would like to ask Mr. Grier to tell us his view about this matter as one with experience in the renegotiation area.

Would you mind stating your experience in this area, sir, and what your view in this matter is?

STATEMENT OF BARRON K. GRIER, FORMER GENERAL COUNSEL TO THE MILITARY RENEGOTIATION POLICY AND REVIEW BOARD

Mr. GRIER. Yes, sir. I should say to you first, Mr. Chairman, that Mr. Willan was not able to reach me on Saturday because I was out of town on an important matter having to do with the closing of the goose and duck season in Maryland. So as a result I did not get to do any preparation until sometime yesterday, and it is rather sketchy. I do not have a prepared statement before me, but to the best of my ability I will comment on section 110 of the conference report.

Perhaps some of my background might be of interest. I was employed by the Ways and Means Committee, and worked for it at the time the wartime act, Renegotiation Act was put on the books, 1942–43. I later became general counsel to the Board which administered a successor act, the Renegotiation Act of 1948, and I helped draft the 1951 act. Since about 1952 I have represented clients having renegotiation problems.

I think to start out with, it is fair to say that the Renegotiation Act is probably one of the most misunderstood statutes on the books, and the drafting of section 110 indicates that misunderstanding. Without going into great detail, it is worth stating that the prices of Government contracts are not renegotiated under the Renegotiation Act. What is renegotiated are the earnings during a given fiscal year of a contractor on all contracts which are subject to that act. There is no real definition, as has been stated several times here today, of excessive profits. The act itself says, almost in these words, that excessive profits are those profits which the Board determines are excessive in light of vague statutory standards. Its application necessarily involves some degree of falibility, of uneven applications under the Renegotiation Act, although the Board members certainly do the best they can with what they have to work with.

The renegotiation process is started under the act by the filing of a report by the contractor which shows his total renegotiable costs and profits. It then takes anywhere from 2 to 4, sometimes even 7 or 8 years to complete the renegotiation process, depending upon how long the Board has it and whether or not the contractor goes into court.

If the Board does not arrive at an agreement with the contractor, as

the act provides can be done, then the Board issues an order. If the contractor does not wish to include the matter at that point he can ask the Court of Claims for a de novo determination.

As compared to that, under section 110 the proceeding would be triggered by the filing of a petition by some person, known as an interested person, without any definition as to who that is. Is it a person who buys gas from his favorite filling station, or is it his filling station who buys it from the oil company, or is it the oil company who buys it from another oil company? I do not know.

How many of these proceedings can you have going at one time by an interested person?

What must the petition say? How interested must the person be? What must the Board do at that point?

Section 110 says that the Board, upon such a petition, may do one of two things. It can set a prospective price, something that the Board has never done and has no expertise in doing. The other is that the Board may determine a windfall profit, to be returned to the interested person. What constitutes a windfall profit is ill-defined, and really is impossible of definition, in my judgment.

What the Board is to do once it gets a petition is difficult to understand. Section 110 says in one case the Board can reset the prices prospectively. How it could do that I really do not know. The other action is to apparently recapture, or purportedly recapture windfall profits, whatever they may be, and distribute them to the people who paid the price which creates those profits.

The truth of the matter is that section 110 is so alien to the present renegotiation process that it makes it almost impossible to understand how it would work. There is a provision which seems to say that the Board must hold a constitutional hearing under the Administrative Procedure Act, something that the Board does not do in its existing processes. It does not hold an on-the-record hearing. The Board is not familiar with that sort of procedure.

Furthermore, whereas you can go to the Court of Claims today and ask it to redetermine excessive profits without regard to what the Board has done below, here you would go up apparently into the courts on a review of agency action, which is a vastly different proceeding. The standards would be whether or not the Board action was arbitrary and capricious. I do not mean to imply anything improper by saying that the nature of the Board's operation is necessarily arbitrary, because it has no real standards to apply in determining excessive profits.

The unconstitutionality of section 110 has been mentioned, and I certainly subscribe to that. The standards are vague and you do not have the saving grace, if it is still there, of the Renegotiation Act having been enacted to prevent the earning of excessive profits out of defense appropriations.

I would hope, Mr. Chairman, that you personally, and the committee will prevail upon the Senate not to accept this proposal. In my judgment it would place a burden in the Renegotiation Board which it is not now equipped to handle and cannot be handled as a part of its normal procedures.

The CHAIRMAN. You do not need to apologize to this committee staff or to the staff of the Joint Committee on Internal Revenue and Taxation or the Ways and Means Committee staff for what you have said about one of the most poorly drawn revenue measures in the history of the country, because my best information is that when the Joint Tax Committee staff undertook to offer its assistance to members of the House Commerce Committee to draft a tax law or revenue bill, knowing the fact that those people had had very little experience in that sort of thing, that offer was declined on the basis that the Commerce Committee staff would prefer to do its own tax work. And so if they can develop some tax competence over there in that area, I certainly want to wish him a lot better luck than any he has achieved so far with this, and I will wait with interest for Mr. Simon's testimony to see if that committee did do what our people do in drafting difficult legislation of great impact on this country, namely, to ask the very able personnel over in the Treasury and Internal Revenue Service to give us their best efforts and the benefit of their brainpower in helping to meet the shortcomings that appear or occur to them in that type of legislation.

We find that you just cannot get too much help, even with all of the help the Treasury can make available, to draw something as difficult and as complicated and presents as many problems as this does. I believe I can assure anyone who is interested, that any time the Finance Committee is working on something as difficult and as troublesome as this matter, we just welcome the assistance of everyone, including every one of you gentlemen sitting here at this table, to show us the bugs in it and to help us bypass the pitfalls that otherwise might occur. I just only hope that the next time the Commerce Committee decides to be a tax-writing committee that it will seek some of the same kind of competence that we have benefited from down through the years, including the assistance of you gentlemen who are here offering us your advice.

Thank you very much for assisting us and giving us the benefit of your vast experience, gentlemen.

We will stand in recess then until 10 o'clock tomorrow, when we will hear from Mr. William Simon, Deputy Secretary of the Treasury.

Many thanks to you gentlemen.

[Whereupon, at 12:40 p.m., the committee adjourned, to reconvene at 10 a.m., on Wednesday, January 23, 1974.]

28-102—74——5

ENERGY WINDFALL PROFITS

WEDNESDAY, JANUARY 23, 1974

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

The committee met, pursuant to notice, at 10:20 a.m., room 2221, Dirksen Senate Office Building, Senator Russell B. Long [chairman] presiding.

Present: Senators Long, Fulbright, Ribicoff, Byrd, Harry F., Jr., Nelson, Mondale, Gravel, Bentsen, Curtis, Fannin, Dole, Packwood, and Roth.

The CHAIRMAN. The committee will come to order.

We are pleased to have before us today the Federal Energy Administrator and Deputy Secretary of the Treasury, Mr. William E. Simon.

Mr. Simon, in my judgment you made a very fine presentation of the energy problem and what should be done about it at the White House this morning, with the President and those that he could squeeze inside the Cabinet room to hear your statement. I believe the record would well demonstrate what your thoughts are about this energy crisis, with particular reference to what this committee can do to help.

We have asked you to tell us whether you think the proposed excess profits tax which is pending on the Senate calendar on a conference report, would help or hurt the matter. And also while you are here, it would be well for you to advise us on what you think we can do to help solve this problem that is present at this moment.

STATEMENT OF HON. WILLIAM E. SIMON, DEPUTY SECRETARY OF THE TREASURY AND ADMINISTRATOR, FEDERAL ENERGY OFFICE, ACCOMPANIED BY GERALD PARSKY, EXECUTIVE ASSISTANT TO THE ADMINISTRATOR; JOHN SAWHILL, DEPUTY ADMINISTRATOR; AND FREDERICK HICKMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. SIMON. Thank you, Mr. Chairman, and members of the committee. I am pleased to be with you here today to make this statement on windfall profits. Before analyzing the provision in the Emergency Energy Act of 1973, allow me to briefly provide some background relevant to consideration of any windfall profits proposal.

First of all, it will take time to increase substantially the supply of crude in the United States. New reservoirs must be discovered and drilled. Old wells previously uneconomical must be rehabilitated.

Processes such as secondary recovery must be put into place. Processes such as oil shale will commence to come on line only over a period of years as producers conclude that they can count on price levels which will make that recovery economic, and then there will be time lags in solving technical problems and building plants.

We believe that supply and demand will come into normal balance over a period of several years. However, before this occurs, the abrupt nature and magnitude of the current shortage could, in a free market, cause the price of crude oil to shoot substantially above the levels required to bring supply and demand into balance. Such a situation produces a "windfall," a price to producers which is more than producers could have anticipated when investments were made and more than that required to produce all that we can in fact expect to be supplied.

For example, suppose that a price of $7 a barrel for crude oil would be sufficient after 2 or 3 years to induce increased supplies and to dampen demand, so that shortages would disappear. Such a price would be "the long-term supply price."

If, in the interim the price goes to $8, $9, or $10 a barrel, the excess of the $8 or $9 price over the long-term supply price is a "windfall"—it is more than the price required to produce all that is in fact being supplied or is likely to be supplied in the next several years.

The windfall and the tax would, of course, be even greater if prices should, on a temporary spot basis, shoot to the range of the $17 or $20 which are prices paid in some recent foreign auctions.

No one knows exactly what the long-term supply price is, as no one can predict the future that clearly. Our best estimate is that it would be in the neighborhood of $7 per barrel within the next few years.

Likewise, no one knows what level the price of crude would reach in the next few months if it were freed from all controls. If prices were freed, we could expect erratic behavior for several weeks, after which the price might settle in the $8 to $9 range, and that thereafter the price would decline gradually to the lower long-term supply price.

There is no doubt that some windfall profits have been made during the past few months and have contributed to the sharply increased over-all reported profits of the oil producers. As a means of addressing this issue, last December the administration asked the Congress to consider a proposal for an emergency windfall profits tax to deal with excess or windfall profits resulting from escalating crude oil prices.

The proposal is designed to deal effectively with the problem which exists. It is coordinated with a total energy program, and it is workable.

The Committee on Ways and Means is expected to begin consideration of the proposal shortly. I strongly urge that you give the proposal, and related energy proposals, your careful attention as soon as possible.

While prompt action against windfall profits is essential, it is equally essential that it be done in a way consistent with the larger goal of attaining early independence from foreign energy supplies. In this connection, I believe that the windfall profits proposal contained in section 110 of the conference report dated December 20, 1973, on the Energy Emergency Act, would be ineffective and unworkable and could seriously prolong our quest for energy independence.

Section 110 is based on traditional excess profits tax concepts which means that the Government has to determine how much profit is "too much" profit. That kind of determination involves the selection of base periods and acceptable profit levels or rates of return from historical profit information. That, in turn, requires a determination that some rate or amount of profit was "normal" for affected taxpayers during this historical period that has been chosen.

In fact, the assumption of normality is false and most of the complexities of excess profits taxes have come from trying to adjust the tax for the abnormalities which always exist. I have attached as an appendix to this statement, a brief discussion of excess profits taxes which describes some of the complexities involved.

In prior excess profits tax laws, the complicated guides for determining the amount of excess profits have consumed pages and pages of statute books. Section 110, on the other hand, expresses the test for excess profits in terms of "reasonable profits," "average profits," and "windfall profits."

An administrator of those provisions would, accordingly, have no workable guide for making decisions. Furthermore, the administrator selected for this awesome task is the Renegotiation Board. This Board was designed for the entirely different and limited purpose of reviewing profits from certain types of contracts. While its personnel are conscientious, the Board is ill-equipped from the standpoint of concept, size, and expertise to deal with a matter of this scope and complexity.

Consider, if you will, that excess profits tax controversies numbered over 50,000 and are still going on 20 years after the tax expired, and that the Internal Revenue Service was the only party with standing to complain about the profit levels of a taxpayer. Compare that situation with the private and individual relief provisions embodied in section 110, under which any interested party could invoke the entire redetermination procedure of prices already administratively approved. The potential volume of cases which could arise is staggering to contemplate.

We agree that action should be taken with respect to windfall profits, but we believe that section 110 provides an unsatisfactory way to go about it. It would be administratively unworkable and it would create such great uncertainties as to what price the Renegotiation Board or a court might several months or years from now determine to be fair, that intelligent investors would be discouraged from making the investments which will be necessary if oil supplies are to be increased.

Billions of dollars of investment are needed to increase energy supplies, and total uncertainty as to the profitability of that investment would certainly discourage it. And, if additional supplies are not forthcoming, prices can only escalate further as consumers bid up the prices for the existing supplies.

Further, this section would take effect January 1, 1975, but apply retroactively to profits derived during 1974. This would create great uncertainty throughout the industry for the entire year. Although legislation during 1974 could supercede this section, any such legislation would be subject to innumerable special interest amendments because of the feeling that it would not be subject to veto.

The emergency windfall profits tax provides a much more careful and satisfactory solution since it focuses directly on the problem by taking away the windfall part of the price increase in crude oil.

It phases out over the period over which supplies will be increased, thus not discouraging the needed new investment to obtain additional supplies.

It falls on the producer, not the consumer, since it merely takes away unexpected profit rather than adds costs which must decrease expected profit or be passed on.

It is simple to administer. It involves no complex calculations, no complex returns and no complex concept.

At this critical time we must be sure that any solution devised for windfall profits does not work at cross purposes with the goal to achieve independence from foreign supplies. Further, it is a difficult and highly technical task to design a tax or other mechanism to deal fairly and efficiently with "excess" or "windfall" profits. It would be most unfortunate to proceed without heed to the lessons learned from our extensive experience with similar taxes.

I urge that you consider this problem as quickly as possible, consistent with a technically satisfactory solution. My staff and I would welcome the opportunity to discuss in detail with you and your staff the operation of the emergency windfall profits tax and the problems inherent in section 110 as outlined above.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Simon.

Now as I understand it, you have the power under existing law to provide the President encouragement to fix the price at which people in this country sell oil.

Is that not correct?

Mr. SIMON. We can set the price on the domestic supply, the old barrel, Mr. Chairman, which we do at $5.25. The Congress has legislated that stripper wells be exempt, which is approximately 12 to 13 percent of the production in this country, in recognition that a stripper well which is a well that produces less than 10 barrels a day requires a higher price, it is not as economic.

The CHAIRMAN. Generally speaking, a stripper well is a very high-cost producer. It produces a relatively small amount of oil and it is a very high-cost producer, and that is why the Congress recommended different treatment.

Do you take exception to the feature that a stripper well under the price control law can be justified in having a higher price than a well that produces a great deal more oil at much less cost?

Mr. SIMON. I think the economics that you just described demand that a stripper well should be allowed a higher price, just as the Cost of Living Council, during 1973, for incentive to bring on new production that we need so badly in this country, gave the incentive of freeing up also new barrels of oil and allowing people to match an old, controlled barrel with it.

The CHAIRMAN. Now there is an exception, and I want to know whether it is an exception by your regulation or an exception by act of Congress, for new oil, for people who drill new wells.

Mr. SIMON. That is Cost of Living Council regulation that was promulgated last year.

The CHAIRMAN. Now if they want to do it, they can roll that price back? Is that correct?

Mr. SIMON. It is now in the Federal Energy Office. This power was turned over to the FEO several weeks ago—yes, we could roll it back.

The CHAIRMAN. All right. Now, furthermore, as I understand it, the price on foreign oil coming into this country is about three times the going price of the oil that was in place and being sold from the wells that we call "good wells" in this country. Is that correct?

Mr. SIMON. Well, today with the new control price at $5.25, it would be about double, although there have been auctions, spot auctions, where the price has gone as high as $17—and in one instance, over $22 a barrel.

The CHAIRMAN. Now what is your power, as a U.S. Administrator, to control the price at which we buy foreign oil? What——

I mean is, as a practical matter, what is your power to control the foreign oil coming in and headed for this country?

Mr. SIMON. Well, we cannot control the pricing on foreign oil. We could prohibit people from importing this oil if we allowed no cost pass through, however, Mr. Chairman.

We could say for any oil that was purchased overseas at above $8, $9, or $10, we would not allow that excess price to be passed through. That could be done. I am not recommending that that is what we ought to do because then we, under present price levels, under the new OPEC prices, we would not be bringing any oil in from abroad.

The CHAIRMAN. Well, while this boycott has been going on, I had the privilege of vacationing for a few days during the recess in the Caribbean area, and I noticed those people were all sitting there hopefully, waiting for a ship to arrive to bring them some oil and some gas.

I would assume that insofar as we are not willing to pay the going price in the world market, that these foreign nations—not so much the American oil companies as the foreign nations—are just not going to ship the oil to us.

Now is that a fair statement?

Mr. SIMON. Well, thus far we have been willing to pay these recent prices. Of course, there has been a recent price explosion when OPEC, in December, announced an increase in the posted price to $11.65.

Now remember $11.65 is a formula price that sets the tax rate and royalty payments in this country at a total of about $8 per barrel, f.o.b. Persian Gulf, and then we have to add the tanker rate on. It is our judgment that such oil will be coming in between $10 and $11 a barrel, versus the $5.25 per barrel control price.

But, of course, the uncontrolled portion of domestic production, which is (a) the stripper well; and (b) the "new oil" incentive well that the Cost of Living Council put in, obviously moves toward this level. Some people say, if the long-term supply price is at $11, we should not have it that high and we ought to remove this incentive by rolling back the price to some average of the long-term price level of the new and old barrel of oil.

And then I say there is a real danger that an awful lot of the wells in this country might immediately become stripper wells. The average well in this country produces 18 barrels a day, and if you have a free price on stripper wells and you are producing 12 to 18 barrels a day,

you would be encouraged to cut back to 9 barrels a day and take advantage of a free price. The well would last longer and you would make more money.

So there are dangers in everything we attempt to do in this area.

The CHAIRMAN. Well, the way I read the conference report on this bill that is on the Senate calendar—for the majority of producers to have good wells and to drill more wells—if the average producer, let us say, made $50,000 during the base period 1967–71 and if he drilled off of one well, and he then proceeded to drill a second well, he would not be permitted to keep $1 beyond the $50,000 that he made during that base period.

Now is that the way you read that bill?

Mr. SIMON. Yes, it is, Mr. Chairman.

The CHAIRMAN. I see your assistants nodding with you on that.

Unless he is just in the business for charity, or regards himself as a Government servant, can you explain to me why anybody would drill an additional well and put it on line to make more fuel available to the public, if he cannot keep 1 penny of the additional money he makes by producing the additional oil?

Mr. SIMON. He most certainly would not.

The CHAIRMAN. I know a situation where large landowners have production on their land. They simply contract with someone to drill a well for them, and they pay him whatever it costs to drill the well.

All that oil is there, and there is no one in position to drain it from them, so they can take it out anytime they want to. They know it will be worth more later on than it is now, and they look upon that oil in the ground as being every bit theirs.

Now, if you are going to tell them that out of the additional oil that they produce they cannot keep 1 penny of that money, can you explain to me why they should drill the wells and make the additional oil and fuel available to you as an Administrator, and to the people of this country?

Mr. SIMON. That is why, Mr. Chairman, we oppose the legislation as presently written. We must not lose sight of our ultimate goal which is the ability for self-sufficiency in this country. We should not destroy the incentive for additional production—and this incentive can be maintained at reasonable price levels. When one looks at the alternative of being held hostage to importing, today, 35 percent of our needs before the end of this decade, assuming demand continues as it did in the past, 50 percent of our needs, it is not an attractive alternative.

This year our fuel bill for imports is estimated at $20 to $25 billion, based on the new posted price. And who is to say it will not be higher than that later on? Is it not a little better to have reasonable price increases in this country that are going to bring on the alternate sources of domestic energy and stimulate this economy?

To me, it makes just such commonsense.

The CHAIRMAN. When we, in this committee, undertake to write a very important, difficult and complicated tax bill that has to take a great number of things into consideration, we call upon the staff of the Joint Committee on Internal Revenue and Taxation to help us draft that bill, because they have good lawyers and expert tax accountants.

I am advised by them that when the House Commerce Committee undertook to draft its excess profits tax, the Joint Tax Committee staff suspected that the Commerce Committee might be needing their expertise, which I think is the best on Capitol Hill, to help draft their tax law, or their renegotiation law. The Commerce Committee staff said, thanks, no, we will just do our own work.

Now I think that was a mistake because those people have a great deal to offer—I am speaking of Mr. Larry Woodworth and those fine assistants that work with him. They are good tax lawyers and accountants.

We would not have turned them down if they had offered us their assistance. In fact, we call upon them to help us draft difficult and important complicated tax measures. In fact, when we were drafting something as significant and as important as the Tax Reform Act of 1969, a bill that ran into hundreds of pages with very difficult problems, we found that even the help that they could give us is not adequate to avoid all errors.

So we oftentimes borrow some people from your shop to help us draft those tax measures. Did the House Commerce Committee ask your people to help them to draft this thing?

Mr. HICKMAN. No, they did not.

Mr. SIMON. No, sir.

The CHAIRMAN. I must say they really overlooked a great deal of fine talent that could have helped them solve some of the problems in this area. If they had used the staff, I think they would have a much better, and workable, proposal than they have now.

Do you think this proposal is constitutional? That is, the one that is on the calendar?

Mr. SIMON. I would defer to my attorney on that.

Mr. HICKMAN. We think there is substantial doubt about its constitutionality for the reasons that Mr. Nolan explained to you yesterday.

The CHAIRMAN. Well, the senior tax counsel of Covington & Burling testified yesterday in place of Mr. Edwin Cohen, who served in a capacity that some of you have right now. He said that in his judgment, this proposal is clearly unconstitutional. He said that the basis upon which the renegotiation law has been upheld is that the people who are subject to renegotiation, have signed a contract and agreed to pay back whatever the Renegotiation Board thought should be paid back.

But he said when you have the vaguest uncertainty, as you have in this statute, and it is just guesswork to try to say what a fair profit would be, then he has not the slightest doubt that the Supreme Court would declare it unconstitutional. Particularly in view of the fact that, in that case, you would not have a signed agreement where somebody has already agreed to pay some amount of money in the event of an excess profit.

I would recommend that your people consider the constitutional features of it because as you know when you pass an unconstitutional law, it is a nullity, it is just the same as if you did not pass anything at all.

But meanwhile, business people, not being sure that the Supreme Court will throw it out, have to try to do business with the uncertainty

facing them that the Supreme Court might throw it out but then again it might not.

Is not that uncertainty a problem for you?

Mr. SIMON. Yes, sir, it is. It is a problem for the whole country, this uncertainty, so far as getting the needed investment is concerned. We need energy.

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

Senator Curtis.

Senator CURTIS. Mr. Simon, you have been very helpful to us on this matter.

With reference to the provision that has heretofore been made for the stripper wells, I can report that that has been very effective, and in the public interest. Nebraska is not, by and large, an oil producing State, but we have a little oil area covering about three counties.

I can cite an illustration of one private operator who had two wells. Their production was down to 6 barrels a day at the price of about $3.80 they could not produce, it would be abandoned. With the price at $8.47, something like that, they are operating. In fact, they are producing more than the six.

And, in that three-county area, which is not an exceedingly profitable oil area at all, there are 100 oil wells operating today that did not operate before the raise was put into effect.

It is not a question of somebody getting an unreasonable profit. It is a question of getting enough to get that oil out of the ground and on the line.

Now in reference to the language in the conference report now pending, is there anything there in that language that would give guidelines to determining where the profit arose? Whether it was in exploration or drilling or production or manufacturing or transportation or marketing?

Mr. SIMON. It is very vague, Senator Curtis. It mentions the "reasonableness of its costs and profit" a "reasonable profit" the "net worth." Hard decisions are going to be left to an administrator, as I said in my testimony, with very few guidelines.

Senator CURTIS. It seems to me what you proposed is so much—well, there is just no question about it. The one would not work and yours would.

Would you, just in layman's language, trace through how the tax you propose would work?

Mr. SIMON. I want Fred Hickman, our tax expert, to do this and make sure that I do not trip up on any of the technicalities involved, but it basically strikes at the heart of the windfall problem: the emotional pricing due to the restriction in the world's oil supply, due to the fact that the Arabs own upward of 70 percent of the world's proven oil reserves.

In a period like this, the long-term supply price is not taken into consideration because demand far exceeds supply, and the price goes to levels of whatever people really wish to charge for it.

We have estimated the long-term supply price for a reasonable level of self-sufficiency at approximately $7 in 1977 and there would be a graduated tax charged on prices above the ceiling prices of the Cost of Living Council as of December 1, 1973. They would be graduated as pointed out. The first 50 cent increase, no tax; the next 25 cents, 10

percent, et cetera, up to the $7 which we estimated to be the long-term supply price.

Everything over the $7 would be charged 85 percent because that is deemed windfall.

Senator CURTIS. And at what point would the tax be imposed?

Mr. SIMON. The point imposed is at the source of the crude production.

Is that correct, Fred?

Mr. HICKMAN. Yes, at the production level.

Mr. SIMON. Imposing the tax at the production level simplifies it greatly, obviously.

Senator CURTIS. How would that reflect in the retail price, if at all?

Mr. SIMON. The tax will not allow the producers to get the windfall profit. It would be removed from the producer, ifyou will. The consumer, obviously, is going to pay the higher price, but indeed he might have paid a much higher price.

This effectively caps the price.

Senator CURTIS. Does it presuppose a price control?

Mr. SIMON. Not necessarily. It is a form of price control itself because if the Government is going to get 85 percent of everything over $7, that does not give much incentive for people to be raising the prices above that.

Senator CURTIS. Now following the proposal that you make, would there be the temptation to indulge in wasteful expenditures because there is an 85 percent tax?

Mr. SIMON. Fred, is that a danger? Wasteful expenditures?

Mr. HICKMAN. No, that is not involved at all in this kind of a tax. The reason you get into that situation——

Senator CURTIS. Now the one that is before the Senate now in the conference report, that is a factor is it not?

Mr. HICKMAN. Yes, because whenever you are imposing a tax determined by net profit, you get into that problem because the net profit is determined by subtracting your expenses from your revenue.

Senator CURTIS. Yes, a taxpayer might not be engaged in any fraudulent expenditures but he could actually be wasteful in his expenditures, excessive, and under the conference report it would lower his tax, is that right?

Mr. HICKMAN. That is right.

Senator CURTIS. But a taxpayer could not do that under this approach that you presented here?

Mr. HICKMAN. That is right.

Senator CURTIS. Now, the conference report also places this tax calculation by having a base period of 1967 to 1971.

Does it take into account any future inflation?

Mr. SIMON. I do not believe it does, Senator Curtis, no, sir.

Mr. PARSKY. No.

Senator CURTIS. One more question.

I am told that Federal Power Commission regulations are in some respect in contradiction or in conflict with the Energy Office.

Now, in my opinion, the Energy Office is the emergency office put up for or created for a special purpose, and that your regulations should prevail in this conflict.

Is that such a conflict that you know of?

Mr. SIMON. I am not aware of any conflict with the FPC. Their regulatory powers are in the natural gas area because we do not do anything in the allocation or regulation of nautral gas. That is strictly controlled by the Federal Power Commission.

Senator CURTIS. Well, I am glad to hear that. If I get anything specific as to what this gentleman is referring to, I shall pursue it farther.

Mr. SIMON. They set their priorities a little bit differently, obviously, than ours, but that is their area.

Senator CURTIS. That is all.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Thank you, Mr. Chairman.

Mr. Simon, I watched you on the Today Show this morning. You stated that the American people were very emotional and they should not be as emotional over the energy issue.

Well, I have always taken pride that Connecticut has been known as the State of steady habits, with very even mannered people.

Let us see what has happened to them. They have seen the prices that they pay for gasoline and heating oil skyrocket. They are starting to lose their jobs. Their children go to school in the cold and dark. They have listened to your requests for conservation and have done a fantastically good job on forming carpools. They are turning their thermostats down.

And yet the entire pattern of the people's habits in the State of Connecticut have changed. You can go into any one of the 169 towns in the State of Connecticut and find those gasoline stations open with huge lines. People do not have the slightest idea whether the neighborhood gasoline station will be open from 7 to 9 in the morning or 3 to 5 in the afternoon, whether it will be closed on Tuesdays or Thursdays or Saturdays. They know they are closed on Sundays.

The people of Connecticut feel from the man that sweeps the floor or the president of a bank that somehow the people of the State of Connecticut have been discriminated against.

Do you know what the fuel situation is in the State of Connecticut?

Mr. SIMON. Yes, Senator.

Senator RIBICOFF. Is what is happening in the State of Connecticut any different from that in the other 49 States?

Mr. SIMON. I would say yes, sir, it is, because shortages work in a very uneven fashion throughout this country. The metropolitan New York area is experiencing problems and queuing at gas stations, as is Oregon and Arizona, and there are other areas that have an ample supply. I say it does work unevenly, and there are many more States that do not have these waiting problems than those that do.

Of course, the new buying habits of the American people are contributing to the shortage. At the outset I really do not think I said the American people should not be emotional. I characterized this as a great emotional question. The American people are confused and they are angry. It is an extremely complex subject, the petroleum industry in the United States. How could we, they are asking, all of our lives have a seemingly endless supply of energy in this country and all of a sudden we have a shortage. Somebody must have contrived this. Somebody must be guilty of this.

As we well know—and Chairman Long especially knows this—the Phillips decision in 1954, and many other factors, including government action and inaction, have contributed to this crisis. The American people were warned of the potential problem, and I have been talking about it for the 14 months that I have been down here, and will continue to.

As this emotional atmosphere gradually calms down, and as we sort out through congressional hearings like this all of the facts of the situation, there will be a better understanding of this situation.

Senator RIBICOFF. All right.

Now, if you concede Connecticut has a different situation, why should there be a different situation in Connecticut than in the other States? What is your responsibility to make sure that the people of Connecticut are treated just as fairly and equally as the people in the other 49 States?

Mr. SIMON. Senator Ribicoff, you know going back to my appointment a long time ago, as Chairman of the Oil Policy Committee, that the particular problems in the New England area have received my very sharp focus. One of the major problems, as you are well aware, in the New England area, is the lack of refinery capacity. Everybody wants refineries but nobody wants them in his State. But what have we done about the problem you mention?

We have done lots about this New England area. Due to the fact that it imports 85 percent of its present needs, with an embargo it would have a shortfall faster than other parts of the country, obviously. We have redirected supply to New England. We have put in an early warning system were we would be warned of supply problems by the Governors of the various States, as well as yourself, and we have attempted to supply the independent component in New England in particular, with the needed product.

Senator RIBICOFF. All right. You say Connecticut does not have a refinery. But aren't there many other States in the United States that do not have refineries of their own and still do not have the problems of the State of Connecticut?

Mr. SIMON. Senator, I did not say the State of Connecticut did not have one. I said there is a lack of refinery capacity in the whole northeast, in the New England area, and that area obviously uses a great deal of heating oil. It is a great deal colder there than other places in the country.

Senator RIBICOFF. All right.

How about gasoline? We did not have these problems before the last few months. Yet the figures that have been brought out before the Permanent Investigating Committee in the last few days indicate at the beginning of 1974 that the major overall supply in this country was 5.5 percent more than it was in the beginning of 1973.

So if we have 5.5 percent more why should there be such a crunch at the present time?

Mr. SIMON. There are very good reasons why the inventories are higher in the middle-distillate area and gasoline inventories are slightly lower. People laugh when I say this, but basically we have succeeded in what we did in the fourth quarter of this year. The American people, as you said, did respond, and they conserved a great deal. We had good fortune in the weather. There was leakage in the

embargo during the first couple of months of the embargo. All of these have contributed to higher inventories of middle distillates.

We had the refineries output shifted slightly so they would produce more middle distillates so we would be able to allocate to industry and jobs and concentrate on employment to prevent the energy problem from having an excessive impact on the economy.

A year ago we had a shortage in middle distillate as well as a coming shortage in the gasoline area. Also at that time, due to particular problems of farmers and the wet weather, they were using a lot of distillate to dry their crops. That brought last years' inventories down a lot farther and specifically this is why the inventories appear higher right now in comparison with last year. We have an allocation program that directs all of these people to allocate specific amounts in accordance with the base period and all of the other essential elements, and they have to live by this requirement.

Senator RIBICOFF. All right.

Let's take that allocation system. You have a system requiring the major oil companies to make a fair share available to every region and every State, but what are you going to do when the allocations come to the State of Connecticut, the majors supply imported spot oil at a price as high as $27 a barrel when the average price domestically would be $8 a barrel?

Now, is an allocation system fair that makes one State pay as high as $27 a barrel compared to another State that is paying $7 or $8 a barrel?

If we are going to have an allocation system, it should be allocated fairly on price as well as on quantity.

Mr. SIMON. Senator, a portion of this is obviously the imports that are being brought in by the deepwater terminal operators and the marketers in the New England States. We will not tolerate an uneven distribution, and I sent wires out to all of the major oil companies 10 days ago to tell them we want a proper mix between the domestic, obviously lower priced oil and gasoline, and the foreign imports. We are working on a scheme of price allocation right now which will be extraordinarily complicated and I will suggest that in some instances it would not be terribly fair to people. Suppose your home was heated by domestic supplies from your XYZ independent fuel dealer and you were paying 25 cents a gallon for No. 2 heating oil produced from domestic oil and you were supplied, Senator Dole, by a distributor who imported everything and who now charge 40 cents a gallon, if I say okay, we are going to mix it all and now the price is going to be 32 cents for everyone, what does a person say who used to pay 25 cents, and now I have legislated his price up to equalize everybody in the country.

So——

Senator RIBICOFF. Well, let's take that. I am sure where Kansas gets its oil and gasoline must come from different places, than where Connecticut and New York get their oil and gasoline, but you have the same major oil companies that are doing the distribution.

Now, I find that application for permits to operate gasoline stations in the State of Connecticut have declined by 466 in 1974 as against 1973. I find that the major oil companies are eliminating their franchised dealers, and yet the major oil companies before the Permanent

Investigating Committee told me that their supplies for the State of Connecticut stayed basically at the same level, and the same proportion as their supplies in the other 49 States.

If that is the case, again, why should Connecticut be having the problem that it is having?

Mr. SIMON. We are basing our allocation, Senator Ribicoff, on the total amount of gallons of gasoline and heating oil that is used, not on the number of gasoline stations. So even if you in Oregon have much fewer gasoline stations, you are still going to get the same supply that you had during the base period.

Senator RIBICOFF. All right, now, if the distribution system has broken down then, which it apparently has since there is the same amount of gasoline and oil available, and you are against gasoline rationing, don't you think you and your office have the responsibility of setting up a distribution system fair to the American people?

Mr. SIMON. What we are attempting to do with our allocation system, is to make sure that areas on the end of the pipeline as far as the distribution is concerned, are going to get their needed products. We try very hard to do that.

Senator RIBICOFF. Well, if the allocation system is not working, do you not think there is a responsibility for devising a system, whether it be like Oregon's with purchases of gasoline on alternate days based upon the last license plate digit, or stickers on the car to take away the panic in which the American automobile driver finds himself. Every time he sees a line in front of a gas station he gets in line. He might only take 2 or 3 gallons of gas, and be riding on a full tank instead of a quarter or a third of a tank as he had in the past.

Solving this is not beyond your ingenuity and your intelligence, which is considerable, to work out, is it?

Mr. SIMON. Senator, there again this shortage is uneven around the country. For example in Oregon or Arizona or metropolitan New York, I would urge that the States with the shortages themselves implement systems, such as Governor McCall did in Oregon using the last digit on the license plate, to allocate the supplies in those States.

The majority of the States do not have this queuing problem. Every State has its particular problems, and a lot of problems are based on the buying habits that have changed, gasoline stations that go out of business, people who commute into New York City during the day, stopping at almost every gas station to put in three or four or five gallons just to get one tank back up to full again. I think that these particular problems could be better dealt with locally than at the Federal level.

Senator RIBICOFF. All right.

Now let me go to another topic.

Since you have been put in charge of energy, what has been the average increase at retail for a gallon of gasoline and a gallon of heating oil?

Mr. SIMON. That I have had control over?

Senator RIBICOFF. Since the President put you in charge of the Federal Energy Office.

Mr. SIMON. The Federal Energy Office did take action in the price area domestically after the Cost of Living Council did their complete study on the nonproduct cost passthrough. Before that, gasoline sta-

tions and other marketeers were not allowed to passthrough overhead and related costs other than product costs. After consultation with the Cost of Living Council and based on their study, we announced the penny and a half, a penny at retail and a half a cent at wholesale, increase in permissible prices.

We also did a refinery shift, 2 cents up in the No. 2 heating oil, and one penny down in gasoline to get at the middle distillate problem. These are the only price actions we in the Federal Energy Office have taken.

Senator RIBICOFF. Well, I would say in the State of Connecticut—and I do not know the figure for the rest of the country—the average price of a gallon of gasoline has gone up about 16 cents in the past year.

Now, the data assembled by the Permanent Investigating Subcommittee of the seven largest oil companies show that their profits for the first 9 months of 1973 average 46 percent, the highest in their history, while the sales volumes averaged only 6 percent higher, with revenues only 20 percent higher than last year.

Now, it would seem that the explanation of this pattern of soaring profits despite lesser gains in volume and revenues is to be found in the runaway prices for gas and oil.

The question then is, how can these prices be justified, especially the higher prices which these companies have set on their own imported oil.

Mr. SIMON. Basically we have very tight rules on what is allowed to be passed through. The rules were established by the Cost of Living Council. But we cannot control imported oil, which accounts for approximately 35 percent of our domestic consumption. And, we talked about a little while ago, the stripper well, which is another 12 percent, is exempt, and the new barrel-old barrel, which is about another 12 percent is exempt.

So uncontrolled prices of crude oil exist. Basically we have seen an explosion of world prices. The prices around the world are much higher than our domestically controlled prices that we continue to control at reasonable levels. At the same time we must be sure that there will be incentive to bring on the additional supplies that we need.

We are doing that in the Treasury Department right now, Senator Ribicoff——

The CHAIRMAN. May I just interrupt? I have a note here from Secretary Simon's assistant that the Secretary will have to leave here at 12 o'clock to return to the White House, and that—and so I would have placed a limitation on myself and on all of the other Senators. I do not believe in a retroactive rule, but I would suggest, so that every Senator could ask his principal question at this point, that we all limit ourselves to 5 minutes to ask our principal questions, and we can reserve the rest or else submit them for a time when the Secretary can be back up here.

You have 5 more minutes, Senator.

Senator RIBICOFF. I respect your wishes, Mr. Chairman.

Now, another thing that bothers me is that the President, on Saturday, assured the American people that gasoline would not go up to $1 a gallon. This is not very reassuring because he could still be truthful and it could go up to 95 cents a gallon.

Now, you and the President and the Secretary of the Treasury Mr. Schultz, have been unalterably opposed to rationing. You have publicly stated time and time again that you believe that the best way of controlling consumption is by higher prices to which I am unalterably opposed. And yet the oil companies are making profits unprecedented in their entire history. The prices keep going up. Domestic production accounts for 75 percent of the oil and gasoline we use in the United States, and yet we are allowing the tail of the dog, the 25 percent that is being imported, to determine the price of what is being charged in the United States.

Now, under these circumstances, do you feel that when 75 percent of the oil comes from the United States, that we should be allowing these huge profits to the oil companies?

It seems to me that the entire answer does not lie in an excess profits tax or a windfall profits tax because you are making the average American taxpayer pay that windfall tax, because the Federal Treasury is getting the benefit. With inflation higher than any time in the history of our Nation, I think it is wrong to make the average taxpayer pay for a wrong governmental policy.

Now, I would like your comment on this because that is the end of my 5 minutes.

Mr. SIMON. Senator, I most certainly wish to because I take some exception to a couple of things that you said. No. 1, pre-embargo, we were importing 38 percent, not 25 percent of our consumption. No. 2, the stripper well and the new and freed barrel account for another 23 or 25 percent, so somewhere in the 55 to 60 percent area is basically not price controlled in this country.

On the second point, I have been incorrectly accused on many occasions of being a person that would manage this entire problem with higher prices—I have said just the opposite on many, many occasions, that we will not allow the prices of domestic crude, which is the first element that controls the price of gasoline, to go to these emotional world levels.

And people ask me what is the price impact and what will the reduction in demand be if gasoline goes up 10 or 15 or 20 cents. I respond to that with a demand elasticity that is created due to a high price, and then they say, well, you are using that price. I am suggesting that we are not using the price mechanism purely to reduce demand and solve the problem. I am saying that we are controlling price at a reasonable level, and the reasonable level is necessary to give incentive to bring on the additional supplies that we need so badly, and this reasonable level is well below the emotional world level that is being charged today.

Senator RIBICOFF. Thank you, Mr. Chairman, for your courtesy.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. I yield to Senator Dole. He has to leave.

The CHAIRMAN. Senator Dole?

Senator DOLE. Mr. Simon, in Kansas we produce oil and we have problems, too. You do not have to be in a nonproducing state to have problems with the allocation program.

I want to commend you for your efforts. Your office has made an extremely good effort thus far, and hopefully a lot of the very sincere questions raised can be resolved. If we just think for a moment about

the thousansd and thousands of different problems around the country with reference to fuel, we can understand it is not an easy thing to do.

We have in front of us the energy conference report on the Senate floor. I do not know what the strategy may be, but it does contain in its present form section 110. Now, as I understood the experts who testified yesterday, this does not apply only to the major oil companies. It is easy to make them the whipping boys, but I think one report said this section would apply all the way down to the corner gas station. Anyone who had an unreasonable profit as determined by the board which is without precedent, would be bound to pay the excess profits tax.

So, I wanted to make it clear that this affects not just six or seven "major oil companies." It affects everyone who touches the product, from the wellhead to the gas tank or wherever it might be, in heating fuel or anything else. Is that a correct interpretation of the section?

Mr. SIMON. Yes, sir, that is.

Senator DOLE. And so we are not talking in some emotional way about some giant corporation making an excess profit. I think the American people have been led to believe that there are six or seven big entities out here somewhere which contrived the energy crisis, and that only these six or seven would be affected by the windfall profits provision.

Mr. SIMON. And with each consumer having the ability to come in and go to the Renegotiation Board, just think of the poor fellow who is going to administer the literally tens of millions of requests as far as price gouging and unfairness and potential price rollbacks that would occur. It is mind-boggling.

Senator DOLE. Perhaps it would be more accurate to say that section 110 should go to the disaster committee for further hearings.

But the point is, it is there. And the question is whether or not we are going to have all of the other things you want in that legislation with section 110, or whether it is going to be recommitted to the conference, to change section 110, or perhaps eliminated it based on the good faith efforts of the chairman of this committee and the good faith efforts of the Chairman of the House Ways and Means Committee to write a meaningful windfall profits tax provision.

But if it goes to the President in its present form, I do not know what he might do, but there is a possibility of a veto, and then, of course, the American people would blame the President for letting these "big corporations" escape an excess profits. And during this time you would be without certain parts of the legislation that I understand you need.

So the dilemma is what do we do right now with section 110? And whatever the intention may have been in the House Commerce Committee, I think most everyone understands it agrees, that it will not work. In the first place, as you indicated, there would be literally thousands and thousands of cases which might be resolved at some period 8 to 10 years from now.

Now, is there any precedent for Government determining reasonable profits?

Do you know of any precedent for the Government to come in and tell the businessman that he has made a reasonable profit?

Mr. SIMON. Well, of course, it occurs to me that it is extraordinarily difficult to do. Getting back to the excess profits taxes, is that not the

way they did it the last time, Fred, determining what was indeed profit? It varies from company to company. Some companies wish to spend more for research and development during the growth period, and their profits would be low, and then when they are ready to cash in on all of the investment that they make, it would be taken away from them.

Senator DOLE. You mean it is hard to have equity in this kind of a situation.

Mr. SIMON. It is impossible to have equity.

Senator DOLE. I just wanted to ask one question, if you could submit an answer later.

The CHAIRMAN. Go ahead. We will let you ask any question you are in the process of asking when the bell rings.

Senator DOLE. The body of the administration provision does not address itself to the plowback of earnings which some of us feel might be an incentive for further exploration. So some suggestions in this area may be desirable, but does it specifically provide for a plowback?

Mr. SIMON. We put two options in, Senator Dole. One, an energy trust fund as an option, to allow the Government to do some things in concert with industry. It could be done many different ways. Or two, to allow a partial or full rebate to the producer if he indeed explored and produced additional wells, or for research and development, or spent the money on any alternate sources of energy.

This is the dialog that will commence before Ways and Means.

Senator DOLE. Well, I appreciate that very much and I just conclude by saying I hope you do something about the price of propane in Kansas.

Mr. SIMON. Yes, sir.

The CHAIRMAN. I am going by seniority down the committee list, and Senator Byrd is next.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, first I want to say to you as I have stated to many others, that I feel that the Government is very fortunate in having a man of your ability and competence and integrity in these two very important positions which you now hold.

Mr. Secretary, you touched on this question I want to ask in your discussion with Senator Ribicoff, but I still am not clear on the answer.

How do you account with the high inventory which you have of petroleum products, how do you account for the very large increase in price that has occurred in the last few months?

Mr. SIMON. To answer this we have to look at the sources of petroleum in this country. Now, in January 1973 the barrel of domestic crude oil was $3.40 in the United States. The Cost of Living Council as the OPEC nations were commencing to raise their price, recognized that there would have to be periodic increases in a domestic price of crude oil to give the incentive to bring on the additional domestic production. So they gradually raised the permitted price over the period of a year going from $3.25—up gradually to $4.25 and to $5.25. So that accounts for price increases in our domestic production.

Of course, the cost of imports has just about tripled in the past year. Now, imports accounted for 38 percent of our consumption just pre-embargo. I earlier mentioned oil from the stripper well, the price of which has been freed up by Congress from price controls.

Senator BYRD. But your imports have decreased sharply, have they not?

Mr. SIMON. Your imports today are just slightly over 5 million barrels a day, and of course, a good portion of this comes from Venezuela and Canada. The prices for this oil immediately seek a world level.

Senator BYRD. Well, the prices have increased somewhere between 30 to 35 percent at least, during the past 90 days. I am speaking now of the retail gasoline price.

Mr. SIMON. That would depend on the area of the country. In the New England States in particular, and all down the eastern seaboard, a good portion of their product and No. 2 heating oil comes from imports, the prices for which are a good deal higher. It is very difficult to find what the average price is around the country. The price depends on the mix of domestic and foreign oil.

Senator BYRD. Are you convinced that the very substantial price increases that have taken place in the price of retail gasoline are justified?

Mr. SIMON. Other than the price gouging such as we have investigated, Senator Byrd, there has been no inordinate profit. The Cost of Living Council has done a thorough job of the profitability of the independent gas station owner. And remember the independent is the owner of 90 percent of the gasoline stations. Even if he has got an Exxon or a Texaco sign out front, he owns the franchise to that station. They have done a very thorough search of the profitability of this industry, and indeed that is why they recommended that the nonproduct cost pass-through be allowed by an increase of 1½ cents per gallon.

So if you take the price of foreign crude, which has gone from $3.30 per barrel approximately, a year ago, to where it is now going to be landing or is landing in some instances at $10 to $11, with spot market barrels having landed at $17 to $22 a barrel, and if you take our domestic crude that has gone up from $3.0 to $5.25—each dollar in a barrel of crude, by the way, equates to about 2½ cents per gallon of gasoline—I think you can trace this right through and justify the price. Prices are not producing windfall, other than in the crude price area. You will find the price escalation in Europe a good deal higher than this where gasoline today ranges from $1 to $1.50 per gallon.

Senator BYRD. But the price in Europe started at a very high point.

Mr. SIMON. It did, because the European countries taxed it very heavily, as you know, Senator.

Senator BYRD. I was not thinking so much—or at all, for that matter, of the filling station or service station operator. I was speaking more to the price being charged the service station operator.

Mr. SIMON. Yes, and this is where the detailed study of the profitability of the oil industry is going to spell out the facts.

Senator BYRD. Then that leads to my next question.

It seems to me what the Government needs and what the Congress needs are far more facts than we seem to have available at the present time.

Mr. SIMON. We are in the process, Senator Byrd, of finishing up a detailed study of the net return on invested capital in the petroleum industry from 1957 to 1973, and breaking it down into 5-, 10-, and the 15-year periods. Our preliminary results show that petroleum com-

panies are in the middle range of all manufacturing companies and that a good portion of their profit in 1973 came from foreign operations where the prices exploded. It also came from tanker rates which went up quite rapidly during the period of high demand. But basically, as I say, they have been in the middle range.

Senator BYRD. My time has expired. Thank you, Mr. Simon.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hansen would be next. He is not here. I would then call on Senator Nelson, then I would call on Senator Dole, because Senator Fannin, you yielded your time to Senator Dole, you can claim his time if you want to.

Senator FANNIN. Yes, I would like to if you do not mind.

The CHAIRMAN. Go ahead.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Secretary, I want to pay my great respects to you for the work you are doing. I have great confidence in your abilities and certainly as director of this activity you have almost an impossible task. We have not solved the problem, but you and your staff, I know, have worked night and day to attempt to do so, and it is, as I say, almost an impossible task. But you have done a very commendable service to our country.

I agree that section 110 of 2589 is absolutely unworkable. There are other items in that legislation I am very much opposed to, but if we are going to accomplish our goal, our goal is to produce sufficient energy to take care of our needs at fair and equitable prices, and I am concerned as to whether we can do that and that under the stipulation of that legislation. I just doubt that we can, although I am very hopeful that we can give you the authority that you need.

I know that you have talked or referred to in your statement—I regret that I was not here to listen to your complete statement—you referred to the excess profits tax, and I agree that we must have a fair and equitable excess profits tax. I think that your goal is to encourage additional exploration and development and investments.

Is that correct?

Mr. SIMON. Yes, sir, that is correct.

Senator FANNIN. Do you feel that with your recommendations that that will be accomplished?

Mr. SIMON. Yes, sir, we do. Our judgment is that the long-term supply price for a reasonable level of self-sufficiency in 1977 is in the area of $7, and this would encourage the investment at reasonable levels.

Senator FANNIN. Do you feel that that would be holding profits to a reasonable return on investments?

Mr. SIMON. Yes, sir, I do.

Senator FANNIN. I think it is highly essential that we do have an equitable excess profits tax or windfall profits stipulation in the legislation. And I commend the chairman because he has great knowledge in the tax field and is determined that we do have legislation that will accomplish the objectives that I think we all have.

Now, I will in writing ask you some questions about this excess profits tax because I am concerned. I just am not sure that I feel it will accomplish the objectives, but then I can do that rather than take the time here.

I just happen to have returned from a mission. I spent about the last 2 weeks in oil producing countries talking to the heads of the governments of these particular countries, and I will say that we started out on a factfinding mission. As we traveled along our way, we found that our mission was to try to convince the oil producing officials, oil producing country officials that they will bankrupt the monetary program of the world if they continue their pricing policies.

Now, do you agree on that statement?

Mr. SIMON. Well, I do not know about bankrupt, but certainly the recent price increases the world cannot afford, there is no doubt about that.

Senator FANNIN. Well, if they cannot afford it, then we will have great dislocations throughout the world.

Mr. SIMON. Yes, sir, that is correct.

Senator FANNIN. We had a difficult time in talking to them because when we would bring up the question of profits and the pricing that was in effect, they would answer us by saying, well, why are all of these other countries calling upon us, working out programs with us? Some are almost what you call barter programs, where inflation will not be involved because they will be getting their repayment in materials of kind. They would say, you continue to say that the prices are too high. Now, how can you account for the sales that we are making on auctions that are far beyond the price, and we tried to convince them that this was not indicative of the overall. They are talking about the same rate that you would charge for peak load.

Would you make a comparison of that nature?

Mr. SIMON. Yes, sir.

Senator FANNIN. Well, this is what we tried to talk to them about, but when we were in some of those countries, it was very hard to convince them, especially when they would complain to us about the price of other products. They kept bringing up wheat and the bare necessities of life as they explain them that have gone sky high. Wheat, they said, had gone—they are paying four times as much for it now as they were just a few years ago. They wanted to tie the price of oil to the price of other commodities.

We explained to them the disruption this would cause around the world. It would be a very difficult matter, as I see it, because the price of wheat and the price of grains and all have gone up because of the increased costs, whereas we know that their costs of oil from 10 to 12 cents a barrel has not risen to any great extent.

So I do not know what the solution would be, but this is something we will be discussing with you when we have more time.

Mr. SIMON. Thank you, Senator.

The CHAIRMAN. Senator Mondale.

Senator MONDALE. Thank you, Mr. Chairman.

Mr. Simon, you know the 1973 Consumer Price Index reflected one of the highest inflationary rates since World War II, and it is well known that one of the key ingredients in this cruel inflation is the spectacularly rising prices for energy—crude oil prices, gasoline, propane, and the rest.

Now, the chief rationale, as I gather it, which the Government has for permitting these prices to rise as high as they have, and perhaps even arguing for higher prices, is first, we have to bear in mind what

the world market is, and thus domestic prices should rise in some relationship to world prices, and second, we need prices high enough to produce profits to encourage exploration, expansion, and production.

Now, my question relates to price, because, I think that is the real issue. An excess profits tax—and incidentally, I think a good case has been made against the one in this particular bill—does not do anything for the average American. What bothers him are high prices. The present inflation now is cruel. There are many millions of Americans whose life styles have been drastically changed by these high prices, and at the same time, it is these same high prices, rather than supply, which threaten dramatically higher unemployment rates in America.

So if we wanted to take the cruelty out of the energy situation we must begin with the price question and ask whether prices are too high.

Now, in my opinion, they are, and I would like to give you my thesis and then you can respond to it.

As I understand it, about two-thirds of the oil consumed in this country is domestically produced, while a third of it is imported. Most of that domestic production is "old" production, traditional production, of about 3 billion barrels a year. I think the record is very clear that when that oil sold for close to $4 a barrel or $4.25 a barrel the companies were making substantial profits, impressive profits, and that that price was high enough to encourage expanded exploration.

I have several quotations—from Business Week, the President of Stanford Oil of Indiana, the Oil and Gas Journal, from the Petroleum Independent magazine—which indicated that if they could ever get oil up to $4.50 or $5, they would really go. As a matter of fact, when "new oil" reached $5.50 or so, the Petroleum Independent quoted a producer-geologist saying: "I have never seen so much outside investing money available for drilling. It wouldn't be difficult for one geologist to raise more money than he can intelligently spend."

Now, that is when prices were several billion dollars below where they are now, and if I understand you today you are talking about $7 oil, which would amount to about a $10 billion additional price tag over $4.50 oil.

Now, how do you justify these fantastic price increases on the basis of any rational national policy?

Mr. SIMON. Senator Muskie, the $7 figure was relative to the long-term supply price, to bring on the alternate sources of energy, not only the existing Outer Continental Shelf that costs increasingly more to drill—it costs a half million dollars to $2 million to drill a well.

Senator MONDALE. Is it your thesis that you should charge more for domestic oil, even though its price is far in excess of any reasonable cost, to get that production, and in order to encourage production on other sources of oil or other sources of energy?

Is that your argument?

Mr. SIMON. Basically. It is not an argument. I have stated on many occasions we are presently controlling the domestic price of crude at $5.25.

Senator MONDALE. Do you not think that is too high?

Mr. SIMON. On a long-term supply price, our preliminary studies in the Treasury Department show it is not too high. That to bring on the alternate sources, to do the job for gassification and liquification of oil shale, to regenerate the coal industry, it is going to cost in the area of $7. That is judgmental though, Senator.

Senator MONDALE. So it is your argument that we must agree to extortionate profits in the oil industry in order to establish a price level that will bring on coal or shale or something else.

Mr. SIMON. No. Let's talk about the statement of extortionate profits, and this, again, is unpopular. I do not defend anybody. I have no ties with the oil industry. My job is to put the facts down as I see them, and when you say extortionate profit I have to take some exception because in going back to 1957 and looking at the profitability of the oil industry, as I said before, they are in the middle range. When we compare 1973 to 1972, which is the traditional way we do our financial reporting, and 1972 was the worst year in those 16 years, there is some distortion.

Senator MONDALE. Well, did you not say in your statement there are windfall profits now?

Mr. SIMON. There are windfall profits in the area of crude due to the fact that 70 percent of it is controlled by foreign nations who wish to charge us these emotional prices. We are not going to allow the domestic price to go to these emotional levels.

Senator MONDALE. So you think $5.25 is essential.

Do you think it should go higher?

Mr. SIMON. At present, $5.25 is plenty to do the job.

Senator MONDALE. Is it too much to do the job?

Mr. SIMON. The Cost of Living Council studied this at great length before they raised the price from $4.25 to $5.25, to stimulate the exploration. We watched this very carefully. We are not just going to precipitously put the price at $6.00 or $5.50 or any other price until we make sure that that is a reasonable price. But let us look at our alternative, Senator. That is the important thing.

Today we are importing 35 percent of our oil. If we continue as we have for the last 20 years in this country to create economic disincentives, and do nothing to build this ability for self-sufficiency here, and our imports rise to 50 percent before the end of this decade, that will subject us, as I said so often, to economic and political blackmail. We will face supply cutoff with all of its economic consequences, or any price that they wish to charge. We can obtain those supplies ourselves and we can do it much cheaper.

Senator MONDALE. I agree that we must do it ourselves. Yet, if I hear you correctly, I hear my Government arguing for billions of dollars a year more than the industry itself said was enough last year.

Mr. SIMON. There again these are the estimates that we have studied on a long-term supply price gaging.

Senator MONDALE. Well, Mr. Chairman, I am going to introduce a resolution before the Democratic conference tomorrow urging a freeze and rollback in prices because I think prices now are clearly above the market demands.

The CHAIRMAN. Well, we will now proceed to call on the next Senator, and that would be Senator Packwood.

Senator PACKWOOD. Mr. Simon, I have talked with you at least three or four times in the last 2 weeks, and with your assistant, Mr. Parsky, an equal number of times, concerning the critical situation about gasoline in Oregon.

With regard to the petroleum shortage: I have never seen Oregonians as irate since the Federal Government tried to do us the favor of storing all of their nerve gas in an Oregon depot several years ago.

Yesterday a story appeared in the Oregonian. I am quoting as follows:

> Texaco dealers across Oregon and Washington may face shutdowns lasting through February and March if the Company's interpretations of new Federal fuel allocation guidelines stand. Originally Texaco allocated dealers 80 percent of the gas pumped the first 10 days of January, 1972, for the first 10 days of January 1974.
>
> With the new guidelines, however, the Company last Friday announced dealer allocations would be 60 percent of the gas pumped in either December 1972, or January 1972. A Texaco official in Los Angeles said that some dealers who were selling gas under the old allocation, may have used up so much gas when the new guidelines were announced, that they could be in debt, in effect, for the months of February and March and thus would not receive anymore gasoline until April.

We called the Federal Energy Office's regional office in Seattle, and asked them what they planned to do about it, and this was the response that was relayed to the news media:

> Confusion with new Federal rules Monday shut down efforts to provide additional gasoline for hard-pressed areas of Oregon and Washington. Oregon officials were told that the Regional Federal Energy Office in Seattle is uncertain of its authority to order redistribution of gasoline from one state to another.

Now, Mr. Simon, let me ask you this: Do you have the authority to order reallocation of gasoline?

Mr. SIMON. Absolutely, Senator.

Senator PACKWOOD. And that would apply to your regional office in Seattle?

Mr. SIMON. It most certainly would apply to them.

Senator PACKWOOD. Now, if Texaco insists—although I met with their officials in my office this morning and I think we are going to achieve some compromise at least for January—if they insist upon allocating to Oregon what is proven to you to be an unfair share, do you have the power to order Texaco or any other major, to increase their allocation to Oregon?

Mr. SIMON. Yes, indeed we do.

As a result of your phone call last night, we talked to our Regional Administrator and he denied vehemently making statements, because he is well aware of his power to allocate any of the products, by law. Indeed we have given our regional offices, and the States as well, as much flexibility and responsibility as we can.

I, as well, talked to Texaco yesterday on this problem, dealing with the regulations that came out on January the 15th. They are going to inject further flexibility into their distribution system from now until the end of the month.

Senator PACKWOOD. Let me compliment you, for your assistance on this. I called you last night about 4:45 from the office, and then left about 5:30 to go home and take my family out to dinner. I got home about 9 o'clock and you were calling for me at home to follow up on

this problem. I wish, Bill, that we had the same kind of concerned response from many other people in our Federal bureaucracy.

Let me ask you one last question: Let us say that the town of Baker, Oreg., or its service stations, had 1 million gallons of gasoline in 1972. Let us assume that the base for distribution in 1974 is 85 percent. Further assume that Baker, as did all other Oregon cities, had a higher-than-average proportion of independent gas stations and that many of them have gone out of business and are not likely to reopen.

In 1974, will Baker, Oreg., under an 85-percent allocation, get 850,000 gallons of gasoline, even if you have to force the majors to, in essence, oversupply their existing stations to reach that amount?

Mr. SIMON. Oregon is not unique as far as the independent gasoline as well as major gasoline stations that close up. Between 25 and 30 percent of the gasoline stations in this country change hands and move each year, and we are allocating, not on the number of gasoline stations in a particular area, but on the total volume of gasoline, thanks to having lots of these thing pointed out to us.

We are not wizards downtown. We foresee a lot of these problems, but even though it makes my job harder on one side, or makes it easier on the other—we will make fewer mistakes if you point out the anomalies to us in your particular regions and allow us to respond to them. So they are going to get the allocation based on what they consumed, not based on the number of gasoline stations they now have versus what they did have.

Senator PACKWOOD. Thank you very much.

I have not further questions, Mr. Chairman.

The CHAIRMAN. Senator Gravel?

Senator GRAVEL. Mr. Simon In front of me I have a press release from the Exxon Corp. which was given to their stockholders at their annual meeting in New York today.

This press release has received quite a bit of attention because of the higher profits it reports. When we talk about a 40 percent increase in profit and convey to the American people that this is the actual profit level, we are doing a disservice to the informational process of the American people.

I would like to pose a question which concerns this fundamental point touched upon by Senators Mondale and Ribicoff, regarding windfall profits.

As I read their report, Exxon achieved an 18.8 percent return on shareholder's equity in 1973. This compares with a 12.8 percent in 1972. From the talk that we have heard in the last 3 months it appears as if Exxon is gouging the American people.

Well, what exactly is a windfall? I understand the New York Times third quarter profits increased 113 percent in 1973. Is this windfall profits for the New York Times?

The highly publicized figures are for world activities. We received testimony before the subcommittee that I chair which says that we are not going to be able to make ourselves self-sufficient until the entire industry has an 18-percent profitability. I introduced an excise profits tax which gave the industry a ceiling of 20 percent. For what reason is it right for them to receive that kind of profit?

Looking precisely to the American activities, we find the return is 12.4 percent as opposed to last year's return of 11.4 percent.

As I understand it, last year the national manufacturing average was about 13 percent. That means that their profitability is below the American average of normal corporate activity and that this year their domestic activities, after these tremendous windfall profits that everybody has accused them of, is on 12.4 percent. In addition, as we know, they are being chased out of the Arab countries.

My question to you, sir, is if Senators Mondale and Ribicoff are successful in obtaining an arbitrary price freeze imposed by the Government, what will happen to oil in this country?

Closing the textbook of economics and saying that the Congress supersedes all economic theory, and that we are going to say that the price is such-and-such, what will happen to the American energy industry in this country?

Mr. SIMON. The results are very predictable. We have a dramatic illustration of this situation in this country today in the price of natural gas which has been controlled since 1954 at what has been deemed extremely uneconomical levels.

Right now we are finding cutoffs, curtailments, throughout this country. Where Louisiana and Texas, in particular, were shipping this natural gas controlled at the wellhead, today, at an average level of 25 cents per Mc. What is going to happen? Well, Texas says why should I? Or Louisiana says why should I be shipping natural gas to New England at 25 cents when I can sell it intrastate, which they can, at 60, 70, or 80 cents at the wellhead.

The CHAIRMAN. $1.

Mr. SIMON. At $1, under a recent contract written in Texas.

You know we think in Government that we can repeal the law of supply and demand on occasion, and of course this is where I get misquoted about free markets. I understand what windfall profits are and what exorbitant profits are. I understand those very well.

Because of this present imbalance between supply and demand, and the cartel that is operating in this world today, we do not have to allow the prices, as I keep saying, to go to emotional levels here in the United States.

All I can say, Senator Gravel, is God bless you for saying this. I do not know many people that talk about the oil companies and their profits as not being exorbitant based upon looking at the rest of the free enterprise system in this country.

I guess you do not get elected to office by making statements like that, but I am not running for anything. I am trying to just put the facts in front of the American people and I guess when I do I will be very unpopular and you can send me home to New Jersey.

Senator GRAVEL. Mr. Chairman, if I might be indulged for one more question? I want to ask—and this first question went on longer than I——

Mr. SIMON. I think I went on longer, I apologize.

Senator GRAVEL. Well, I think, Mr. Simon, that you are correct. Economic theory will prevail regardless of what we as politicians want to do.

I want to ask you a question that I think is very important because we have read a lot about conspiracy and withholding product from the marketplace in order to increase price.

Do you know of any group of people, a company, or a group of companies, that is withholding from the market any sizeable stock of oil that would have an impact on the economy? If you knew of such a company, what are you and the President prepared to do to these people?

Mr. SIMON. I just came back from Texas yesterday afternoon from a meeting with the Texas Railroad Commission to find out about the reserves in their State, how they are calculated; how the maximum efficiency rate on production is indeed established to insure a long-term supply and not look for the short-run objective of raising the production in a well which has the long-run impact of reducing or damaging or destroying this well.

We do not, in the Federal Energy Office, know of any hold-back but I will defer to the Justice Department as fas as the contriving. I do not know who contrived to have exploration peak in 1956, or production peak in 1970. Did somebody contrive to have demand continue to go up at 4 to 5 percent a year?

And why are imports today at 7 million barrels a day on the way to 10 or 12, while we continue to supply the foreign countries this year, as I said, $20 to $25 billion—in dollars while we could be spending a hell of a lot less here domestically and giving us the ability for self-sufficiency?

This is pretty fundamental economics.

Senator GRAVEL. Mr. Simon, I would like to report to you as a member of the executive branch and maybe you could transfer it to the Justice Department, that I do know of an instance where there is a contrived effort, to hold billions of barrels of oil from the American people. An impact on price is and will get felt as long as these people continue to hold this oil from the marketplace.

I can cite other examples, but the one I know of first-hand is the petroleum reserve, where the Navy is sitting on as much as 33-billion barrels of oil. If that oil were permitted to go into the American market place, it would have an impact on price, and eventually make us self-sufficient.

I do not know why they insist upon sitting on that oil. They talk in terms of national defense, but we just had a crisis and they did not take any oil from their reserve. They took it from the American people. They took it from the American people on the west coast and on the east coast I would hope that some investigation could be made by the executive branch as to the motivation for withholding this oil from the American people.

Mr. SIMON. We have this legislation before Congress right now, and the Senate has already passed this bill to not only allow us to use immediately these 160,000 barrels a day of production from Pet 1, but also to use the moneys to go up and finally prove out Pet. 4.

With all of the estimates we have gotten, we have talked about it for years, let us get going on it.

The CHAIRMAN. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

Mr. Simon, I think it is important that this country adopt a national energy policy. And one of my concerns here is that by only considering some kind of a windfall tax, we are not considering the whole bundle of wood.

There are a number of proposals, as I am sure you are well aware, that changes should be made in depletion—perhaps, we should change our tax credit policies.

So, my first question to you is, does the executive branch of the Government, intend to make further recommendations in the tax area involving oil, either directly or indirectly? Or is this the only recommendation to be expected this year?

Mr. SIMON. Our tax reform proposal last April suggested a change in the way the intangibles are treated as far as international oil companies are concerned. An international company can go over in its 1st year, obviously incur losses drilling the well, et cetera, and then write it off against other income.

In the 2d year, when one well becomes productive, the foreign country takes a tax on the profit. We do not think that is very fair and we made our recommendations to deal with that which thus far the Congress has not enacted.

We are going to do something in the foreign depletion area. We want to change the tilt, if you will, to encourage domestic production and exploration in this country versus the foreign. We are looking at the tax and royalty question in the area of the foreign tax credit.

Obviously we want our companies here, our multinational companies to be competitive worldwide, and the taxes that are charged by other countries, that is fine, that ought to be a tax credit. And the IRS has so ruled since 1950.

But, what has happened recently is we have had an explosion of prices and taxes. Can we consider the tax on the posted prices today being charged by the Persian Gulf countries, as purely a tax?

Well, we do not think so. We think that using this as a tax credit is wrong. Part of it should be a tax, but the rest of it ought to be a deduction like an operating expense.

So, yes indeed, we are moving in all of these areas, Senator Roth.

Senator ROTH. Well, if I may urge, because I think Congress is going to act fairly rapidly if you read the morning paper. I am also a member of the Government Operations Committee where we have had the seven presidents of the big oil companies before us. Certainly there is considerable evidence that raises substantial doubt about the wisdom of our present tax credit.

And I would urge and ask that we have your recommendations in this area very promptly because I think this is something Congress is going to have to consider.

A second area——

Mr. SIMON. I think you are going to have them this afternoon, Senator Roth.

Senator ROTH. That is faster than I normally hear from the executive branch, Mr. Simon.

The second question I would like to ask is a basic question on depletion. There have been a number of proposals even by some oil executives, that we ought to get rid of oil depletion allowance at this time. The profits are high enough that the oil companies can exist without it. There are some people so claiming.

Do you intend to make any recommendations in this area?

Mr. SIMON. In the domestic area, we do not, and I would like to speak to that for a moment.

An economist, which I am not, would tell you that the depletion allowance has basically been passed through to the consumer all of these years in the form of lower prices, so it is a benefit to consumers. Some of your major oil companies have considered it a millstone around their neck due to this fact, and so some of them have recommended that it be removed.

If the price of oil were allowed to go to certain levels, that would more than compensate on elimination of percentage depletion for same. But remember, between 70 and 75 percent of the wells that are drilled in this country are drilled by independent producers.

These independent producers do not have the wherewithall to drill all of these wells. And they go all around the country getting their pools of capital to speculate, if you will, and this is gross speculation, to drill the wells. And one of the incentives to investors is the depletion allowance.

So this is argued back and forth.

Senator ROTH. Could a distinction be made between the large companies on depletion allowance, and the medium and small, your wildcatters?

Mr. SIMON. I do not know if it is equitable really, to discriminate against a large company because he is large. I think you might find the producers would act a little bit differently if it were that way.

Senator ROTH. One further question.

Will the entire tax package of the administration be available? You mentioned this one area, will that complete your recommendations? Or will there be further recommendations?

I think it is most important that we consider the tax package not piecemeal, but entirely.

Mr. SIMON. Oh, it will all come up together and we will be testifying before the Ways and Means Committee, I believe it is February 4, and we will have them all intact at that time, Senator.

Senator ROTH. One further question, there was testimony given on the other side, for example, that Gulf Oil paid something like 2-percent U.S. income tax on earnings. I am not sure of that figure.

What impact, and I know you cannot give us specific answers, but what impact would you estimate that your emergency windfall profits tax would have on a company like that? Would it have any?

Mr. SIMON. Oh, boy, you would have to really go into their balance sheet to figure that one out, Senator. I could not even begin to give you an off-the-cuff answer on that.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

First, Mr. Simon, let me join in the others to commend your dedication, ability, and energy you have brought to this job.

I, for one, am very appreciative of it. I have heard the State of Texas used as an example a number of times here. I think it might be of interest to state, that although Texas produces 38 percent of the oil and gas in the United States, last year, last summer according to Department of Interior figures, there were more cited instances of fuel shortages in Texas than any other State in the Union.

Not this winter, but last year, Texas, in towns like Austin were turning out the lights on one side of their street. They were turning off their fountains, they were turning down their thermostats, so it is not unique to Connecticut or some of these other States.

Let me make it clear that I do not believe that any person or company should make an unconscionable profit or windfall off the troubles of this country of ours. But I want to be very careful as to accomplishing the objective of seeing that they do not make windfalls that we do it in a workable manner, and that we do not negate our objective of making this country self-sufficient on energy. And that is what we ought to work toward.

Section 110 of the present energy bill before us for consideration, I think would be an administrative nightmare. I asked the Congressional Library to find out how many individual sellers of petroleum we had in the country, because that it is the way the bill is phrased. It refers to "sellers."

And they came up with these figures for me, that there are 10,000 to 12,0000 companies involved in crude oil production, 250 refineries, 14,000 petroleum jobbers, 26,000 storage, 220,000 gas stations of which 70 to 80 percent of them were individually owned and operated.

Now if you had individual pricing, would it not hamper your efforts to try to bring about an orderly allocation program?

Mr. SIMON. It is impossible, Senator.

Senator BENTSEN. Now with the experience that you have had concerning complaints filed about possible price violations with the Federal Energy Office under the present pricing authority, what do you think would happen if you had the individual citizen who could file charges against 220,000 gas stations in this country for an individual determination of their profit structure?

Do you think it would be much of a job to administer that?

Mr. SIMON. As I said, I just pity the poor fellow who ends up as administrator of that nightmare.

Senator BENTSEN. Let me give you an example of how careful you must be in this type of situation to see that you really accomplish your objective.

When we are talking about an excess profits tax, or a limitation on profits, there was an example in Texas of how the profit margin test can have the effect of restricting new sales in the application of the Cost of Living Council's regulations.

Due to the demand for drilling pipe, the L. B. Foster Co. had increased its volume, without a corresponding increase in cost, and was up against the profit margin ceiling. So here industry was needing drilling pipe, and needing tubeless steel to drill wells to try to overcome this shortage, but by the end of October, Foster Co. had made all of the profit they were allowed to make, so they quit selling.

They had 1,600,000 feet of oilwell casing. They had that much casing, badly needed. But they could not sell it under this kind of provision and they asked for an exemption on that.

I would like to put that in the record, Mr. Chairman, if I might?

The CHAIRMAN. Certainly.

[The material referred to follows:]

[Telegram]

HOUSTON, TEX.,
November 20, 1973.

Senator LLOYD BENTSEN,
Senate Office Building,
Washington, D.C.
(Attention of Gary Bushell).

We share your concern over the steel shortage besetting oil and gas producers as a consequence of phase four. We represent an independent oil operator who has recently completed a devonian discovery well capable of producing 400 barrels per day. The wells necessary to develop this discovery cannot be drilled because of lack of casing.

Not only steel manufacturers but suppliers as well have been forced by phase four to curtail deliveries. The following is an official announcement prepared by another of our clients, L. B. Foster Company, a major supplier of oil and gas casing, distribution and gathering pipe, as well as water well and irrigation pipe, to be given to all customers as the basis for its inability to accept new orders for delivery in 1973.

The L. B. Foster Company follows a policy of phase four compliance giving rise to the current situation. Abnormally high order entry through October forces us to suspend acceptance of any new orders for shipment in November and December of 1973. This will not only enable us to achieve compliance with phase four controls, but to maintain as well a balanced working inventory in conjunction with new material arriving in the coming period. We will thus have a broad assortment of material to resume shipment at a normal rate in the first quarter."

The L. B. Foster Company took the step reflected in the announcement only with great reluctance and after careful review of the various courses of action open to it under the regulations. In view of the energy crisis so graphically detailed by the President two weeks ago, Foster's distress in being forced to take this step has deepened. It's inventories are substantial. Its Houston division which serves the south and southwest has in inventory or will receive in time for delivery before the first of January 1,653,000 feet of oil well casing, 21,400 tons of oil and gas gathering and distribution pipe and 4,500 tons of water well casing and irrigation pipe, and the divisions serving the other sections of the country also have substantial inventories. With the situation as it is in the energy and agricultural sectors of our economy it is very important to remove any barriers to further deliveries of goods essential to meet those situations. The L. B. Foster Company recognizes the seriousness of the energy and agricultural crises and would resume the acceptance of new orders and the making of deliveries immediately upon an amendment of the price regulations or the issuance of an order effectively protecting it from liability under the economic stabilization act, and specifically for any overage under the gross margin and the net margin limits, arising directly or indirectly out of the making of such deliveries. On Friday, November 16, Foster filed an exemption request with the Cost of Living Council in Washington seeking such relief, and an exception request seeking similar relief was filed Monday with the Internal Revenue Service District Director in Pittsburgh. It is hoped that favorable action on either or both of these requests will be taking promptly.

ROBERT H. PARSLEY,
BUTLER, BINION, RICE, COOK & KNAPP.

Senator BENTSEN. So I would like to see a windfall profits tax which would in some way encourage increased drilling within the North American Continent. for the building of these refineries that we need to try to meet these shortages.

Would you give consideration to that kind of an approach?

Mr. SIMON. We propose two options on our windfall proposal, one, an energy trust fund, and two, a full or partial rebate if indeed the money were used to further explore or bring on the alternate sources of energy, or research and development in any other energy related activity.

We have also last April in our tax reform proposal, submitted a tax credit proposal for exploration in this country. This would give a 7 percent investment tax credit for exploration costs with an additional 5 percent given for a successful well.

Senator BENTSEN. Mr. Simon, it also seems to me that we have an acceleration of sale of offshore leases. I look at a situation like the Gulf of Alaska which geographically stretches a distance which would go from Miami at the tip of Florida, all the way down to Brownsville, Tex., and there are some enormous structures out there. We do not know what the reserves are until we drill those things, but I would like to see a diminished emphasis on the bonus payment on the front which is a rather unique approach in this country to the situation, and a greater participation for the Federal Government on the wells when they find production. That way we could accelerate the sale of these leases. This approach would get more companies drilling offshore that would be a better competitive situation.

Mr. SIMON. We are developing a program, hopefully like that, right now. We have already tripled the amount of leasing that has been announced, and that is in process as per the last leasesale a couple of weeks ago. We are looking at putting an additional amount of acreage on starting next year. That will be good, and that in itself will help bring down the price that the Federal Government gets. I could not agree with you more. We are pound wise and penny foolish when we look to extract the last nickel out of a capital short industry—and remember, it is the independents that bid on lots of these leases, too.

And then they have to spend the additional moneys to drill.

Senator BENTSEN. But this would let more smaller companies get out there and compete.

Mr. SIMON. Yes, and we are going to deal with that, too, as far as the consortium of majors, et cetera, yes, sir.

Senator BENTSEN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Fulbright.

Senator FULBRIGHT. Mr. Secretary, Mr. Simon, I am sorry I was not here earlier, but I am very interested in the statements——

The CHAIRMAN. Mr. Simon, I know you have to go to the White House. I hope you can stay for 5 minutes for Senator Fulbright. At that point I will excuse you.

Mr. SIMON. Yes, I will be glad to stay, Mr. Chairman.

Senator FULBRIGHT. I will try to make it as brief as I can, although it is an extremely important matter.

The Secretary of State, I believe, stated that he is either hopeful or expects a lifting of the embargo by the Mideast producers, in the near future. If that is done, what effect will that have on the petroleum situation?

Mr. SIMON. Well, it all depends, Senator Fulbright, on the level of production that is set in the Middle Eastern nations after the embargo is lifted. Will they raise production sufficiently to meet the demand in this country?

Senator FULBRIGHT. Supposing they resumed what was anticipated as the normal production as of the time they imposed the embargo.

Mr. SIMON. The September 1973 level?

Senator FULBRIGHT. Yes.

What would be the effect?

Mr. SIMON. That would be very helpful in one way and very harmful in another. It would enable us to go back to our wastrel ways and go back to sleep again on the problem.

Senator FULBRIGHT. Not with the new, higher prices. It does not automatically mean the price goes down to what it was, does it?

Mr. SIMON. No, it certainly does not.

Senator FULBRIGHT. So that is still a point which would discourage waste, would it not be?

Mr. SIMON. Yes, sir.

Senator FULBRIGHT. Certainly in the use and production of electricity and so on we would still move to the use of coal, would we not?

Mr. SIMON. Yes, sir.

Senator FULBRIGHT. In my State, a most critical problem at the moment is the price of propane, and I am bound to say I have been puzzled. Propane has gone up more in my State than gasoline, I mean relatively, and there seems to be a great question about the actual shortage of this product. The price has gone up in Arkansas from 17.9 cents last summer to 34.9, nearly 35 cents a gallon, just in the course of 6 months. My State is to a great extent rural, with a large farming community, and this is especially hard upon them.

Do you have anything to say about the propane situation?

Mr. SIMON. Yes, Senator. It is absolutely dismal. I really wish you could give me an answer to that; 70 percent of the propane in this country comes from natural gas, as you well know.

Senator FULBRIGHT. Yes.

Mr. SIMON. And in the past year we have seen sharp curtailments in the use of natural gas by utilities, for the industries, and curtailments on the interstate flow. Faced with these curtailments, many new buyers, or many buyers of natural gas have shifted to alternate fuels.

So we had a shortage of propane to begin with, and increased demand for propane exerted itself from utilities who were being cut off from the natural gas, and their demands took it away from rural areas, the farmer, et cetera.

Now, we have allocation programs that attempts to allocate among the priorities that we have established, but there really is not enough to go around.

Senator FULBRIGHT. Of propane?

Mr. SIMON. At the present, yes.

Senator FULBRIGHT. You have stated that in the allocation program there is a high priority for farmers, for the production of food for the United States. Arkansas is one of the top producers of soybeans, cotton, rice, poultry, and livestock, and the farmers there are very apprehensive about this coming season. The allocation problem, though, seems to be at the dealer level. When the farmers ask for fuel the dealers have not got it and cannot get it from their suppliers. I get a great many very worthy inquiries about this situation. Is there not anything we can do about this?

Mr. SIMON. That is what we are working on, some propane price regulations now. There again, the regulations certainly will not create any additional supply of propane, as I have described where it comes from, which you well knew. I asked Senator Dole, who has the same problem, and I wish that somebody would come up and tell me what the answer is with the increased demand and reduced supply.

Propane was a problem long before other petroleum products were a problem in this country.

Senator FULBRIGHT. Well, of course your mentioning natural gas reminds me that, as long ago as 1954 and 1956 I was the sponsor of a bill to deregulate the price at the wellhead. It was vetoed. It was passed by the Congress and vetoed, and my experience with that regulation of the wellhead price does not encourage me about the effectiveness of the across-the-board price freeze that is being proposed. I think in a short-term situation it can be a useful tool, but as time goes on it may just dry up the supply and discourage drilling.

Mr. SIMON. And that is the answer as far as propane is concerned, greater production of natural gas.

Senator FULBRIGHT. I realize that is a basic cause. I think the price control policy for natural gas was a great mistake. Of course, when we have made mistakes either in this field or in the foreign policy field, we always like to find a scapegoat rather than admit that we have been unwise in our policies. You have already commented on that a moment ago. Since you are not up for election, you can afford to be truthful about this.

[General laughter.]

Senator FULBRIGHT. The truth is we are now reaching the culmination of a long period of several mistakes in other areas, not only the Vietnam war, but our Middle East policy.

Now, if the Secretary is correct about the embargo, as I hope he is—that is why I asked you about what would happen if we get the embargo lifted—at least it will take some of the emotion out of this. I think a lot of these high prices are caused by the apprehension of having to pay $7, $8, or even $10 or $12 for oil. If we could get that embargo lifted, it wolud have a great psychological effect upon the pricing structure, don't you think?

Mr. SIMON. I believe it would.

Senator FULBRIGHT. Would you not say that is the highest priority to give immediate relief?

Mr. SIMON. Oh, yes, and that as far as the consuming nations are concerned is No. 1 on the agenda.

Senator FULBRIGHT. That is No. 1 on the agenda, if we can do it. What the Secretary is doing is all important to this energy question, but I do not think that means that we should not try to do something, at least in the short term, on prices because the pressures are such that there is a distortion beyond the necessities of the case.

I am very doubtful about our being able to effectively deal with the shortage by price controls because of our experience in the case of natural gas. I think history has proven that it was a mistake to veto that deregulation bill. I would like to help you any way that I can to get fuel for my farmers. They are really very worried about the question of availability in spite of the high priorities for agriculture. If you do not make fuel available, then we will have the same kind of shortage in food as we have already have in energy and the same kind of increase in price of farm commodities in some cases, wheat for example, as you have in oil. And that does not help anybody either.

So it is all tied together.

Well, I think you have shown great energy and initiative. It is a very hard problem and it is not your problem alone. I think we all

bear a great responsibility for unwise policies that relate to this in the past. It is too bad we did not think of gassifying coal instead of going to the moon time after time after time, but we did. It was a very poor sense of priorities, but now there is no use crying about it. We have got to do something about the fuel shortage, and I will try to help you do something about it.

Mr. SIMON. Thank you, Senator.

The CHAIRMAN. Mr. Simon, thank you for coming up here, and I want to thank you on behalf of this country, as far as I have the power to speak for this country, for the sacrifice you are making to do everything that is in your power to meet a very difficult situation.

In my judgment, these difficulties that we are facing are here because the Congress and the Executive did not have wisdom and foresight in the years gone by to make it more advantageous to produce our energy here than to produce it abroad, and we are paying for that mistake now. As Senator Fulbright mentioned, it was a bad mistake not to permit gas producers to sell gas into interstate commerce on a competitive basis. We are paying for that mistake.

You have made a lot of sensible, logical recommendations to us, and if I have my way, Congress is going to give you the kind of cooperation that you are entitled to expect to solve this energy problem.

Thank you very much for coming here today.

Mr. SIMON. Thank you, Mr. Chairman.

The CHAIRMAN. I would like to ask Mr. Sheldon S, Cohen, Mr. K. Martin Worthy, Mr. Charles Davis, and Mr. William S. Whitehead to take the witness stand, and I will ask that each of them read their statement as a panel of witnesses so that they can conclude their testimony at this morning's session.

Gentlemen, I want to thank you very much for appearing here today and offering us the benefit of your advice. You have served this Government ably in years gone by and this committee will appreciate your advice with regard to the difficult tax problem and renegotiation problem that is facing us now.

I first call Mr. Sheldon S. Cohen who has served us with distinction as Chief Counsel for the Treasury and former Commissioner of Internal Revenue.

STATEMENT OF SHELDON S. COHEN, FORMER CHIEF COUNSEL, DEPARTMENT OF THE TREASURY, AND FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. COHEN. Thank you, Mr. Chairman.

As you know, this morning I appear at your request to comment on the proposals to tax the so-called windfall profits of energy companies. I should say I appear here as an individual. I practice law here in Washington. I do not represent any company that has an interest one way or the other in this legislation, so whatever views I speak are my own.

I apologize for not having a prepared statement since it was just a couple of days that your chief counsel notified me of this hearing. While flying back from an out-of-town trip yesterday I did try to compose some thoughts on the subject.

Any attempt at an excess profits tax is not going to be very good. No attempt at one is worse. That is, the American public, I do not

believe, will stand for the fact that if there are excessive profits—and at least most people now believe that, as I probably do also—we must have some means of taxing those profits or requiring that the price be adjusted. Price adjustment would be an even better technique I suspect.

The drafts, however, of the bill now before you, are not very good, and that is probably being charitable. The tax is probably virtually unadministerable. It would be a terribly complex thing.

Now, one of the problems that faces the oil companies that was alluded to during the session this morning was the fact that they will not be able to make judgments on what the law is. Now, that problem is going to exist in any event, however, Senator, because there are many proposals before the Congress. Mr. Simon alluded to several. There are a number of others that have been proposed on this side or on the other side, all of which are going to be considered in the next few months, and some of which are going to be enacted.

So we must face the fact that it is virtually impossible to predict with any certainty what will be the law by the end of this year. We do know that there will be some proposals. The oil industry would be well served, as would the American people be well served if this committee and Mr. Mills' committee and the Congress could get to these bills out of order, as quickly as possible. They can then be enacted as early as possible, and these people can take into account in their financial considerations during the rest of the year what the burden is going to be on them.

One other series of comments I might make as an adjunct to this study, some of the things that Mr. Simon also alluded to this morning ought to be studied. We have a series of problems in the oil and gas area and perhaps in the whole mineral industry of historic accidents. Historic accidents have a way of becoming ingrained in the law, and perhaps the economic structure, too, but just because they happen does not mean they should not be reexamined from time to time.

And so we have that whole problem of the intangible drilling expense, which is probably a larger benefit to the oil industry than percentage depletion. There have been some suggestions by the Treasury at least as to foreign oil that some of these allowances be changed. I think that might be a good start, but that does not excuse us from reexamining them, even as they apply to domestic situations.

The foreign tax credit as applied to the oil situation in the Persian Gulf is an abomination that we have lived with for about 25 years or close to that. It was encouraged probably by our Government. It was certainly not discouraged by our oil companies. If an oil company—I live in Montgomery County, Md., and they are not likely to do this, but if they want to drill a well in my backyard and offered to pay me a 25-percent royalty; they would get a deduction for it. If they drill it in the backyard of the sheik of a Persian kingdom, he calls it a tax and they get dollar for dollar benefits from it. This was done at a time when it was virtually that way.

There really was no excuse for it, and as Mr. Simon says at this point where they are adjusting the price in cartel-like fashion, this may be the time to say, now, wait a minute, let's stop this sort of thing.

Now, it has been done before. The oil companies may not like to say it, but during a period shortly after the Suez crisis, oil sold at a

discount off posted price. Posted price was the price which was established as a result of the closing of the Suez Canal in 1956, as I recall. When the canal was reopened and oil began to flow freely in commerce again, the price fell in international trade. The oil companies were required by the various Persian Gulf countries to continue to use the posted price in terms of computation of tax. The Internal Revenue Service made substantial adjustments in that situation. It said that the difference between the world price of oil and the posted price actually used for computation was a royalty and not a tax.

I would also like to make one other comment. I would be wary of a rebate system at all because a rebate system is in effect no tax at all. The U.S. citizenry and public will be paying for something from which there will be no benefit.

If I were convinced that we had a perfect market in oil, as the economists would call it, a perfect market where the prices did reflect all of the various factors, I might be more inclined to say a rebate system which would encourage the further exploration and might work to the benefit of the American public. However, I am not that sure of it.

The CHAIRMAN. Thank you very much. Before we ask any questions, I am going to ask the other witnesses to give us their statements.

Next I will call on Mr. K. Martin Worthy, who was former Chief Counsel of the Internal Revenue Service.

STATEMENT OF K. MARTIN WORTHY, FORMER CHIEF COUNSEL, INTERNAL REVENUE SERVICE

Mr. WORTHY. Mr. Chairman, my name is K. Martin Worthy. I am a member of the law firm of Hamel, Park, McCabe & Saunders, with offices in Washington and Chicago.

As you recall, I served from 1969 to 1972 as Chief Counsel for the Internal Revenue Service.

The CHAIRMAN. And you did a very fine job for us, sir.

Mr. WORTHY. Thank you, sir.

Except for my Government service, I have been engaged in law practice in Washington since 1948. The first couple of years of my practice were devoted almost entirely to cases arising under the relief provisions of the World War II excess profits tax acts. I also later had some, though less extensive, experience with the excess profits tax imposed during the Korean war. I have also been involved, from time to time, up to the present, in several matters arising under the Renegotiation Act of 1951.

I would like to say, Mr. Chairman, that I am here at the committee's request, and that while I am presently chairman of the section of taxation of the American Bar Association, I do not speak for that section or that association and, so far as I know, they do not have any position on the matters being discussed here today. I would also like to say that the law firm of which I am a member has, from time to time, represented and does presently represent, various energy companies in tax matters, and I do not purport to speak for such companies in any way. I think, in fact, that it would be inappropriate for me to comment on the second question with respect to the kind of advice I would give such companies if a windfall profits tax, such as

has been proposed, were enacted into law, and I will confine my remarks to the problems of administering such a law were it made applicable to any industry or group of industries.

We have had numerous efforts in American history to limit excessive profits and certainly from what I have seen and what is recorded as a matter of history, none of them have been very satisfactory, either from the standpoint of equity to the taxpayers or administrative simplicity. During World War I, the Congress originally, in 1917, imposed an excess profits tax based solely on the amount of a taxpayer's earnings in excess of a fixed return on invested capital. In recognition of the fact that due to differences in circumstances, and particularly in corporate efficiency, a fixed rate of return on investment did not necessarily represent a normal return to a particular corporation, the Congress in 1918 hastily amended the law to provide for imposition of the tax in part on the basis of a fixed return on investment capital, and in part on the average income of the particular taxpayer concerned during a base period consisting of the immediate prewar years of 1911, 1912, and 1913.

It was quickly recognized, however, that even this approach could work most unfairly in a particular case and special assessment provisions were enacted, under which the Commissioner was given broad authority to redetermine the tax of a particular taxpayer by reference to the average tax of representative corporations engaged in a like or similar trade or business, where he found that owing to abnormal conditions affecting the capital or income of the corporation, the regular computation of the tax would work an exceptional hardship.

Although it was essential to avoid gross inequity that there be included some such relief provision, where, for example, invested capital was paid in when the value of the dollar was much greater than when the tax was imposed, or where income was depressed by some unusual circumstances during the base period, the lack of very meaningful standards in the law resulted in prolonged disputes and litigation between taxpayers and the Commissioner, which were not finally resolved until 1938 or 18 years after the tax itself had been repealed at the end of 1920.

An excess profits tax was again imposed during the World War II years from 1940 to 1945. The original act ran for some 20 pages; in somewhat oversimplified terms, tax was imposed on earnings in excess of either a fixed return on invested capital or the taxpayer's average income in the base period, 1936 to 1939, whichever produced the lesser tax.

Again, it was quickly found necessary to amend the original act. First of all, to take care of abnormalities in the base period, it was provided that if income in one of the base-period years was less than 75 percent of the base-period average, there could be substituted an amount equal to 75 percent of the average for such actual. Second, to avoid penalizing companies that had become more productive in the latter than early part of the base period, companies were permitted to substitute for their actual average an amount equal to the average for the second half of the base period increased by one-half of the amount by which earnings in the second half exceeded those in the first half. Although these rules provided somewhat rough justice for many taxpayers, Congress also, in 1941, found it necessary again to amend the

act to provide a general relief provision which became known as section 722, permitting a theoretical reconstruction of the taxpayer's actual base period net income to determine what taxpayers' earnings would have been, that is, its normal earnings, if certain unusual events had not occurred, such as a flood, strike, fire, abnormality in the price structure, or a change in the character of its business so fundamental that actual earnings during the base period were not representative of what would be expected to be normal at the beginning of the war years.

Relief was also provided for adjusting invested capital for changes in the original values of a company's assets or the failure to include in assets such items as goodwill. At the same time, it was also recognized that there might be not only abnormalities in income of the base period years, but abnormalities in income in the taxable years resulting from the receipt in those years of income attributable to earlier periods, but for which adjustment would be required.

Despite the obvious need for some such relief provisions to prevent basic unfairness, to correct, for example, for circumstances beyond the taxpayer's control such as fire, which may have already depressed a taxpayer's earnings in the base period, and should not bring on a second disaster in the form of imposition of an unfair tax in the current period, the World War II provisions proved very frankly to be an administrative nightmare. As a result of widespread complaints of the administration of section 722, both with respect to the long delay of the Commissioner in disposing of such claims, and the unsatisfactory way in which they were finally disposed of, the Joint Committee on Internal Revenue Taxation conducted extensive hearings in 1946, which resulted in the creation of an independent excess profits tax council in Washington and various excess profits tax committees throughout the country to consider and dispose of such claims.

Although in my opinion the council then did its work with expedition and great skill, the mass of evidence which each taxpayer claiming relief under that section was required to accumulate and disputes which arose under the terms of the statute resulted in the final case under the World War II tax not being disposed of under those provisions until 1967, 22 years after the tax was repealed at the end of 1945.

A Korean war excess profits tax was also imposed from 1950 to 1953. The basic approach of that tax was the same as the World War II tax, except that as a result in part of the complaint about the administration of section 722, the Korean tax permitted relief in the case of abnormalities in income, growth or substantial change in character of the taxpayer's business, by substituting for the taxpayer's actual average base period income a constructive income computed simply by multiplying its total assets by the rate of return for its industry classification.

This was much simpler than the World War II approach, but was also extremely inequitable in that the inefficient were permitted to raise themselves up to the industry average, whereas the efficient got no relief at all. Even so, despite the relative simplicity of the Korean tax, I regret to tell you that we were still involved in litigation over that tax when I left the chief counsel's office 2 years ago, or 19 years after the Korean tax had been repealed.

In an effort to perhaps avoid some of the problems created by the World War I, World War II, and Korean excess profits taxes, the pro-

posed windfall profits tax being considered here today is based in part on reasonableness of profits to be determined under standards imposed by the Renegotiation Act of 1951 for the determination of excessive profits under Government contracts. Having worked under both the relief provisions of World War II and the Renegotiation Act, I can only say that the World War II relief provisions were a model of preciseness and objectivity compared to the standards of the Renegotiation Act.

While I do not intend for a minute to deprecate the efforts of the Renegotiation Board, which must, of course, administer the law as it finds it, the lack of any precise rules as to how the various statutory factors such as reasonableness of cost and profits, volume of production, net worth, risk, and efficiency, ought to be taken into account, make any objective determination of excessiveness of profits extremely difficult to attain. The lack of adequate guidelines for applying and weighing the statutory factors was the subject of criticism in a report by the Comptroller General to the Congress on the Renegotiation Act just last May.

The Comptroller General said that as a result it was unable to evaluate the reasonableness of the Board's determinations. Even if authority were to be granted to the Renegotiation Board, with its familiarity with such standards to determine excessiveness of profits, rather than to the secretary or delegate as is provided by the bill before the committee today, it is still quite apparent that extended litigation would ensue—just as it has under the Renegotiation Act—before the amount of excessive profits of many companies would finally be determined.

Take for example the matter of net worth. The Renegotiation Board has always taken the position that in applying the net worth factor, a comparison must be made of the contractor's profit on renegotiable business, to net worth attributable to renegotiable business. Net worth attributable to renegotiable business is ordinarily computed by allocating total net worth to renegotiable and nonrenegotiable business on the basis of cost of goods sold of renegotiable and nonrenegotiable profits. This obviously has the effect of attributing a greater net worth to renegotiable business the greater the taxpayer's cost of performing renegotiable business, and thus a lower return on net worth than would otherwise be the case, so as to favor the contractor in the renegotiation process.

On the other hand, the greater the contractor's cost from renegotiable business, the less its efficiency, with the result that increasing cost hurts the contractor under the efficiency factor while helping it under another; that is, the net worth factor, at exactly the same time.

An identical problem, it might be noted, will arise under the proposed windfall profits tax, since it would apply only to business arising from the sale of energy products, and not from the taxpayer's total business.

A whole new problem, certain to be extensively litigated because it would be a mixed question of law and fact, would be created as to what is meant by, and I quote from the bill, "profits from sale of energy products," as contrasted to other profits of energy companies.

Another problem which is characteristic of the renegotiation process is that no credit is given in one year for subnormal income in any other year. This is a defect carried forward into the proposed windfall prof-

its tax, and is contrary to experience in World War II and the Korean war, in which Congress found it necessary at a very early stage to provide unused excess profits credit carryforwards and carrybacks so as to prevent the imposition of an unfair tax burden over a period of several years.

I might say that I was also astonished by the fact that the proposed tax would be based on a company's earnings in excess of the lesser of average profits during the years 1967 through 1971 or what is determined to be a reasonable profit under renegotiation standards. This is exactly the reverse of the World War I, World War II, and Korean war concepts, that the minimum credit to which every taxpayer was entitled was its average earnings during the base period, and that adjustments should be made upward in such a credit if it was not reasonable in the case of the particular taxpayer.

I would think, in fact, that serious constitutional questions would arise if the taxpayer were limited to a credit based on its average earnings during the base period, even though he could demonstrate under the standards set forth in the act that a reasonable profit would be at a higher level.

The taxpayer would be permitted under the proposal——

The CHAIRMAN. Could I just interrupt you at this point?

I am going to have to go now to manage a bill on the Senate floor. I am going to ask that Senator Fulbright and Senator Fannin hear the conclusion of these statements, and I want to assure you gentlemen that I will see to it if it is within my power that the Senate does know of your views on this matter before it acts contrary to the very fine advice that you are in the process of extending this committee. I want to thank you gentlemen very much for your statements.

Mr. WORTHY. Thank you, Mr. Chairman.

The CHAIRMAN. I will be back in touch with you.

Mr. WORTHY. Shall I continue, sir?

Senator FULBRIGHT. Yes. The Commerce Committee is meeting at 12:30 p.m., but I was very interested in your statement. I would like to hear the rest of it before I have to go.

Mr. WORTHY. Thank you, sir.

The taxpayer would be permitted under the proposal before the committee to substitute for its own average base period profits, and I quote, "the average profit obtained by sellers of energy products during the calendar years 1967 through 1971." First of all, I do not know what this means. Does it mean the average of all sellers of energy products—coal, oil, gas—retail, wholesale level—or does it simply mean sellers of similar energy products at similar levels?

Surely, it cannot mean aggregate dollar profit of the entire industry, and must mean profit in relation to something else, conceivably revenues or investment. But if so, which? If it means investment, does it mean net worth? Does it mean invested capital, which included 50 percent of borrowed capital for World War II purposes and 75 percent of borrower capital for Korean war purposes? Or does it mean total assets, as were used for some purposes under the Korean war tax? And if based on the taxpayer's own average base period profit, is any adjustment to be made for additions to capital since the base period—in the form of additional productive facilities, for example—as were permitted under the World War II and Korean acts, and

presumably would be intended to be encouraged by the Congress? And is no relief to be provided for taxpayers suffering a fire or flood, or some other abnormal circumstance during the base period, except in the form of substituting the average industry profit, as was done so unfairly under the Korean tax?

And what particularly about the company that has already increased its productive facilities in the latter part of the base period, and thereby already established a higher earning level than the average of the base period? Is it to be brought down to the level of the taxpayer who did nothing to improve its productivity during the years immediately preceding the crisis?

It would seem clear that the enactment of legislation determining excessive profits in the manner set forth in the proposed legislation before the committee today would create not only great inequity to many companies—and by the same token, of course, windfalls to others—but also tremendous administrative problems and also endless litigation, which could be expected to ensue for a long period to come.

Thank you, Mr. Chairman.

Senator FULBRIGHT. Mr. Fannin, I have to go. The Commerce Committee is meeting at 12:30 p.m.

Could I ask just one question?

Senator FANNIN. Certainly.

Senator FULBRIGHT. If we should take the change suggested or discussed a moment ago by Mr. Simon about a reform of the existing law with regard to tax credit on the particularly foreign operations—I mean, the people who have been so severely criticized, the big international companies who pay no tax here, pay it all in the producing countries, particularly in the Arabian countries, resulting in no tax here—is that type of reforms, where the existing tax laws—will it have a more orthodox impact so they pay about the same as other companies do?

Would that be a substantial step toward solving the problem of excess profits, in your opinion?

Mr. WORTHY. Mr. Chairman, I think that whole area might well be examined. I think there is a lot of misunderstanding about that.

For example, it is commonly assumed that all oil royalties paid to sheiks and other potentates abroad are treated as taxes for tax credit purposes. That is far from the truth. Some payments have been allowed as taxes, and perhaps that area should be reexamined. But the situation with respect to the oil companies is a part, perhaps a major part, of a broader question of the way in which American companies doing business abroad should be taxed.

Some sovereigns, unlike the United States, do not tax their citizens at all on income earned outside of that particular sovereignty. This country has for a long time taxed all of its citizens, individuals, and corporate taxpayers alike, on income derived from whatever source, at least so long as they are domiciled in this country, and as a compensation for that, for the recognition of the fact that if they earn income from sources abroad, permitted them to take into account the tax they pay abroad so as to be sure they are not taxed twice on the same income by two different sovereigns.

I think some of us have had that experience between States. Members of the Senate would have it, for example, if appropriate adjustments were not made in the law to prevent your being taxed both at home and in the District of Columbia on the same income.

That whole area does perhaps need reexamination. Whether that is the solution I am not prepared to say.

Senator FULBRIGHT. I do not think there is any good solution I am really contemplating here. You have made such a case against the effectiveness of the excess profits tax in the past, and I wondered, with all of its faults, if a proper reform of existing income tax laws were included in the suggestion, would it not be a better, or at least a less difficult thing to administer?

It is more in accord with orthodox taxation. We all know that, of the specific cases arising out of the oil companies. Nobody is bothering so much about other companies. General Motors is not down. We do not know whether there is going to be a big depression. They are all exorcised about the oil industry. That is probably because of a desire to have a devil to blame all our troubles on. Obviously, you have already commented on it. But the public has to have a devil of some kind, and there is always a conspiracy, and if things go wrong it could not be our own stupidity, it has got to be somebody, somebody has been a traitor or there is something wrong like that.

But recognizing that, we have got to do something.

Would it or would it not be better to reform or try to reform existing laws, such as these tax credits, which would make these particular culprits, as they are now made to be, pay some more tax, because then they read in the paper that Gulf pays only 2 percent or Texaco 1.7 percent. It makes them mad. They have got to pay a bigger percentage of the tax to satisfy the public.

Mr. WORTHY. Of course, those percentages relate to the amount of U.S. tax paid in relation to the income from all sources, and that must be taken into account.

Senator FULBRIGHT. I understand. But the problem has got to be made to appear to be that.

Mr. WORTHY. It certainly is deserving of consideration. I do not have any opinion. I certainly would think it would be a great mistake to do away with the foreign tax credit entirely for industry. And beyond that, I think the matter may be re-examined and some changes in the existing system may be appropriate. I really am not prepared to answer that today. I am sorry, Mr. Chairman.

Senator FULBRIGHT. Of course, I am not a tax expert. But it seems to me if we could make the regular laws, income tax laws, more effective in these particular respects it might be preferable to setting up a whole new administration which has all the problems which you explained and what—about four different efforts, none of which were satisfactory. Maybe that is the best we can do, but you experts have got to bear the burden of recommendations on what is a better way.

Mr. WORTHY. Certainly.

I would like to make clear that I would favor a general overall simplification of the tax laws. I think a great many of us are becoming greatly concerned by what has happened in our lifetime and in our professional careers to the size alone of the Internal Revenue Code, and we do need some serious effort, given, I think, to an extensive simplification in the law.

Senator FULBRIGHT. I am very embarrassed. I, of course, did not expect to be taken to this, and I cannot do it because we have Mr.

Heller as a visitor invited to the Foreign Policy Committee, which met at 12:30 p.m. Mr. Fannin, I have got to go.

Senator FANNIN. Yes, I understand that, Mr. Chairman.

Senator FULBRIGHT. I think the other witnesses have written statements which I will be able to read. I believe you have supplied them. And I apologize.

Senator FANNIN. Well, you gentlemen are performing a very valuable service, and I want you to know how much we appreciate it.

Then we will hear from Mr. Davis, and the Honorable William Whitehead. But we very much appreciate your being here. I just want to emphasize that. What we do in this legislation, I think, may determine the outcome of our energy program and the solving of the problem. So we are so appreciative of your being here today.

So, Mr. Davis, if you want to give your statement at this time.

STATEMENT OF CHARLES W. DAVIS, FORMER CHIEF COUNSEL, INTERNAL REVENUE SERVICE

Mr. DAVIS. Thank you, Mr. Chairman.

My name is Charles W. Davis and I am an attorney in private practice in Chicago.

I suggest in the interest of time rather than read my statement that it be filed so it may appear at this point in the record.

Senator FANNIN. Your complete statement will be made a part of the record. I want you to know your statement, as you know, with all the experience you have had in this activity, will be read by the members, and we know that they will be appreciated very much.

Mr. DAVIS. My primary concern is the effect the so-called "windfall profits tax" would have upon tax administration and compliance generally if it were to be enacted in its present form. It seems to me that it provides, as Mr. Worthy has detailed so vividly, an unworkable standard to enable any taxpayer to compute the tax on windfall profits and properly reflect it on his return. And indeed, I would hate to think of what revenue agents in the field offices of the Internal Revenue Service would do in attempting to audit the returns as filed.

The horrendous complications under the section 722 of the World War II excess profits tax or under the somewhat more refined and more complicated Korean excess profits tax are nothing compared with the complications involved under this proposal.

Similarly, the compliance problems are grievous to contemplate. I think, Mr. Worthy underscored this problem with his example where a taxpayer would not be able to rely upon his own base period income, or over the industry base period, but would be subjected to a determination that a reasonable profit was less than either of these, forcing him to speculate. I suppose every taxpayer preparing his return would choose either the industry base period or his own base period. But in doing so he would have to speculate that an examining officer would probably require him to establish what was a reasonable profit under the proposal's more vague and general concept.

Mr. Chairman, I think with the coverage Mr. Worthy has given to the technical deficiencies of the proposal I will yield to Mr. Whitehead.

Senator FANNIN. Thank you very much, Mr. Davis.

[Mr. Davis' prepared statement follows:]

PREPARED STATEMENT OF CHARLES W. DAVIS

Mr. Chairman. My name is Charles W. Davis. I am an attorney in private practice in Chicago. The invitation to appear today to express views on the proposed windfall profits tax was extended, as I understood from Mr. Robert M. Willan, Tax Counsel to the Committee, because of my experience in tax administration in the government and specialization in the law of Federal taxation in private practice.

When I joined the staff of the Tax Legislative Counsel in 1941, preparation of the Treasury Regulations under the World War II Excess Profits Tax was then in progress. My next encounter with an excess profits tax came as a member of the staff of the House Committee on Ways and Means during the consideration and enactment, late in 1950, of the Korean War Excess Profits Tax. Subsequently, as Chief Counsel for the Internal Revenue Service, I had responsibilities in the administration of the Korean War Excess Profits Tax, and even of several remaining unresolved cases under the World War II Excess Profits Tax. In private practice my firm has had a number of excess profits tax cases.

An eminent authority in the field of Federal taxation has observed that "the excess profits tax is an excrescence of crisis. Typically it has been one element in an emergency fiscal program designed for a mobilizing economy." (Mertens, Law of Federal Income Taxation, Introd. V. 6A.) Judges who have been required to consider the provisions of the Excess Profits Tax Act of 1950 have observed that it is perhaps the most intricate and baffling enactment ever to receive Congressional approval. Accordingly, it may be appropriate to evaluate the current proposed windfall profits tax in the light of the most recent experience of the Congress in the imposition of the Excess Profits Tax Act of 1950.

Although that law was enacted during a period of approximately 6 weeks, from the beginning of hearings in the House Committee on Ways and Means to its signature by the President, there was a consistent theme expressed by witnesses before the tax writing committees and by committee membership that the standards for computation of excess profits subject to the excess profits tax should be explicitly stated in the statute, with much less reliance upon vague generalities than had been the case under the World War II Excess Profits Tax. In expressing aversion to the general relief provision of section 722 of the World War II law, this Committee observed in its report:

"In each instance the section provided that a hypothetical base period earnings credit be 'tailor made' for the particular taxpayer and that certain assumptions be made in connection with the case. Each case was a problem in research, and the legal or tax result generally was intertwined with complicated accounting and economic problems. Almost every factor which had any influence on the particular business was pertinent to the case and the time and expense involved in reconstructing the average base period earnings credit were tremendous."

". . . The determination of what the taxpayer's base period income would have been in the absence of the claimed abnormality was largely a matter of subjective judgment, and a great deal of complaint has arisen on this account". (Report No. 2679, 81st Cong., 2nd Sess., p. 17)

In sharp contrast with the experience and judgment of Congress even in that period of war emergency are the vague concepts under the proposed windfall profits tax to which you are now giving consideration.

It is fundamental that a technically sound statute is the foundation for sound administration of the tax laws. My principal problem as a tax administrator was the coordination of efforts to instruct and supervise Internal Revenue field personnel in the application of the tax laws in the audit of taxpayers and in the resolution of tax controversies under the compliance program. This is possible only when the tax law prescribes specific standards to be applied in the examination of returns.

The importance and, yes, the fragility of our self assessment system for the collection of taxes cannot be overestimated. The self assessment system contemplates first and foremost that each taxpayer will know what is expected of him and will be able to compute and return a fair, if not an exact, account of his tax liability. The single most important element of such a system is a law which a taxpayer can understand and apply to his own affairs,—sufficiently clear and well defined to give him distinct pause at the thought of noncompliance. Stated somewhat differently, if the system is to work, a taxpayer ought to be on notice of what could constitute noncompliance. The proposed Windfall Profits Tax is utterly deficient in this respect. It fails to provide a workable premise for self assessment, even by the most sophisticated corporate

taxpayers. By failing to prescribe adequate standards by which even major corporate taxpayers can compute and report their liability, it erodes the very foundation of our tax system, by courting—and perhaps even inviting—massive noncompliance. It is no secret that the audit capabilities of the Internal Revenue Service were under strain even before the promulgation of wage and price controls, and that the percentage of returns being audited is now down to 2 percent. The field audit effort that would be necessitated by the proposal presently before this Committee would add a further responsibility to this already overburdened agency, and would inevitably result in weakened compliance efforts in other sectors. (Please refer to attachment 1)

I urge you to give sufficient time and consideration to whatever energy tax policy you may find to be appropriate to develop a technically sound, administratively operable law.

PROPOSED WINDFALL PROFITS TAX PRESENTLY BEFORE SENATE FINANCE COMMITTEE

(a) *Imposition of Tax.*—In addition to other taxes imposed by this subtitle, there is hereby imposed a "windfall profits" tax on the taxable income of every energy corporation for each taxable year ending after December 31, 1973. In computing such tax a credit shall be allowed for the taxes imposed on such corporations under Section 11 with respect to the income subject to the addition to tax imposed herein.

(b) *Definition of Income Subject to Windfall Profits Tax.*—The addition to tax imposed under subsection (a) shall be equal to 85% of the amount by which the profits of any energy corporation for the taxable year derived from the sale of any energy product determined by the Secretary or his delegate to be in excess of the lesser of—

(1) a reasonable profit with respect to the particular seller as determined by the Secretary or his delegate upon consideration of—

(A) The reasonableness of its costs and profits with particular regard to volume of production;

(B) The net worth, with particular regard to the amount and source of capital employed;

(C) The extent of risk assumed;

(D) The efficiency and productivity, particularly with regard to cost reduction techniques and economies of operation; and

(E) Other factors the consideration of which the public interest and fair and equitable dealing may require which may be established and published by the Secretary or his delegate;

or

(2) The greater of:

(A) The average profit obtained by sellers of energy products during the calendar years 1967 through 1971; or

(B) The average profit obtained by the particular seller of energy products during such calendar years.

(c) Except as provided in subsection (b), for the purposes of this section, the term "windfall profits" means profit in excess of the average profit obtained by all sellers for such products during the calendar years 1967 through 1971.

Senator FANNIN. Our next witness is Mr. Whitehead.

STATEMENT OF WILLIAM S. WHITEHEAD, CHAIRMAN, RENEGOTIATION BOARD

Mr. WHITEHEAD. I have a prepared statement, Mr. Chairman, which I would like to read. It is very short. I would like to read portions of it because the Renegotiation Board, of which I am the chairman, is involved in section 110. I assume this will be put in the record verbatim.

Senator FANNIN. Mr. Chairman, this complete statement will be made part of the record.

Mr. WHITEHEAD. My name is William S. Whitehead. I am chairman of the Renegotiation Board. The Board's current statutory responsi-

bility is the recapturing, under certain circumstances, of excessive profits earned by defense contractors and subcontractors engaged in business with those Government agencies named in the Renegotiation Act. The Senate Finance Committee and the House Ways and Means Committtee exercise legislative oversight over our activities.

The Board was created under the Renegotiation Act of 1951, and has been periodically extended to expire on June 3, 1974.

The first session of this Congress mandated the undertaking of a study of the renegotiation process through the joint efforts of the Board and the Joint Internal Revenue Taxation Committee. We have cooperated fully with the committee and Chief of Staff, Dr. Laurence N. Woodworth, and we will be ready to report the Board's position on various points raised in the study within the next 6 weeks.

In recapturing excessive profits from contractors, the law directs that the Boards evaluate their performance within the factors set forth in the act, namely, and I will abbreviate now: the efficiency of the contractor; the reasonableness of the costs and profits; the net worth; the extent of risk assumed; the nature and extent of contribution to the defense effort; the character of business; and such other factors the consideration of which public interest and fair and equitable dealing may require.

Now, let me parenthetically point out at this time that section 110 in the conference report includes, practically verbatim, several of the factors under which we operate.

Let me emphasize that the Board does not employ formulae or percentages or any other type application in the determination of the amount of excessive profits earned by contractors. Rather, we evaluate and judge the contractor's performance within the meaning and interpretation of the statutory factors, and then determine, within our best judgment, the amount of excessive profits earned, if any.

The Board staff, as presently constituted, has personnel strength of about 200, and we have two regional boards. Under its present workload, the agency appears to be adequately and efficiently staffed, particularly after considerable management streamlining accomplished during the past 6 months.

I would like to point out that under the existing renegotiation law, profits derived from the sales of refined oil and gasoline, by companies to the Departments of Defense, Army, Navy, and Air Force and other agencies are subject to review by the Board. Each seller, with sales of $1 million or more, must file with the Board an annual report showing gross renegotiable profits, expenses, and net renegotiable income.

And I might again parenthetically point out that at the present time we have seven oil companies being reviewed and studied in the field whose fiscal years total about 18 years.

Under the present conditions, the Board certainly is not equipped with manpower nor facilities to handle the responsibility proposed to it as set forth in section 110 of the conference report.

However, if the Congress directed this great task to the Board, naturally it would assume same, firmly and fairly, but could only do so after it had been provided with a very considerable increase in the number of estimated required personnel and increase in appropriations.

On Saturday last, the President assured the Nation that U.S. oil companies would not be permitted to reap unconscionable profits because of shortages, and urged Congress to enact a windfall profits tax, which he previously had requested. I subscribe wholeheartedly to both of those positions.

In conclusion, gentlemen, my four Board colleagues and I stand firmly prepared to assist the President and the Congress in doing whatever is necessary, appropriate, and expedient to ease this existing energy crisis within that statutory authority provided the Board.

Senator CURTIS. Mr. Whitehead?

Mr. WHITEHEAD. Yes, Senator Curtis?

Senator CURTIS. This morning it was indicated that there are probably 10,000 to 12,000 oil producing companies and 220,000 service stations that could be affected by the windfall profits curb in S. 2589. So if any interested person could petition the Renegotiation Board, how long would it take the Renegotiation Board to gear up to handle this volume of appeals?

Mr. WHITEHEAD. Well, it would take a considerable amount of time, Senator, because if we have to go from the wellhead to the gasoline service station—I think Senator Bentsen said something like 220,000 gasoline stations, and the act provides that any person can file a complaint—I would assume that it would take us a very considerable amount of time, and it would be a very great, considerable increase in our appropriation. I hesitate to give any appropriate number of personnel or additional personnel that would be required. But, I believe it would run into the thousands.

Senator CURTIS. How long would it take to dispose of a case?

Mr. WHITEHEAD. After we got it?

Senator CURTIS. Yes, and assuming——

Mr. WHITEHEAD. I have no knowledge of that, sir, right now, because you would have to set up rules and regulations and procedures, and goodness knows how complicated those would be, how long it would take to recruit the people. I would think that it would take 6 to 9 months to recruit all of the people that we need, unless we hired an outside employment specialist firm.

Senator CURTIS. And then some of the cases would go on to court?

Mr. WHITEHEAD. Yes, sir.

Senator CURTIS. Of course, these 220,000 service stations, a lot of them will just quit because they have got—the average small businessman has got such a burden now, not only tax burden, but all of the reporting and compliance when you add up that which comes from all of the different departments and agencies of Government.

I am sorry that I did not get in here for the entire presentation of the panel. I do commend you for making yourselves available and giving your testimony, because the matter that is now before the Senate in the way of a conference report, if allowed to become law, would make our energy crisis so much worse that it would be a grave injustice for the American public. And I thank you.

Senator FANNIN. Thank you, Mr. Chairman. Again, I want to express my appreciation to all of you, and as I say, you have rendered a very valuable service.

One matter—I could ask quite a few questions, but I certainly do not want to hold you, as I know you are very busy people. But the

problem that we have in writing this legislation is so complex. Now, the chairman, Chairman Long said, in view of the vagueness of the stipulations—do you gentlemen feel that this legislation, section 110 of this legislation is constitutional?

I think that one of you gentlemen referred to that earlier, that it would be very difficult to assess.

Do you feel this legislation is constitutional?

Mr. DAVIS. I for one believe that there is a reasonable doubt as to whether there are sufficient standards in the proposal. Indeed, the standards could be conflicting, and these factors would make it a serious question.

Senator FANNIN. It could be challenged as unconstitutional?

Mr. DAVIS. Yes.

Mr. WORTHY. Well, as I said, Senator Fannin, in my prepared statement, I have serious doubt as to the constitutionality of an act which would provide that even though the taxpayer can show that a reasonable profit is higher than his base period average, he nevertheless would not be permitted to use that as a basis for determining excessive profits, particularly in light of the fact that the tax would not be imposed on business generally, but only members of a selected industry. And I even have some question in my mind as to the constitutionality of the act because of that fact alone, that it is confined to a single industry.

Sentaor FANNIN. Thank you, Mr. Worthy.

Any other comments?

Mr. COHEN. I do not think I want to express an opinion on the constitutionality, since I have not given careful attention to it. However, I would agree with the prior two gentlemen that there is an awful broad discretion granted to the persons administering this law. While I have great confidence in Mr. Simon and Secretary Schultz, I always said when powers were granted to me that I thought were unduly broad that I had great confidence in my own judgment, but I did not know who would be sitting there next. Since I did not want that unknown person to have that kind of power I had better not give it to myself. And I would say that the same thing might be true of these gentlemen, that this is an awful broad discretion without congressional standards.

Senator FANNIN. That is a highly erudite statement.

Yes, Mr. Chairman?

Mr. WHITEHEAD. I would have to beg off answering, since I am not an attorney. However, I would like to get this on the record. Since the language in section 110 looks as if it was lifted from the Renegotiation Act—as a matter of fact it is practically the same in the three fractors that are quoted there—I want to stress the fact that nobody consulted the board in the drawing up of section 110.

Senator FANNIN. They did not consult the board, Mr. Chairman?

Mr. WHITEHEAD. No, sir. No one, not to my knowledge, and I am sure that I would have been aware of that. We were not a party to the development of that section 110, as far as I know, and I am sure I would have known it if we had been.

However, I will say that the constitutionality of the Renegotiation Act has been questioned on a number of occasions, and found to be constitutional in each instance.

Senator FANNIN. I see. Thank you, Mr. Chairman.

Mr. Cohen, you said any attempt at excess profits tax will not be very good, but the public demands one.

Well, do you not think that the public is demanding because of their anger now from the standpoint of what is happening, not being able to drive into the service station getting fuel or being cut back in their homes?

Do you not think it would be a mistake to write punitive legislation against the oil companies now, leading the public to believe that it is going to solve that problem?

Mr. COHEN. Well, I believe if we are going to legislate we ought to legislate in an intelligent and knowledgeable way, and not in a frenzy. I was the person assigned to the extension of the Korean excess profits tax when I was in the drafting group at the IRS in the 1950's. The act was never extended, so I made an extended study of the act, and it is a very tough—and I would go back into the acts that Mr. Worthy described and accurately described. However, if I put myself back in the 1950's and during the Korean period, or during the 1940's, early 1940's during World War II, I would have known then that any excess profits tax was going to be an imperfect instrument. However, in a war emergency, or perhaps in an energy emergency, one is necessary anyway. You must do, if there are these potentials for excessive profits, and that is a factual determination I am not in a position to make, I only read the newspapers, as you gentlemen do, if there is an emergency situation, then the Congress must respond by doing something about it. That was my point.

Senator FANNIN. Yes, and I agree with your point. I did not dispute it at all. I feel that we have announced that we are going to have windfall profits, we are going to have an excess profits tax. I think we should go forward with it. I am in favor of it.

At the same time, I think that we must realize our goal is to try to solve the energy problem, and the only companies that can help us solve that energy problem, or that can do the most—the companies than can do the most—let me word it that way—to solve the energy problem happen to be the oil companies. Now, if we write punitive legislation, and—it was referred to, the legislation that would affect these operations in foreign countries, it could be a disaster and I agree with that.

Now, we also know that the legislation must permit our companies to be competitive in the foreign market. And we have many problems. I happen to have returned last night late from a trip to six of the producing countries of the world, and listen to them talk about why they should have these higher prices. As I stated earlier when we went on this mission, it was a factfinding mission to determine what was happening, what we could find out what could be done about it, to assist us in better writing legislation. After we arrived in Iran and started through Kuwait and Saudi Arabia and Abu Dhabi and Egypt and Algeria, we found that the greatest problem that we faced was convincing these people that even the present prices should hold. And when we talked—just the day before yesterday we talked with the president there, Boumediene. He has based his statements on what the companies were doing and what the other nations were doing in bidding up these prices.

He said, how can you say that the profits are going to be excessive and that is going to affect the profits of these companies, and so that is going to bring all of these reserves to that part of the world, and so it is going to be devastating—he did not use those words, but words to that effect—devastating to the world economy or to the world monetary program. And we had a hard time answering him. We had a hard time answering King Feisal on these questions. When they would say that the price of oil should have risen, we said yes, if it had doubled, but it quadrupled.

Now our problem is to hold it below those points that have now attained, or to push it back, and I think that we must consider all of these factors when we are writing this legislation because our companies must compete on a world market. When you have France going in and making bilateral agreements, and you have Japan paying prices far above what we have been paying to the past, then we must recognize it is a serious situation.

Do you have any suggestions as to what we might do in the way of the consideration, you are so knowledgeable in what is happening as far as the tax provisions on our foreign companies.

Do you foresee any action, or could you recommend any action we might take that would be of assist in that regard?

Mr. COHEN. I indicated in my earlier remarks that I thought serious consideration should be given to curtailing depletion allowances and/or intangible drilling and the investment credit—excuse me, the tax credit, foreign tax credit—because at the moment they are running such excessive credits that the other two will not make any difference unless something is done in the credit area. And Secretary Simon indicated earlier that the Treasury is thinking along those same lines and perhaps would come up with some suggestions.

Senator FANNIN. I think it would be very helpful if we could take some of the steps that are needed to convince the public that every effort is being made consistent with being able to carry through the goal that we have of producing more energy.

I did not mean to keep you so long. You have been very patient, and in speaking for the committee I know that every member wants to thank you for your appearance here and for the valauble information you have given us. As I listen to the testimony now I realize what a real problem we have in writing fair legislation that will not be punitive and damaging to the goal we all have.

Thank you, gentlemen.

[The prepared statement of Mr. Whitehead follows:]

PREPARED STATEMENT OF WILLIAM S. WHITEHEAD, CHAIRMAN, RENEGOTIATION BOARD

Mr. Chairman, members of the committee. My name is William S. Whitehead and I am Chairman of the Renegotiation Board. The distinguished Chairman of this Committee extended an invitation to testify regarding the proposed windfall profits tax provision in connection with the Conference Report which refers to the Energy Emergency Act, and I am happy to accede to his wishes.

The Renegotiation Board's current statutory responsibility is the recapturing, under certain circumstances of excessive profits earned by defense contractors and subcontractors engaged in business with those Government Agencies named in the Renegotiation Act. The Senate Finance Committee and the House Ways and Means Committee exercise legislative oversight over our activities.

The Board was created under the Renegotiation Act of 1951, and has been periodically extended to expire on June 30, 1974.

The First Session of this Congress mandated the undertaking of a study of the renegotiation process through the joint efforts of the Board and the Joint Internal Revenue Taxation Committee. We have cooperated fully with the Committee and Chief of Staff, Dr. Laurence N. Woodworth, and we will be ready to report the Board's position on various points raised in the study within the next six weeks.

In recapturing excessive profits from contractors, the law directs that Regional and Statutory Boards evaluate their performance within the factors set forth in the Act, namely, the efficiency of the contractor or subcontractor with particular regard to attainment of quantity and quality of production, reduction of costs, and economy in the use of materials, facilities, and manpower; and in addition, there shall be taken into consideration the following factors:

1. Reasonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products;
2. The net worth, with particular regard to the amount and source of public and private capital employed;
3. Extent of risk assumed, including the risk incident to reasonable pricing policies;
4. Nature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;
5. Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover;
6. Such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time as adopted.

Let me emphasize, the Board does not employ formulae, percentages or any other such type application in the determination of the amount of excessive profits earned by contractors.

Rather, we evaluate and judge the contractor's performance within the meaning and interpretation of the statutory factors and then determine, with our best judgment, the amount of excessive profits earned, if any.

The Board staff, as presently constituted, has personnel strength of about 200 and we have two regional boards. Under its present workload, the agency appears to be adequately and efficiently staffed, particularly after considerable management streamlining accomplishing during the past six months.

I would like to point out that under the existing Renegotiation law, profits derived from the sales of refined oil and gasoline, by companies to the Department of Defense, the Army, the Navy, and the Air Force and other agencies, are subject to review by the Board. Each seller, with sales of $1,000,000 or more must file with the Board an annual report showing gross renegotiable profits, expenses and net renegotiable income.

Under present conditions, the Board certainly is not equipped with manpower nor facilities to handle the responsibility proposed to it as set forth in Section 110 of the Conference Report.

However, if the Congress directed this great task to the Board, naturally it would assume same, firmly and fairly, but could only do so after it had been provided with a very considerable increase in the number of estimated required personnel and increase in appropriations.

On Saturday last, the President assured the Nation that U.S. oil companies would not be permitted to reap unconscionable profits because of shortages, and urged Congress to enact a windfall profits tax, which he previously had requested. I subscribe wholeheartedly to both of those positions.

In conclusion, Gentlemen, my four Board colleagues and I stand firmly prepared to assist the President and the Congress in doing whatever is necessary and expedient to ease this existing energy crisis within the statutory authority provided the Board.

If there are any questions I might be able to answer, I would be pleased to do so.

Senator FANNIN. The hearing will stand in recess, subject to the call of the Chair.

[Whereupon, at 1:15 p.m., the committee recessed, subject to the call of the Chair.]

APPENDIX

COMMUNICATIONS RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THESE HEARINGS

STATEMENT OF CRANE C. HAUSER, FORMER CHIEF COUNSEL OF IRS

Gentlemen, I have been requested, as a tax practitioner and as a former Chief Counsel of the Internal Revenue Service, to submit my views regarding the proposed "windfall profits tax" pending in Congress.

This is a proposed annual tax of 85 percent of the amount by which the profits of any "energy corporation" from the sale of "energy products" exceed the lesser of (1) a "reasonable profit" as determined by the tax authorities, giving consideration to certain enumerated factors, or (2) the greater of (A) the average profits of sellers of energy products for the years 1967–1971 or (B) the average profits of the taxpayer for the years 1967–1971. A credit is allowed for the ordinary corporate income taxes on such excess profits.

In my view, this proposed statute unhappily combines the vagueness of the Renegotiation Act of 1951 (from which the factors enumerated in determining a "reasonable profit" were derived) with the basic unfairness of a base period income excess profits tax.

One need only consult the Tax Court reports on Renegotiation cases to see that a "reasonable profit" is simply a matter of opinion, regardless of how many underlying factors are enumerated. While it may have been proper to impose such a vague standard as a matter of contract, it is certainly unfair, and perhaps illegal, to enact a tax statute where the measure of the tax is not ascertainable.

The base period income device is also, in my opinion, not an appropriate measuring device. Initially, there are two obvious deficiencies: (1) No allowance is made for the shrinkage in the value of the dollar and (2) no assurance is given that the taxing authorities will regard the base period profits as reasonable.

More importantly, base period profits are rarely any fair measure of excess profits. In the World War II excess profits tax, section 722 of the 1939 Code was enacted to provide relief from base period abnormalities. It was a miserable failure. Recognizing this, Congress, in the Korean War Excess Profits Tax Act, enacted sections 442 through 447 of the 1939 Code to provide a variety of relief provisions in certain situations.

In my experience, little relief was accomplished. The incidence of the tax proved to be arbitrary and unfair.

Basically, I do not believe it is possible to define either "reasonable profits" or "excess profits" fairly. If the "windfall profits tax" should be enacted, I would anticipate an administrative nightmare for the Internal Revenue Service, extended uncertainty for affected taxpayers, and a profound disinclination on the part of "energy producers" to increase their production of "energy products".

COMMENTS OF JAY W. GLASMANN, FORMERLY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

The Senate Finance Committee is considering a legislative proposal to impose a so-called "windfall" profits tax on energy corporations. The Committee has indicated that comments on the proposal should be directed towards the following questions:

1. What problems do you anticipate would arise in the administration of such a "windfall" profits tax, including areas such as development of regulations, rulings and litigation?

2. Based on enactment of such a tax, what kind of advice would you give energy corporations with respect to the planning of their operations, including proposed capital investments for the purpose of expanding their energy reserves and supplies?

In response to the Committee's first question, I believe that the absence of sufficient statutory guidance renders the proposal totally unworkable from the Government's point of view. The technical determination of "windfall" profits is so vague as to render the proposal an administration nightmare.

The tax laws are based on rather specifically defined terms such as "gross income", "adjusted gross income" and "taxable income". Even if the term "windfall" could be adequately defined based on the standards provided in the proposal, the concept of "profits" is totally foreign to the Internal Revenue Code.

As a practical matter, the lack of statutory guidance in determining a reasonable profit under section (b) (1) of the bill might well render such section meaningless. Perhaps it is intended that the working definition of windfall profits be determined solely with reference to the historical standards contained in section (b) (2) of the bill.

Assuming for the moment, however, that adequate definitions could be developed under section (b)(1) of the bill, a significant question would still exist as to the feasibility of determining "the average profit obtained by sellers of energy products" and "the average profit obtained by the particular seller of energy products" during the calendar years 1967 through 1971.

Corporations normally compute their earnings on an overall entity basis. Many of the corporations which would be affected by the proposed windfall profits tax have multiple divisions which produce many different products.

The statutory language in section (b) of the bill appears to limit the application of the tax to sales of energy products. Based on this interpretation, integrated companies and conglomerates would be required to compute their income on a product line basis in order to identify profits from sales of energy products. Furthermore, this would exist not only for the year under consideration but also for the base years 1967 through 1971.

I have significant doubts that an effective product line profit rule could be developed administratively. The Treasury's current experiences with section 861 of the Internal Revenue Code and Proposed Treasury Regulation § 1.861–8 highlight some of the problems of allocating expenses between United States and foreign source income. One need only magnify these problems tenfold to understand the complex allocation problems involved in product line reporting. Furthermore, a company's stake in avoiding an 85 percent tax are so great that all of the traditional cost accounting rules will likely be manipulated by companies seeking to avoid the windfall profits tax.

Even assuming that all of the foregoing problems could be solved administratively through the regulations and rulings process, I doubt that the requisite data could be reconstructed for the years 1967 through 1974. Furthermore, industry-wide data would be required to establish a limitation under section (b)(2)(A) of the bill. By what means would the Government establish and vertify such information for all of the years in question?

In addition to these problems, there are countless other questions involving the definition of such terms in the bill as "energy corporation", "extent of risk assumed", "efficiency and productivity", "fair and equitable dealing", etc. I sincerely doubt whether the Internal Revenue Service has the manpower to devote its full attention to resolving these problems administratively.

In response to the Committee's second question, I would advise any clients who would be affected by this proposal to litigate its validity. The vagueness of its scope certainly raises questions in my mind concerning the constitutionality of the statute. Even assuming that the legality of the statute were upheld, I would strongly encourage clients to obtain expert accounting and legal advice in order to reduce windfall profits to the maximum extent permitted by law. Furthermore, I would discourage any potential entrants into the energy field from embarking on any large scale ventures and would counsel existing companies to postpone expansion until the tax climate improved substantially.

In conclusion, I think that the enactment of this bill would prove counterproductive to ameliorating the energy crisis which presently faces the United States and the world.

SYOSSET, NEW YORK,
January 22, 1974.

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

DEAR SENATOR LONG: After several months of research, I have carefully prepared this tax reform proposal.

With respect to consideration of a "windfall tax", the United States could be on the verge of making a serious error in its handling of the energy crisis. If oil profits are permitted to be accumulated in a tax free reserve over and above a 15% profit margin and as long as they are 100% dedicated to the search for additional oil reserves, both the United States Government and its citizens will be the primary beneficiaries.

However, I do believe that the oil industry will consider an increase in taxes. I have outlined in this proposed tax reform, the elimination of the 22% oil depletion allowance and in its place, the allowance of a 20% investment credit on all newly discovered oil and gas producing wells. In this way your committee would perform a twofold service to the people of the United States by pointing out that oil revenues will be subject to the same taxable rates as

corporate income and that sufficient reserves will be encouraged by investment credits to seek new oil and gas producing wells on a continuing basis.

Please give this your most serious consideration.

Sincerely yours,

LEO J. BENJAMIN.

P.S.: The substitution of a 20% investment credit, "plow back incentive" as replacement for the 22% oil depletion allowance would accomplish the two things the country wants most—incentive for more oil and gas and a fair taxation of oil and gas revenues.

A COMMONSENSE APPROACH TO TAX REFORM

(By Leo J. Benjamin)

SUMMARY OF FEATURES

1. Allow tax incentives for specific expenditures related to the accomplishment of defined national economic and social goals.
2. Establish a minimum income tax rate of 36% for all income over the 36% tax table rate, below which allowable deductions would not apply.
3. Establish a flat 36% tax rate for corporate income and for all preference income, that is, income up until now not subject to the ordinary income tax.
4. Establish a flat 36% tax rate for long term capital gain.
5. Establish a one-year holding period to qualify as a long term capital gain asset.
6. Continue the maximum tax rate of 50% for earned income and a maximum tax rate of 70% for passive income.
7. Continue estates taxes as is but require inherited assets to carry the same cost basis and holding period as that of the deceased.
8. Allow private homeowners straight line depreciation on their owned homes. Allow accelerated depreciation as incentives for only low and medium income government sponsored housing.
9. Allow a tuition aid credit of $750 per student attending non-government, private education facilities be it either private grammar, private high school or a private college regardless of faith, creed or color.
10. Require certified accounting and audit of all public tax incentive limited partnerships tax returns. Remove all allowable tax incentive deductions as "exceptions" to the I.R.S. code and make them instead government spending as line items of expenditure under the Bureau of the Budget.
11. Allow tax deferral write-offs against earned income as long as they result in higher taxable rates of passive ordinary income in subsequent years of the limited partnership. Deferred earned income should be taxable as passive ordinary income at the end of more than one complete calendar year.
12. Eliminate the 22% oil depletion allowance and in its place allow a 20% tax investment credit for all new producing wells.
13. Continue deductions for intangible drilling costs for all wells drilled regardless of whether they are exploratory or development, producing or dry.
14. Taxpayers with gross incomes of less than $24,000 a year should have their personal exemption of $750 increased to $1,000 to make net after tax dollars saved equivalent to that of higher tax bracket taxpayers.
15. Charitable deductions should be allowed all taxpayers to the extent charitable contributions aggregately exceed 3% of net taxable income. This means that 3% of net taxable income should automatically be allowed for I.R.S. recognized charitable donations.
16. Corporations and other employers should be disallowed tax deductions for contributions to retirement trusts whenever it is found that:
    (a) employees do not receive vesting rights after three years employment.
    (b) employees do not get the right of portability to transfer their benefits from one company's retirement trust to another company's retirement trust.
17. All employees, regardless of their company's organizational tax status and regardless of who makes the contribution, the employer or the employee, should have the right to set aside 15% of annual earned income into a qualified retirement trust. Qualified retirement trusts should be established separate and distinct from their corporate counterparts to avoid conflicts of interest and invasions of principal by contributing corporations in the form of corporate borrowings.

18. All taxable income of less than the 36% tax table rate should be taxed at the existing current rates which appear on Schedules X, Y and Z of the Federal tax returns.

A Federal tax system which encourages reasonable incentives to invest in the development of vital resources—reflects common sense. A Federal tax system that makes every effort to eliminate preferential tax deductions for non-essential expenditures—that is tax reform. It is essential for our tax revenue code as well as our Federal expenditure system to have as its primary standard—the ultimate benefit of all the people—especially hard working people striving to stay off welfare; striving to achieve success by improving their talents; hoping to acquire enough equity in their working lifetime so that they may be able to retire with dignity . . . and hoping that in their retirement, failing health and medical care will not leave them penniless, dependent, wards of the State.

To strike a common sense approach to what is considered fair in the way of income taxes as opposed to what is worthwhile in terms of tax incentives, the people of the United States as well as their Congress should have an honest and accurate accounting of the national economic and social benefits to be achieved. On the one hand, there is the benefit of increased revenues to the Federal Government; but on the other hand, there is the need to prevent critical shortages of vital national resources which every American must have to maintain an acceptable level of living.

The economic history of the United States demonstrates beyond the shadow of a doubt that the American consumer motivated by the incentive to accumulate capital and with net after tax income has consistently accounted for 66% of the total gross national product of the United States. Government spending by all political subdivisions, conversely, has contributed consistently to about 33% of the nation's gross national product. It would be a betrayal of the American way of life to change our tax system in a way which would adversely upset our country's sensitive proportionate contributions to its economic growth. By frustrating the incentive of the American consumer, the equivalent of 66% of our economic growth potential could be frustrated.

Those who subscribe to the concept that our tax revenue system must work for the ultimate benefit of the government and not for the people are dead wrong. This is a government of our people and for our people—not the other way around.

PRIVATE INVESTMENT ESSENTIAL TO PROVIDING VITAL RESOURCES

Industry statistics demonstrate that over the past several years, more than 37% of all capital invested in cattle feeding operations resulted from private investors[1] . . . more than 40% of all capital invested in domestic oil and gas well drilling came from private investors and more than 50% of all capital invested in low and medium income real estate was invested by individual citizens. To discourage such investments by the disallowance of their tax deductions would be paramount to depriving American Citizens of an adequate supply of table meat, heating fuel and living quarters. This would be mass social and economic disaster as it would deprive the working citizen of resources necessary to preserving everyday "taken-for-granted" living standards.

Agricultural resources, energy resources, industrial resources, scientific and medical resources, environmental resources, shelter resources, educational facilities, employment and welfare resources, and capital formation resources, are, to name a few, some of America's vital resources that are worthy of tax incentive investments. Without an adequate supply of these essential resources, the people of the United States will be faced with a further meteoric price rise in the cost of living.

In the short two hundred year history of our nation, the Federal government has not been able to provide taxpayers these resources at a smaller cost than what enterprising Americans with incentives have been able to achieve by themselves, for themselves and for their fellow working man through the incentives of private investments.

Tax reform, therefore, should address itself to the elimination of preferential treatment for investments in non-essential resources . . . a few examples may include write-offs for pornographic movies, corporate toys and so-called business

[1] In 1972 it was reported that 90% of all cattle on feed in the state of Arizona was owned by tax oriented investors and that industry wide between 40% and 50% of all cattle were owned by tax incentive investors.

vacation trips. There are a multitude of other activities not deserving of tax

write-offs. Therefore, the need is great to spell out and define those activities which do contribute to the accomplishment of vital national economic and social goals and those activities which do not. To do this requires a full accounting and an honest evaluation of results. It also requires *faith* in the American way—*belief* in the average American's desire to succeed and it requires *trust* in every citizen's wish to make our free enterprise system work for the benefit of all. And it also requires a convenient, reliable way to qualify tax incentive Government expenditures through IRS controls over allowable tax deductions. What this means simply is that worthwhile tax incentives should be removed from the classification of being an exception to the normal revenue code and instead, inserted as line items of expenditure under the control of the Bureau of the Budget.

A MINIMUM TAX RATE IS JUSTIFIED

To provide horizontal as well as vertical equity to our tax system, there is also the need to establish a minimum income rate. No person however wealthy, no matter how worthy the investment, no matter how vital the goal, should avoid the payment of a minimum income tax. There is therefore, the need to establish a minimum income tax rate below which recognized tax deductions would not apply. This minimum tax rate should not be so high as to remove or to frustrate the taxpayer's incentive to invest in desired national economic and social goals. Since the Federal Government contributes at least 33% to the gross national product, a minimum tax rate of 36% is surely reasonable to provide the Government with necessary revenues for expenditures. For this reason, the 36% minimum tax rate which now appears on I.R.S. schedules X, Y and Z should be applied to all gross income regardless of exemptions, deductions and exclusions from items of tax preference.

TREATMENT OF EXCLUSIONS

Non-taxable forms of income should be reported on Federal tax returns. Recipients of welfare income should also report welfare payments on federal tax returns. If a working man with the same family conditions as a welfare man earns the same amount in taxable income as the welfare recipient receives in tax free benefits, then one should not be taxed while the other remains tax exempt. The American people, the Congress and the Treasury Department should be able to control and to evaluate the need for and the cost of the beneficial effects of non-taxable forms of income.

Since income from exclusions are tax preference items, the minimum preference income tax rate of 10% should be increased to 36%. In addition, because in some individual cases, tax preference income may be the sole source of income, a minimum tax rate on preference income of 36% is not only reasonable and fair but equitable to all lower income taxpayers. Moreover, it would be fair to other taxpayers to reduce tax preference income personal deductions from $15,000 per individual to $750 per individual. Tax exempt bonds, the untaxed half of capital gains, the difference between accelerated depreciation and straight line depreciation (on capital goods and equipment as well as on real property), partially exempt income from oil, gas minerals, etc., as well as excluded income of U.S. citizens residing abroad—should all be listed on Federal tax returns as income exclusions subject to a minimum 36% tax preference income tax rate. To preserve fairness of treatment, corporate income reduced by deductions should also be subject to a minimum 36% tax rate.

SIMPLICITY IS THE ESSENCE OF PERFECTION

By establishing one simple minimum tax rate of 36% below which deductions do not apply all income will be covered and it will not be necessary to eliminate all the good sense we now have in our tax revenue code.

But what is income? Distinction should be made between assets, principal and equity as opposed to the yield, income and return which is generated by assets. principal and equity. A man who has built up a plumbing supply business over a life time of work and who sells his business in order to retire—is this the same as income? A family that has held on to securities for years as part of the principal of a portfolio designed to provide for their retirement—is this the same as income? A mother and father selling their home because their children are now married—is this to be treated as income?

WHAT IS INCOME?

What should be taxed as income? What are assets, principal and equity? How should they be treated for tax purposes in a just and equitable manner?

ESTABLISH A ONE YEAR TIME PERIOD

Since an income tax return is based upon an annual event, it is reasonable to say that anything which within the time period of one year produces a cash return in excess of cost—that is income. A business created and sold within one year with a cash return in excess of its cost may then be considered as having created taxable income. The profit on the sale of a home purchased and sold within a twelve month period should be taxable as income.

WHAT IS CAPITAL GAIN

Beyond a holding period of one year the event becomes one of capital formation and this is desirable. The profitable disposition of assets, principal and equity held for more than one year is deserving of preferential treatment. One year is a reasonable holding period to qualify as long term capital gain. There is no need for complicated sliding scales.

For consistency, for fairness, long term capital gains should also be taxed at the minimum set rate of 36%.

If for incentive purposes, a taxpayer may wish to elect the normal method of adding one-half the capital gain to earned income and treating the remaining one-half of the capital gain as preference income, then two standards should apply:

1. First, taxable earned income combined with ordinary income should not be reduced by allowable deductions lower than the 36% rate.
2. Secondly, the remaining preference income, after allowing for an individual deduction of $750, should be taxed at a rate not less than 36%.

In this manner, a family who has decided to sell their corner hardware store, their home and their portfolio of securities in order to retire would not find themselves in the unfair and untenable position of paying an extreme income tax on assets of a life time of family accumulation.

Estate Taxes should be sufficient revenues to the Government without burdening the taxpayer with an additional artificial capital gain tax on assets inherited from the dead. However, to be fair to the Federal Government, which estate taxes should be based upon date of death values, the transferred cost prices to beneficiaries as well as transferred holding periods should be the same as those originally of the deceased.

It's unethical on the part of the Federal Government to impose both an Estate tax as well as an artificial capital gain tax on assets inherited by beneficiaries. It is fair however to continue the same estate tax rates as we now have and to allow the beneficiary to pick up the same holding period and the original cost basis of that of the deceased. With this one exception, existing revenue codes which apply to the determination of cost basis should be continued.

DEPRECIATION DEDUCTIONS

Straight line depreciation should be imposed upon all forms of real property except for forms of real property worthy of tax incentive. For example, low and medium income Government subsidized housing should continue the accelerated method of depreciation.

In addition, since private homeowners are faced with stiff real estate taxes by their local governments to support schools and local government services, some relief to homeowners is long overdue. In order to help defray the costs of local public education and to avoid unfair discrimination, the Federal Government should also allow private homeowners a straight line depreciation of the homes they own.

EDUCATIONAL ALLOWANCE

A minimal tuition aid credit of $750 per student should also be allowed every parent for each student attending either a private grammar, a private high school or a private college regardless of faith, creed or color. Discriminating practices against schools because of race, *creed* or color is the antithesis of our Democratic process.

TREATMENT OF TAX INCENTIVES

All tax incentive limited partnerships should be ruled upon and assigned tax identification numbers by the IRS. All expenditures by limited partnerships which result in tax deductions should be qualified by the IRS. All public limited partnerships for worthwhile incentives should be audited and shown as a line item of expenditure in the Federal Budget.

Tax deferral deductions which generate losses against earned income in excess of 100% of cash invested in year one but which generate taxable income in excess of 100% of cash returned in subsequent years should be continued for equipment leasing, cattle breeding and cattle feeding operations. Deductions of expenses should be allowed only when they are essential and legitimate to the accomplishment of such tax incentive activities. Tax deferral deductions in effect should change earned income into passive income. After earned income has been deferred more than one year then it should become passive and subject to the passive tax table rates which are taxed up to the maximum rate of 70%. The maximum 50% rate for earned income should remain as is. Allowable write-offs, however, should never reduce taxable income below the 36% rate within any given year.

Oil And Gas Deductions should be allowed to encourage private investments in both exploratory and development drilling. In view of their high economic risks and because oil and gas resources are in acute short supply, intangible drilling costs, and other non-recoverable costs associated with putting oil and gas wells down should be allowed for both exploratory and development drilling. However, to encourage exploratory drilling as well as explorations for new forms of other energy resources, a tax investment credit of up to 20% should be allowed for all new producing wells. In fact, tax investment credits of up to 20% for new producing wells should be allowed and the 22% oil depletion allowance dropped.

RELIEF TO TAXPAYERS IN LESS THAN THE 36 PERCENT TAX RATE

The great majority of Americans earn less than $24,000 a year. In view of the cost of living, personal deductions for taxpayers earning less than $24,000 a year should be increased from $750 to $1,000. This would be fair since the present $750 deduction results in $375 dollars saved to the 50% taxpayer but only $270 dollars saved to the 36% taxpayer. A $1,000 deduction, however, would have at least $360 dollars to taxpayers earning $24,000 or less which would better balance the $375 dollars saved by the $750 personal deduction to the 50% and higher taxpayer.

ITEMIZED DEDUCTIONS

Taxpayers earning less than $24,000 should have the alternative of either listing all deductions or taking advantage of a 15% standard deduction. Taxpayers earning more than $24,000 should be able to list deductions or take advantage of a 10% standard deduction.

Charitable Deductions should be allowed all taxpayers who elect to itemize deductions only when such charitable deductions are at least 3% of net earned income.

RETIREMENT BENEFITS

Any corporation, any union, any organization which does not allow full vesting of retirement benefits to recipients after a maximum three full year period of employment should not be allowed to deduct corporate contributions and in fact should be taxed on contributions to pension plans when it can be proved that such contributions were never paid out or fully vested to participants. Full vesting after three years with portability rights for workers so pension benefits may be transferred from one retirement trust to another retirement trust must be introduced and provided all workers as being the single most important retirement resource our country can encourage. Retirement contributions by employers per year per individual of 15% of annual earned income should be tax exempt until retirement distributions are made.

CONCLUSION

There is much that is good with our present tax revenue system. Our system of taxation improves every year by virtue of experience based upon fact not theory. Many worthwhile decisions have been arrived at by careful consideration of our tax courts. Simplification and justification of the code is desirable. How-

ever, a new internal revenue system that completely eliminates the old would be disastrous if in the introduction of a new code of taxation all the practical sense of the past were lost. It would be a great tragedy if a new code of taxation meant that all incentive as well as our free enterprise system were to be cast to the four winds.

Let us first improve upon what we have. The United States of America has had an unbeatable economic record with our present system of taxation. It is not perfect by any means but it is good enough to warrant a face lift.

Why Tax Shelters Should Be Preserved and Improved

(By Leo J. Benjamin)

If there is one word for the unrelenting efforts of the many patriots who have made America's history honorable and great during its 200 year life . . . if there is one word which accounts for the industry of America's countrymen working side by side to carve out for all times the most unprecedented record of economic growth and development for any nation during any 200 year period in this world's history . . . if there is one word which best explains the reasons why America's hard working people have expanded their reach from the early wilderness of the backwoods country to the modern wilderness of lunar space . . . that word is incentive.

Let us never enact a law, nor create a social climate, nor implement a political school of thought that would rob America of this—its greatest resource—the incentive of its people to want to succeed, to better their lives, to continue making this the greatest country on earth.

Incentive, therefore, is a great power and for this reason should be used wisely. Industries were built, educations financed, technologies advanced and medical cures found—all through the power of incentive.

Tax Incentives are those deductions created by the Congress to encourage taxpayers either to invest or to set aside funds for the accomplishment of a particular national economic or social good. In 1969, the Congress amended the methods by which incentives could be applied for tax purposes. These amendments were proposed only after due deliberation of their tax consequences. Now only four short years later, tax incenitves are once again under the fire of half-truths—victimized by political talks that have appended unfounded labels to them—magnified to unpopularity through the mass media which in turn has resulted in mass misunderstanding.

The application of incentives to tax considerations is a subject of deep concern and importance to the nation as a whole and the complexity of the subject deserves much more than shallowness of political infighting. For the taxpayer, for the members of Congress, for the good of the country as a whole, tax incentives deserve nothing less than a thorough study in depth conducted by a task force of experts who are most knowledgeable in the major areas and the purposes for which incentives were created in the first place.

Today, America is faced wtih challenges to maintain peace and prosperity at home. These challenges demand of our Government and of our people restraint in our actions, thoroughness in our thinking, and most of all, the incentive to succeed. Those who cry "tax incentives favor only the rich" . . . those who cry "tax incentives rob our nation of needed tax revenues" are victims of misunderstanding permeated by means of mass media because nothing could be further from the truth. All that one need do is to consult their hometown newspapers. I quote from the Saturday, January 13, 1973 issues of Newsday:

"The nation's natural gas shortage, which hastened the national fuel oil shortage, is now threatening Long Island with a possible shortage of 1,000 jobs and 300,000 cakes a day" . . . bakeries have been forced to shut down due to the rationing of gas deliveries."

Over the radio on February 1, 1973, the New York City Housing Administration announced a reduction in heat to more than 60% of city housing units in order to preserve fuel . . . they found it more prudent to favor discomfort rather than risk the subsequent loss of health that could be caused by a total lack of fuel.

It is obvious, therefore, that increasing tax revenues by digging down into the barrel of tax incentives is certainly not the answer. The Tax Reform Act of 1969 in reducing the allowable depletion allowance from 27½% to 22% deprived the oil and gas industry of $600 million dollars annually . . . $600 million dollars to invest . . . which could otherwise have gone into financing the extremely

high costs incurred in the search for oil and gas . . . and it is no coincidence that ever since then, 1969, the annual consumption of oil and gas in America has far exceeded the annual discoveries of new oil and gas reserves.

Because 80% of our nation's total output of all forms of energy is expected to remain dependent upon oil and gas discoveries, tax incentives are indeed necessary not only to encourage the search for new reserves but even more important, to fund the research necessary to develop new forms of fuel for energy. The need is great . . . the time is now—all that remains in this country today is: 13 years estimated reserve of gas: 8 years estimated reserve oil.

The following quotation is taken from a recent prospectus of Energy Ventures, Inc., a company formed for the benefit of the Columbia Gas Systems, Inc. to search for new gas discoveries:

"Demand for energy in the United States is growing faster than visible supply. The imbalance has become further accentuated by attention to environmental concerns, and the resulting limitations on the use of fuels contributing to pollution. Conversely, the demand for non-polluting fuels, natural gas in particular, has increased. The developing shortage of natural gas is preventing major gas pipeline companies and distributors from satisfying service requests from present and potential customers, and has led to a curtailment of service to a number of metropolitan areas by several gas pipeline companies.

The Federal Power Commission ("FPC") staff forecasted that the future development of U.S. gas supplies, both conventional and supplemental, will be inadequate to meet projected demand, and more specifically that:

*An annual natural gas supply deficit will exist of approximately 9 trillion cubic feet by 1980 and 17 trillion cubic feet by 1990.

*Proven gas reserves in the contiguous U.S. will decline from 259.6 trillion cubic feet in 1970 to 170.4 trillion cubic feet by 1990.

*Imported gas and other supplemental supplies, including synthetic natural gas ("SNG") will account for 40% of consumption by 1990".

If by tax incentive we may increase our nation's supply of energy; provide a greater supply of food for consumption; accelerate medical cures; sustain a non-inflated growth of our economical output: create the means by which needy citizens may avail themselves of employment, shelter, medical care, and welfare; . . . if through the prudent application of incentives we may strengthen the dollar; alleviate our nation's deficit in our international balance of trade; improve the quality as well as the availability of education for all; encourage citizens to accept their obligation to serve as jurors . . . America will indeed continue to be the greatest nation on earth. However, we must have faith in the people, in the power of capital formation and in the force provided by tax incentive investments which secure for the Government and for the nation, the necessary means to achieve vital economic and social goals.

No government has ever been able to achieve for its people through bureaucratic means major social developments, important environmental benefits, even essential economic goals is a shorter period of time, at a lesser cost and with greater efficiency than what people with incentive in the performance of their own expertise have been able to do as individuals for themselves and for their country. It is in the power of its people that a government can derive its greatest strength to do the greatest good.

Headline from Sunday News, February 11, 1973:

"BUREAUCRATIC CHOCKING IN ATTEMPTS AT CONTROL

Medicaid has become an unmanageable monster in New York City, consuming billions of tax dollars while failing to keep its promise of an effective system of responsible health care for the poor."

What The House Ways and Means Committee should do is to seek a fair statement of standards with which to measure and justify the reasons why a particular tax incentive vehicle should be allowed. Carefully spelled out standards can be set down to substantiate the legitimacy of the taxpayer's expenses which comprise tax deduction. Rather than examine the amount of tax dollars which may be recovered through the discontinuance of logical deductions, the House Ways and Means Committee should examine each tax shelter vehicle individually in terms of its need to exist. Therefore, the committee should define those specific areas which serve our nation's greater needs.

Let us, indeed, legislate, monitor and structure guidelines for tax incentives to help solve, for example:

1. The nation's need to export, to repatriate U.S. dollars, to overcome its weak international monetary exchange, to alleviate and prevent deficits in the United

States' international balance of payments . . . in other words to strengthen the value of the dollar abroad and its purchasing power at home.

2. The nation's need to diversify and to increase its available sources of fuel and energy.

3. The nation's need to get out from under the business of providing welfare by creating incentives to educate, train and employ the unemployable, to construct housing based upon sound financial terms, and to provide for the continuance of justice in offering tax allowances to alleviate the inconvenience of those who serve as jurors.

4. The nation's need to provide an ample supply of beef, produce, grain and other food products at prices consumers can afford.

5. The nation's need to provide medical care and hospitalization at prices the sick and old can afford and with the patients' freedom to choose their own physicians.

6. The nation's need to increase its real productivity, to eliminate feather bedding, to replace obsolete plant and equipment, to increase employment rolls and through incentives to encourage a hard day's work for a hard day's pay so as to halt runaway inafition, and finally:

7. The nation's need to expand its tax revenue base.

The nation's need for its citizens to be stronger in body, mind and in spirit—to work and to accomplish—this is where tax incentive hearings should begin—with the goals to be achieved—with an examination of its purpose—with the need for the tax incentive to exist and not with the tax dollars to be retrieved by its omission. If we are getting our money's worth with tax incentives, the tax dollars are not lost but spent well!

The House Ways and Means Committee should begin by seeking expert advice to define a specific list of standards designed to achieve long and short range objectives for our country. Examine each social area, each economic activity in terms of why each is necessary for the people, for the nation. If you start from the real beginning, the House Ways and Means Committee can find ample room for reform.

Reform is required where the existence of either a tax shelter or its deductions cannot be justified. Why, for example, should the government permit tax incentives for non-vital economic or social activities or purposes such as "corporate toys," pornographic movies, or other non-essential luxuries? The questions to ask, therefore, are which incentives are most worthwhile and which are not. Does the tax incentive serve a useful economic goal or national social good. Will it help get people off welfare, find jobs, improve employable skills, provide food, shelter and health care? Does the tax incentive ultimately cause an actual increase in tax revenues by assisting capital formations to be invested in ventures which do create additional jobs or which subsequently increases the taxpayer's taxable base to a higher rate when applied later? Does the tax incentive perform a required function or essential service cheaper and more efficiently than what would have been achieved through an increase in government spending?

With these thoughts in mind it should be obvious that instead of frustrating the development of tax incentive investments, the Congress indeed should encourage their perfection.

CAPITAL GAIN—WHY IT SHOULD BE TREATED AS AN INCENTIVE

The United States may yet fall victim to the power of those few who have taken it upon themselves the dedication to remove from America its greatest moving force—the incentive to succeed—the incentive of every individual to go out and invest—to create greater wealth and thereby well being, not only for themselves, but for their fellow citizens as well. In its place, those who favor the removal of individual incentive instead favor the enrichment of government tax revenues by virtue of a logic which believes the government can perform for its people better than the people can perform for themselves.

Capital formation has always depended upon the incentive of achieving an economic gain even in the face of possibly risking a greater economic loss. Let us remember the balance of the scale has never really been level nor even on the side of the entrepreneur. Whereas capital gains have been taxed at 25% or more, taxable income was never permitted to be reduced 25% or more by any loss remaining as a result of capital investment.

Now the proposal on the part of a few in government is to remove the incentive from capital formation—to treat long term capital gain as if it were ordinary income which in effect removes the balance and the scale altogether.

If capital gain is to be treated taxable as ordinary income, then it would only be fair to treat capital loss as an outright deduction against ordinary income. In any given venture, the possibility of realizing a profit has been and will be the primary incentive for capital formation. Capital formation, in the United States, has been the necessary traditional embryonic force from which industries have been founded, companies underwritten and jobs created.

Capital formation for economic endeavors rather than government spending for bureaucratic services is the moving force behind the gross national output of the United States. Remove the incentive to invest, to search for the ultimate profit potential and you will effectively remove one of the primary incentives which create and expand the nation's tax base. By removing the incentive associated with achieving long term capital gain, the ultimate effect may be to discourage capital formation as well as to discourage further expansion of the nation's taxable base. For this reason alone, government officials should move with extreme restraint before it removes the capital gain tax incentive to invest capital at home.

Unfavorable treatment of capital formation at home may encourage the outflow of capital to investment opportunities abroad where favorable tax treatments encourage capital formations. It is highly ironical why the United States should be so anti-capitalistic to capital formation efforts at home especially at a time when the outflow of capital has resulted in a 6.7 billion trade deficit this year and a further devaluation of the dollar. At a time when capital formation should be encouraged at home, it is being discouraged at home. Favorable tax treatment of capital gain allows for a certain stability of investment so necessary to the first few years of newly underwritten companies. Even for the established corporate giants, capital gain incentive is also vital to the success of their secondary offerings. Favorable tax treatment of capital formation efforts is necessary for the creation of some permanence of investment during the formative periods of new industrial growth. It doesn't seem logical for this nation to aggravate its industrial growth by encouraging the flow of its investment capital to foreign tax havens.

LET US RETAIN THE INCENTIVE TO SUCCEED

From the very moment of birth in this country to the last moment of life's breath, each of us is endowed with certain inalienable birthrights of freedom which create the environment and permit the climate for us to seek the gainful employment of our physical skills as well as the beneficial development of our intellectual talents. America has always believed in this and is great because of this and America has consistently held out to its citizens as incentives the honor, recognition, compensation and respect as just rewards for getting ahead. Specifically the incentive to succeed is what has caused our fellow countrymen to make America the greatest country that it is.

[Telegram]

HON. LLOYD BENTSEN,
Senate, Washington, D.C.

We share your concern over the steel shortage besetting oil and gas producers as a consequence of phase IV. We represent an independent oil operator who has recently completed a Devonian discovery well capable of producting 400 barrels per day. The wells necessary to develop this discovery cannot be drilled because of lack of casing.

Not only steel manufacturers but suppliers as well have been forced by phase IV to curtail deliveries. The following is an official announcement prepared by another of our clients, L. B. Foster Co., a major supplier of oil and gas casing, distribution and gathering pipe, as well as water well and irrigation pipe, to be given to all customers as the basis for its inability to accept new orders for delivery in 1973.

The L. B. Foster Co. follows a policy of phase IV compliance giving rise to the current situation. Abnormally high order entry through October forces us to suspend acceptance of any new orders for shipment in November and December of 1973. This will not only enable us to achieve compliance with phase IV controls, but to maintain as well a balanced working inventory in conjunction with new material arriving in the coming period. We will thus have a broad assortment of material to resume shipment at a normal rate in the first quarter.

The L. B. Foster Co. took the step reflected in the announcement only with great reluctance and after careful review of the various courses of action open to it under the regulations. In view of the energy crisis so graphically detailed by the President two weeks ago, Foster's distress in being forced to take this

step has deepened. Its inventories are substantial. Its Houston Division which serves the south and southwest has in inventory or will receive in time for delivery before the first of January 1,653,000 feet of oilwell casing 21,400 tons of oil and gas gathering and distribution pipe and 4,500 tons of water well casing and irrigation pipe, and the divisions serving the other sections of the country also have substantial inventories.

With the situation as it is in the energy and agricultural sectors of our economy it is very important to remove any barriers to further deliveries of goods essential to meet those situations. The L. B. Foster Co. recognizes the seriousness of the energy and agricultural crises and would resume the acceptance of new orders and the making of deliveries immediately upon an an mendment of the price regulations or the issuance of an order effectively protecting it from liability under the economic stabilization act, and specifically for any overage under the gross margin and the net margin limits, arising directly or indirectly out of the making of such deliveries. On Friday, November 16, Foster filed an exemption request with the Cost of Living Council in Washington seeking such relief, and an exception request seeking similar relief was filed Monday with the Internal Revenue Service district director in Pittsburgh. It is hoped that favorable action on either or both of these requests will be taken promptly.

ROBERT H. PARSLEY,
MILTON PORTER, *President.*
C. R. LADEN, Jr., *Vice President.*

HODGSON, RUSS, ANDREWS, WOODS & GOODYEAR,
Buffalo, N.Y., January 21, 1974.

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

DEAR SENATOR LONG: Thank you for inviting me to appear and comment on the proposed windfall profits tax on the profits of energy corporations. I am sorry that my schedule does not permit me to appear personally or to study the proposal more thoroughly. I have discussed with Jerome Kurtz his statement which he plans to make before the Committee and I concur fully with his views.

It is my view that the definition of income subject to windfall profits leaves so much latitude to regulations by the Executive branch that there is no legislative standard whatsoever. What is a reasonable profit subject to taxation should not be left to the determination of administrative officials. The standards set forth in the proposed legislation are so broad that they are, in effect, a complete delegation of legislative authority to the Internal Revenue Service. I recall that in 1961 when it was proposed to delegate authority to the President to raise or lower tax rates temporarily within fixed standards and subject to congressional veto, the idea was ridiculed as an unwise delegation by Congress of its power to tax. The proposed legislation goes far beyond the 1961 proposal in delegation.

The many ambiguities, administrative difficulties, and inequities which would arise in determining standards of reasonable profit, the profits of particular sellers of energy products from their energy related business and the like are so obvious that no one with any experience in the administration of tax laws could recommend such legislation. As I understand the definition of an energy corporation, it is so broad that it could include the corner gasoline station operator. To subject businesses to tax provisions so complex is needless.

It has been pointed out that there are many serious problems in basing any tax legislation on profits of energy corporation. "Profits" is a new undefined term for tax purposes. If "profits" refers to taxable income, it would be much sounder to deal with those fundamental deductions for percentage depletion and intangible drilling costs which keep the taxable income of energy corporations low. An 85% marginal tax on windfall profits will lead to many uneconomic practices and expenditures simply to reduce income subject to tax. It would be far more appropriate to apply the regular corporate tax rate to a concept of taxable income analagous to that of manufacturing corporations. The effect in reducing windfalls to energy corporations would be the same without the necessity for the unwarranted administrative delegations of the proposed legislation.

Sincerely,

DONALD O. LUBICK.

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