SMALL BUSINESS TAX REFORM

JOINT HEARINGS

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS

AND THE

SUBCOMMITTEE ON FINANCIAL MARKETS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

FIRST SESSION

ON

STUDY OF THE BUSINESS TAX STRUCTURE AS IT AFFECTS SMALL BUSINESS

PART 2

SEPTEMBER 23, 24, 25, AND NOVEMBER 18, 1975

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CONTENTS

Statement of Senators— Page

Bentsen, Hon. Lloyd, a U.S. Senator from the State of Texas 709, 906, 1137, 1388

McIntyre, Hon. Thomas J., a U.S. Senator from the State of New Hampshire 711

Nelson, Hon. Gaylord, a U.S. Senator from the State of Wisconsin 707, 904, 1137, 1384

Appearance of—

Amdur, Martin B., of Weil, Gotshal & Manges of New York City, and counsel to the National Retail Merchants Association 1232

Asbill, Mac, Jr., attorney and former chairman, Tax Section, American Bar Association 1444

Barnes, David, CPA, Coopers and Lybrand, chairman, Tax and Government Regulation Committee, Council on Smaller Enterprises, Cleveland, Ohio 750, 908

Barth, William D., director of Small Business Worldwide Organization of Arthur Andersen and Co 908

Bixler, Roland M., president, J.B.T. Instruments, Inc., chairman, Small Business Tax Policy Task Force, National Association of Manufacturers 750

Covey, Richard B., attorney, Carter, Ledyard and Milburn, and special counsel to the Trust Division of the American Bankers Association 1247, 1378

Davis, John C., III, president, Davis Brothers, Inc., and a wholesaler, Denver, Colo 1247

Eisner, Robert, chairman, Department of Economics, Northwestern University 1105

Fairbanks, Frank B., Jr., vice-chairman of the Government Relations Committee, Smaller Manufacturers Council, Pittsburgh, Pa 908

Fielding, Bruce G., CPA, secretary, Board of Directors, National Federation of Independent Business, and member, Commission on Federal Paperwork 1138

French, Verrick O., vice president for governmental affairs, National Retail Merchants Association 1232

Goldstein, Hon. William M., Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury, accompanied by Seymour Fiekowsky, Associate Director of Business Taxation, Office of Tax Analysis, Treasury Department; and Charles Temkin, Legislative Counsel, Treasury Department 1390

Haldeman, Donald R., dairy farmer, and president, Wisconsin State Farm Bureau 1247

How, Jared, publisher, The Free Press, Mankato, Minn 1247

Jones, Jerry T., president, Sonicraft Corp.; chairman, Board of Directors, National Association of Black Manufacturers 750

Mauer, Bruno, businessman and president, Independent Business Association of Wisconsin, Milwaukee, Wis 908

McCamant, William C., executive vice president, National Association of Wholesaler-Distributors 1229

McDonald, Charles, chairman, Federal Legislative Committee, Council of Smaller Enterprises of Cleveland 908

Mendelsohn, Murray, merchant, and member, Independent Stores Board, National Retail Merchants Association 1232

Okun, Arthur M., senior fellow, Brookings Institution 719

Pendergast, Edward, past president, Smaller Business Association of New England 908

Page

Penick, William, chairman, Federal Tax Division, American Institute of Certified Public Accountants 1500
Rau, Charles W., director of taxation, Allis Chalmers Corp., chairman, Taxation Committee, Wisconsin State Chamber of Commerce. 750
Schotland, Roy A., professor of law, Georgetown University 737
Shemo, Michael A., CPA, Schultz, Krahe, Martin, and Long 908
Sherman, Gerald, attorney, Silverstein and Mullens, and general counsel, Association for Advanced Life Underwriting 1247
Sinai, Dr. Allen, director of financial economics, Data Resources, Inc., and visiting associate professor of economics and finance, Massachusetts Institute of Technology 1460
Stafford, Dr. Frank P., Special Assistant for Economic Affairs, Office of Policy, Evaluation and Research, U.S. Department of Labor 1105
Stewart, Milton, president, National Small Business Association, Washington, D.C 1105
Sumichrast, Michael, chief economist, National Association of Homebuilders, Washington, D.C 750
Tomko, William A., CPA, Tax and Government Regulation Committee, Council of Smaller Enterprises of Cleveland 908
Treptow, Dean A., president, Brown Deer Bank, and chairman, Legislative Committee, Independent Business Association of Wisconsin 1247
Ture, Dr. Norman B., economic consultant, Washington, D.C 750, 1229
Voight, David, legislative representative, National Federation of Independent Business 1138
Ward, Oliver O., president, Smaller Business Association of New England, Waltham, Mass 908
Weiss, Abraham, Assistant Secretary for Policy, Evaluation and Research, U.S. Department of Labor 1105

Statements of—
Council of Smaller Enterprises of Cleveland 958
Rinfret, Dr. Pierre A., president, Rinfret-Boston Associates, Inc., New York, N.Y 1132

EXHIBITS

Table, Brazil's financial savings, 1964–74 736
Table, tax-incentive mutual funds and ordinary mutual funds, 1968–74 736
Letter dated September 18, 1975, to Hon. William E. Simon, Secretary, U.S. Department of the Treasury, from Senator Gaylord Nelson, chairman, Select Committee on Small Business, and Senator Lloyd Bentsen, chairman, Subcommittee on Financial Markets, Committee on Finance, U.S. Senate 748
Graph, total new construction as a percentage of gross national product, 1915–75 753
Graph, new residential construction as a percentage of gross national product, 1915–69 754
Table, value of new construction put in place in the United States, privately and publicly owned, 1972, 1974 755
Table, holdings of total construction loans and land and development loans, 1974 755
A summary of analysis by Norman B. Ture, Inc., on the economic impact of the proposed capital recovery allowance system on the economy, 1975–85 803
Survey, results of the Council of Smaller Enterprises of Cleveland memberships, topic: depreciation 879
Table, loss in dollar value due to inflation, machinery cost $100,000, acquired January 1, 10½ year life 891
Table, loss in dollar value due to inflation, building cost $100,000, building acquired January 1, 45 year life 892
Table, loss in dollar value due to inflation under provisions of H.R. 7543 893
Graphs, equipment, plant, plant and equipment, from Survey of Current Business, vol. 55, No. 6, June 1975 894
Table, Smaller Business Association of New England, Inc., effects of various approaches to reduction in corporate tax rates 924

	Page
Table, Smaller Business Association of New England, Inc., financing data for small companies, 1968–75	925
Table, Smaller Business Association of New England, Inc., history of income tax on corporations, 1936–74	926
Table, Smaller Business Association of New England, Inc., calendar year corporation, 1972–76	927
Letter dated October 16, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from Frank B. Fairbanks, Jr., vice chairman, Government Relations, Smaller Manufacturers Council	931
Table, corporate employment trends	939
Table, present estate tax structure	940
Smaller Manufacturers Council details of proposed changes in section 303, estate tax law	941
Letter dated October 6, 1975, to Herbert L. Spira, tax counsel, Senate Small Business Committee, from Abraham Weiss, Assistant Secretary for Policy, Evaluation and Research, U.S. Department of Labor	1106
National Federation of Independent Business 1975 tax reform proposals	1151
National Federation of Independent Business pension reform proposals	1168
Press release dated September 25, 1975, from the National Federation of Independent Business	1183
Letter dated September 4, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from William J. Kuhfuss, president, American Farm Bureau Federation	1330
Paper, estimate of estate taxes on small businesses by Richard B. Covey, attorney, Carter, Ledyard and Milburn	1375
Statistical information based upon various categories of business determined by reference to assets, sales, and income, prepared by the Office of Tax Analysis, U.S. Department of the Treasury	1420
Charts and tables, results of simulations, by Dr. Allen Sinai, director, Financial Economics, Data Resources, Inc	1470
"Recommended Tax Law Changes," excerpts from booklet by the American Institute of Certified Public Accountants, November 13, 1975	1516

APPENDIXES

I. Letter dated September 26, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from Vincent A. Fochtman, president, Automotive Service Industry Association	1543
II. Statement of Jack Pester, senior vice president, National Oil Jobbers Council	1545
III. Letter dated October 1, 1975, to Senator Gaylord Nelson, Chairman, Select Committee on Small Business, U.S. Senate, from Michael E. Strother, Washington representative, Land Improvement Contractors of America, with accompanying enclosures	1548
IV. Letter dated October 22, 1975, to the Select Committee on Small Business, U.S. Senate, from David B. Palo, attorney at law, Traylor, Palo, Cowan and Arnold	1554
V. Letter dated October 22, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from John E. VanKirk, president, VanKirk, Martin & Associates, organizational consultants, Cincinnati, Ohio	1556
VI. Letter dated October 22, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from William E. Hardman, executive vice president, National Tool, Die & Precision Machining Association, with accompanying statement	1558
VII. Table, social security financing schedule, calendar years 1937–76	1572
VIII. "Small plants play key role," article from American Machinist Magazine of October 29, 1973	1573
IX. Letter dated October 31, 1975, from Prof. Neil E. Harl of Iowa State University, relating to intergenerational transfer of farm property, with enclosure	1579
Enclosure: "Deaths and Taxes—Policy Issues Affecting Farm Property Transfers," Special Publication 38, Cooperative Extension Service, University of Illinois, September 1975	1581

Page

X. Letter dated August 11 1975, from J. H. Butala, Jr., vice president, Cleveland Trust, Cleveland, Ohio, transmitting background material on small business tax problems, with enclosure 1597
Enclosure: Memorandum on Liquidity Problems of Small Estates, dated October 5, 1970, prepared by the American Bankers Association 1598
XI. Chart showing estate tax returns filed as percentage of U.S. deaths, 1958-72 1612
XII. Letter dated August 11, 1975, to Senator Gaylord Nelson, chairman, Select Committee on Small Business, U.S. Senate, from Stephen S. Gardner, Acting Secretary, Department of the Treasury 1613

HEARING DATES

September 23, 1975:
Morning session 705
September 24, 1975:
Morning session 903
September 25, 1975:
Morning session 1135
November 13, 1975:
Morning session 1383

SMALL BUSINESS TAX REFORM

TUESDAY, SEPTEMBER 23, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:50 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business) and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance) presiding.

Present: Senators Nelson, Bentsen, McIntyre, Haskell, Byrd, Javits, Brock, Weicker, and Packwood.

Also present: William B. Cherkasky, staff director, Senate Small Business Committee; Herbert L. Spira, tax counsel, and Judah C. Sommer, minority counsel, Senate Small Business Committee; George Pritts, minority staff, Senate Finance Committee; and David Allen, Office of Senator Bentsen.

Senator BENTSEN. Gentlemen, these hearings will come to order. They are being cochaired this morning by Senator Nelson, and I am joining with him in that effort.

This morning, the Senate Financial Markets Subcommittee and the Senate Small Business Committee open the second in a series of joint hearings on the tax and financial problems currently facing our Nation's small businesses. Americans too often forget the indispensable role of small business in promoting healthy competition in this country of ours, bringing about innovative ideas and products. Small business, in many instances, is the essence of our country's promise. It is the small businessman that forms the economic backbone of our Nation. It is the small businessman who provides about half of the jobs of our private workforce. And the survival of the small businessman across this Nation is indispensable if we are to maintain healthy competition in our economy.

In response to our first round of joint hearings, held last June, Senator Nelson and I introduced legislation to provide greater tax equity to the Nation's small businessman by extending the provisions of the 1975 Tax Reduction Act which apply to small business.

These provisions increased the corporate tax exemption from $25,000 to $50,000, reduced the tax rate on the first $25,000 of cor-

porate income from 22 percent to 20 percent. In addition, the amount of used property that can qualify for the investment tax credit has increased to $100,000 from $50,000. An extension of these provisions would recognize the particularly difficult economic problems faced by the small businessman during the current recession and inflation.

Also, in response to our first round of hearings, Senator Nelson and I joined in sponsoring legislation to amend the new pension law to specifically require the Secretary of Labor to issue simplified reporting disclosure requirements for small pension plans.

Our concern is that if you don't do that, with the cost of filling out all the Government forms and all the reporting that may be required under this new law, which is a complex law, that you may find some small businesses, just abandoning these pension plans. That sure isn't our objective. We want to see pension plans promoted and we want to see them enlarged, and we want to see their scope increased.

So to try to avoid that kind of result, we have introduced this kind of legislation.

One of the problems we have run into is that small business is absolutely inundated with Government forms. We had one study that showed—and Senator McIntyre took a very major lead in that—that taxpayers across the country are spending some $18 billion a year just filling out Government forms. So we joined in the creation of the Commission on Paperwork to try to simplify that and try to cut out some of the duplicate Government forms and to try to remove some that aren't necessary, and to try also to simplify the language so that Americans can understand just what they are being called upon to handle.

I would like to now yield to my cochairman, Senator Nelson.

Senator NELSON. Well, I have a brief statement that covers some of the same material Senator Bentsen just read, and I will just submit it for the record, in order to save time.

Senator McIntyre, did you have any statement?

Senator MCINTYRE. Mr. Chairman, I am submitting a statement for the record. I would like to say that that congressional commission you are talking about on paperwork, the Federal Commission on Paperwork, is in its formative stages. While we all understand the size and the problems ahead, I do have high hopes that we are going to be able, in the next year or two, to be able to cut through some of this mammoth paperwork that inundates the small businessman particularly. Hopefully, we will have some positive accomplishments within the next year or two.

Thank you very much, Mr. Chairman.

Senator NELSON. Senator Haskell?

Senator HASKELL. I have no statement. I look forward to hearing from the witnesses.

[The prepared statements of Senators Nelson, Bentsen, and McIntyre in full follow:]

HEARINGS BEFORE

SENATE SELECT COMMITTEE ON SMALL BUSINESS

AND

SUBCOMMITTEE ON FINANCIAL MARKETS, SENATE FINANCE COMMITTEE

September 23, 1975
9:30 a.m., Room 2221, DSOB

OPENING STATEMENT BY SENATOR GAYLORD NELSON

The hearings this week are part of an in-depth study of the business tax system undertaken jointly in April 1975 by the Select Committee on Small Business and the Financial Markets Subcommittee of the Senate Finance Committee.

Our purpose is to develop recommendations from the small business viewpoint for inclusion in the general tax reform legislation currently being considered by the House Ways and Means Committee.

Our study reached the stage of public hearings on June 17, 18, and 19 of this year. An additional day of testimony was taken on August 26 in Minneapolis, Minnesota, in cooperation with the Joint Economic Committee, on estate and gift tax problems of small businessmen and farmers.

It is likely that a future session will be scheduled later this year, to accommodate the Treasury Department which has been invited to testify whenever they wish to do so.

Our June hearings led to the introduction of S. 2149, a bill to continue indefinitely the small business rate reductions and increased eligibility of used equipment for the investment credit which were enacted as a part of the emergency Tax Reduction Act of 1975. This recommendation was presented to the House Committee on Ways and Means on July 31 as a part of testimony rendered by myself and Senator Bentsen.

Congress must act before the end of this year on the question of whether these provisions should be continued, either temporarily or permanently, or whether taxes for small and medium-sized businesses will revert to a higher level.

Beyond this, however, our two Committees are finding that basic areas of the tax law have been unchanged and largely unexamined for many years.

For example, in the area of corporation tax rates, which are basic to the retention of earnings and the ability of businesses to attract outside capital, the tax structure has changed little in the past 25 years; and indeed, since 1938 when the distinction between larger and smaller businesses was established at $25,000.

In the estate tax area, the Federal estate tax exemption of $60,000 was enacted in 1942, and has remained in the law at that figure since that time.

Employment taxes were established in 1935 with the Social Security Act of that year, but their relative impact and the associated paperwork burdens on small businesses have not received a great deal of attention.

Each of these areas needs to be re-examined thoroughly in the light of circumstances which change and those which do not.

As background, we have prepared the following chart of inflation since 1940 as reflected in the increases in the wholesale and industrial prices.

Inflation in Industrial Commodities

(Wholesale Price Index of Industrial Commodities: 1967 = 100)

WPI		Increases from	
1940	44.0	1940-74	349.5%
1942	50.7	1942-74	303.3%
1950	78.0	1950-74	77.3%
1974	153.8	--	--
July 1975	171.2	1974 - July 1975	11.3%
		1940 - July 1975	389.1%

It seems clear, from these figures, that some changes, particularly in the fixed-dollar provisions of the Internal Revenue Code, are necessary to bring our tax system up to date, and thus to bring a meaningful tax reform and relief to the nearly 13 million new small, family, and medium-sized independent business enterprises in this country.

OPENING STATEMENT
SENATOR LLOYD BENTSEN
JOINT HEARINGS -- SENATE FINANCIAL MARKETS
SUBCOMMITTEE AND SENATE SMALL BUSINESS COMMITTEE

September 23, 1975

This morning the Senate Financial Markets Subcommittee and the Senate Small Business Committee open the second in a series of joint hearings on the tax and financial problems currently facing our Nation's small businesses.

I include family farmers and ranchers in this category.

Americans too often forget the indispensable role of small business in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. Small business, in many ways, is the essence of our country's promise. It is the small businessman who forms the economic backbone of our Nation. It is the small businessman who provides jobs for about one-half of our private work force. The survival of small businesses across our Nation is indispensable if we are to maintain healthy competition in our economy.

Following our first round of joint hearings last June, Senator Nelson and I introduced legislation to provide greater tax equity to our Nation's small businessmen by extending the provisions of the 1975 Tax Reduction Act which apply to small business. These provisions increase the corporate surtax exemption from $25,000 to $50,000 and also reduce the tax rate on the first $25,000 of corporate income from 22 percent to 20 percent. In addition, the amount of used property that can qualify for the investment tax credit is increased to $100,000 from $50,000. An extension of these provisions would recognize the particularly difficult economic problems faced by small businessmen during the current period of simultaneous recession and inflation.

Small businessmen are at a competitive tax disadvantage compared to large corporations. A 1974 Congressional study of 143 large corporations found an average tax rate of 23.6 percent, compared to a tax level of all corporations of about 33.4 percent.

Also in response to our first round of hearings, I introduced legislation with Senator Nelson to amend the new pension law to specifically require the Secretary of Labor to issue simplified reporting and disclosure requirements for small pension plans.

This proposal will relieve thousands of small businessmen across our Nation from unreasonably burdensome and costly paperwork. Detailed reporting requirements that may be applicable to our Nation's largest private pension plans are simply not needed for the smallest pension plans. In fact, many small businessmen may be forced to terminate their retirement plans if the paperwork burden becomes too costly and overwhelming.

In terms of dollars and cents, or frustration and irritation, the endless tangle of paperwork imposed by government has become unbearable. With well over 5,000 forms in use in the Federal government, excluding tax and banking forms, the private citizen is inundated with requests for information. Some have referred to the endless series of forms and documents as "strangulation in triplicate." Others have referred to this as "Federal forms pollution." The Federal bureaucracy generates more than 2 billion pieces of paper annually. That is probably enough to fill several baseball stadiums.

There are 10 forms to be filled out each year for every man, woman and child in the United States. It is estimated that small business spends well in excess of $18 billion annually on government paperwork. It is particularly difficult for small firms to absorb the cost of this paperwork. Small businessmen must employ outside accountants and lawyers to fill out complex forms and keep the extra record keeping involved. Professional assistance, of course, is expensive. Having few employees, the small firms find it more difficult to spread the cost. A rise in per unit cost to cover paperwork can result in loss of sales and loss of competitive standing for small enterprise.

Small businesses, especially "mom and pop" operations, must fill out numerous reports, as many as 52 tax forms in a single year. This is not an example of a government which is concerned and responsive to the needs of its people. It is not a government which is protecting free enterprise. It is instead a government which favors only those large concerns that can satisfy repetitious requests for data, statistics and information.

We have to cut this tangle of redtape. We have to hold back the growing number of government forms.

Enactment of the legislation which we introduced to extend the small business tax provisions of the 1975 Tax Reduction Act and to reduce the paperwork burden resulting from the new pension law will be steps in the right direction.

But more is required. Government policy must be directed towards creating a favorable economic climate that will strengthen small firms and enable them to operate on a more equal basis with larger competitors.

The goal of these hearings is to formulate such a policy.

September 23, 1975

STATEMENT BY SENATOR McINTYRE

Mr. Chairman, I am pleased to join in this continuing study of the tax needs of small business by the Senate Select Committee on Small Business and the Subcommittee on Financial Markets of the Finance Committee.

It is only recently that the problems of small business under our present tax laws have come clearly into focus. For example, according to data gathered by the Small Business Committee, the effective tax rate on small companies can be as much as 15 percent higher than that paid by large corporations, which have the resources to take advantage of the complexities of the law and the lobbying clout, to make their needs known.

These hearings also serve, I believe, to remind us all of the tremendous importance of allowing small business a fair chance to grow and develop. The statistics on the role of small business in our economy have been recited often, but I think they bear repeating: small business accounts for 97 percent of all business by number; 52-53 percent of all private employment; 43 percent of all business output, and about one-third of the gross national product.

This series of hearings has brought an impressive group of expert witnesses before us, and I am looking forward to developing recommendations which will have a significant impact on tax reform efforts under way in the House Ways and Means Committee. Indeed, the June hearings have already resulted in a proposed extension of rate cuts and increased eligibility for used equipment under the investment tax credit passed in the Tax Reduction Act of 1975. I am pleased to be

Mr. McIntyre (cont) 3.

a co-sponsor of that proposal.

We have before us these next three days issues of tremendous significance for small business and hence for the fundamental health and progress of our economy:

--What further stimulation, if any, is needed to sustain and promote economic recovery, and what form should that stimulus take?

--What should be done to increase investment for necessary economic expansion which will help less capital-intensive small businesses?

--What changes should be made in our estate tax laws so that family businesses, including farms, can be preserved, with their invaluable traditions of service and quality and close ties to their communities?

--And very important--what can be done to simplify and update our tax laws so that they are understandable to the small businessman?

Senator NELSON. The list of witnesses has as our first witness Arthur M. Okun, senior fellow, Brookings Institution. Mr. Okun, the committee is very pleased that you are here this morning. We appreciate your taking the time from your busy schedule to come here and present your views. Your statement will be printed in full in the record. You may present it however you desire.

(The prepared statement of Mr. Okun in full follows:)

Statement by Arthur M. Okun
Senior Fellow, Brookings Institution*
before the
Select Committee on Small Business
United States Senate
September 23, 1975

As a general economist rather than an expert on small business, I shall focus on the nation's overall economic problems, hoping to provide some useful background for your consideration of particular measures with respect to small business.

Fortunately, I can at least begin on a positive note: the economy is recovering briskly today. Economic activity hit bottom this spring -- probably in April -- after a severe recession that was roughly double the average size of its postwar precedessors. Because the recovery began from such a depth and has been underway for such a short time, the economy is still operating at abysmal _levels_ today; but the _rate of improvement_ in the past several months has been significant and gratifying. It is, of course, normal and natural for a recovery following an inventory liquidation to begin with a bounce. When businessmen regard their inventories as better balanced in relation to sales, they start filling orders to an increasing degree out of current production and to a reduced extent by drawing goods off the shelves. That gives a big boost to output and employment. The tapering off of inventory liquidation in recent months has been strongly reinforced by a rebound in consumer spending, which reflects in

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*The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

part the constructive anti-recessionary fiscal measures -- tax rebates, withholding tax cuts, and payments to the elderly -- enacted earlier this year.

In my judgment, the current forces of recovery have considerable momentum and will continue to produce gratifying growth of output and employment through the remainder of 1975 and into the early part of 1976. But — neither the inventory turnaround nor the present consumer rebound can keep fueling the economy. Moreover, when I try to look beyond a six-month horizon, my crystal ball becomes engulfed by a number of storm clouds. I can list my four main worries alliteratively as: food, fuel, Federal Reserve, and fiscal policy.

Food. Since mid-year, the outlook for food prices has deteriorated sharply because of evidence that U.S. policy puts a much higher priority on extra exports of farm products than on adequate domestic supplies. Over the past three years, the policy of agricultural export promotion backed by no public stocks of farm products has done more overall economic damage than the various mistakes of fiscal and monetary policies that I could list. At this point, no one knows how large our crops or our total export demand will be; but we do know that once again the nation is playing Russian roulette with its vital food supplies. The price rise already experienced in grain markets in the last few months will impose a heavy toll on the family meat budget during 1976. Until and unless the President or the Congress takes decisive action to put the American housewife at the head, rather than the back, of the line for U.S. food supplies, double-digit food inflation looms as a danger for 1976. In its report last week, the Congressional Budget

Office used a 9 percent rate of food inflation as its working assumption; at mid-year, I suspect that the reasonable outlook was more like 4 percent than 9.

Fuel. The stalemate between the Congress and the President over the future of oil price controls is distressing. In my personal judgment, the President's proposal for a very gradual 39-month decontrol was fairly reasonable, and I regret that the Congress did not accept it as a basis for compromise. On the other hand, the President's veto of an extension of existing controls was a serious mistake that threatens us with more extra inflation than could conceivably have been saved by all of his previous vetoes. I keep hoping that a satisfactory compromise will be hammered out; but rarely have I seen a time when the reasonable people on both sides of an issue have seemed so ineffective, and the effective people so unreasonable. A combination of abrupt decontrol and an OPEC price rise of 10 percent would take nearly $20 billion out of the pockets of the American fuel consumer over the coming year and add roughly 1-1/2 percentage points to the inflation rate. Two-thirds of that toll could be eliminated by an effective compromise on a slowly phased decontrol.

In stressing food and fuel inflation, I am expressing the judgment that a general acceleration of inflation is neither a current fact nor an imminent threat. Nonetheless, the response of prices in most industrial sectors to the recession was rather disappointing. A competitive market is supposed to operate both ways, pushing down prices in response to excess supply as reliably as it pulls up prices in response to excess demand. That clearly has not happened. It raises some serious questions about how competitive our economy is, and it creates opportunities for vigorous policies of price-wage restraint -- short of a return to ~~comprehensive~~ direct controls -- to help curb inflation.

Federal Reserve. During the past three months, monetary policy has been extremely hawkish in a battle to curb the vigor of recovery. Short-term interest rates have been pushed up by policy actions by 100 basis points since mid-June, with adverse effects that are already evident on inflows to thrift institutions and on the fragile recovery of homebuilding. Whether judged by that sharp rise in short-term interest rates or by the remarkably low (perhaps as low as 3 percent) annual growth of the money stock, Federal Reserve policy in the third quarter must be classified as the most restrictive ever pursued in the infancy of an economic recovery. The recent spurt in interest rates clearly results from holding out the liquidity needed to finance an appropriately brisk economic expansion rather than from any crowding out by federal debt financing.

I simply do not understand why any Federal Reserve officials believe that the recovery needs to be slowed down, how they expect tight money to have a valuable anti-inflationary influence at a time of the highest unemployment rates and the lowest operating rates in a third of a century, or how they can view monetary restraint as an appropriate response to food and fuel inflation after the bitter lessons of 1974. But given the views that seem to be reflected in current Federal Reserve policies, and given the likelihood that private credit demands will strengthen in the months ahead, interest rates must be expected to rise into the disintermediation zone and to abort the housing recovery. With a scarcity of funds for homebuilders and other small businesses, economic growth would most probably sag undesirably during the course of 1976.

Fiscal policy. As I have indicated, the tax cuts and transfer payments that bolstered consumer income this year contributed mightily to the recovery

that we are now experiencing. Those antidotes to recession are a minor part of the present huge federal deficit; the major part stems from the poison of the recession itself. The economic system is still suffering from that poison; and, while it does not need stepped-up doses of antidotes, it cannot be taken off its supportive medicines entirely.

Ideally, in my judgment, a combined program of supportive monetary policies and gradually less stimulative fiscal policies could, by pursuing an average of 8 percent growth of real GNP, carry the economy to about a 5-1/2 percent unemployment rate and to a balance in the federal budget early in calendar 1978. An attempt to achieve budgetary balance sooner -- or to achieve it in spite of a flagging recovery or a restrictive monetary policy -- is likely to be as self-defeating as the misguided crusade for a balanced budget in the early stages of the 1973-75 recession.

The detailed tax decisions for 1976 that the Congress must make this fall should be guided by the best possible evidence on the outlook for federal spending and for monetary policy. Nonetheless, I feel confident now that it would be disastrous fiscal policy to allow the present law to expire and thus permit personal income taxes to rise abruptly at a rate of $10 billion at the end of this year. Indeed, a continuation of those tax cuts seems to be a minimal and safe measure to recommend at this point.

I would also favor the extension of the increase in the corporate surtax exemption from $25,000 to $50,000 that was enacted for 1975, as well as the small cut in the "normal" tax rate. With that, and a 10 percent rate on the investment tax credit (already enacted for 1976), I would view the tax program as appropriately balanced between consumers and businesses.

In making that judgment, I am impressed by the severe impact of recession and fuel inflation on the real disposable income of American families. The resulting cutback in real consumption, in turn, produced the setback in plant and equipment investment during the past year and a half. Business investment in plant and equipment is today at least $40 billion below the levels that would have emerged in a normal prosperity situation. The main problem of American businesses, small and large, today and the main disincentive to investment is a customer shortage -- not a capital shortage and not a tax overburden. The alleviation of that customer shortage should be the top-priority goal in Congress' determination of tax legislation for 1976.

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I offer you a mixed set of views: optimistic on the short-run outlook for recovery, and gravely concerned about the longer run. It is particularly important that the good news for the next few months be properly interpreted as a healthy but temporary rebound. If the makers of fiscal and monetary policy wrongly interpret the signals of recovery as a self-sustaining boom and administer abrupt restraint, that recovery is bound to be short lived.

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. OKUN. Thank you very much, Mr. Chairman. My prepared statement is brief and I prepared it with the intention of trying to go through it without taking an undue amount of time. With your permission, I will do that.

Senator NELSON. If you would pull that microphone up closer, it would help.

Mr. OKUN. As a general economist rather than an expert on small business, I shall focus on the Nation's overall economic problems in this brief survey, hoping to provide some useful background for your consideration of particular measures with respect to small business.

Fortunately, I can at least begin on a positive note: The economy is recovering briskly today.

Senator MCINTYRE. I would just like to interrupt to say I have just come back from New Hampshire, I have been traveling around New Hampshire, and I am delighted you can use the term "briskly," but it is not recovering briskly in the little towns of the State of New Hampshire.

Mr. OKUN. I think sometimes it is difficult to detect the rate of improvement when we are still so far down. What the statistics are telling us that is while it is not uniform in all areas or industries, the overall rate of recovery is significant and substantial.

They suggest that economic activity hit bottom this spring—probably in April—after a severe recession that was roughly double the average size of its postwar predecessors. Because the recovery began from such a depth and has been underway for such a short time, the economy is still operating at abysmal levels today; but the rate of improvement in the past several months has been significant and gratifying. It is, of course, normal and natural for a recovery following an inventory liquidation to begin with a bounce. When businessmen regard their inventories as better balanced in relation to sales, they start filling orders to an increasing degree out of current production and to a reduced extent out of drawing their goods off the shelves. That gives a big boost to output and employment. The tapering off of inventory liquidation in recent months has been strongly reinforced by a rebound in consumer spending, which reflects in part the constructive antirecessionary fiscal measures—tax rebates, withholding tax cuts, and payments to the elderly—enacted earlier this year.

In my judgment, the current forces of recovery have considerable momentum and will continue to produce gratifying growth of output and employment through the remainder of 1975 and into the early part of 1976. But neither the inventory turnaround nor the present consumer rebound can keep fueling the economy. Moreover, when I try to look beyond a 6-month horizon, my crystal ball becomes engulfed by a number of storm clouds. I can list my four main worries, if I may be alliterative, as: food, fuel, Federal Reserve, and fiscal policy.

Let me go into each—food: Since midyear, the outlook for food prices has deteriorated sharply because of evidence that U.S. policy puts a much higher priority on extra exports of farm products than on adequate domestic supplies. Over the past 3 years, the policy

of agricultural export promotion backed by no public stocks of farm products has done more overall economic damage than are the mistakes of fiscal and monetary policies that I could list. At this point, no one knows how large our crops or our total export demand will be; what we do know is that once again the Nation is playing Russian roulette with its vital food supplies. The price rise already experienced in grain markets in the last few months will impose a heavy toll on the family meat budget during 1976. Until and unless the President or Congress takes decisive action to put the American housewife at the head, rather than the back, of the line of U.S. food supplies, double-digit food inflation looms as a danger for 1976. In its report last week, the Congressional Budget Office used a 9 percent rate of food inflation as its working assumption; at midyear, I suspect that the reasonable outlook was more like 4 percent than 9.

Senator NELSON. Let me ask a question. We have a surplus every year, and it is substantial in, say, grains. It is more than we can store and more than we can eat, by a substantial amount. How would you manage that surplus in such a way both to do justice to our own economy and the consumer and the farmer too?

Mr. OKUN. I think there are a number of possibilities. As you put it so correctly, the issue is not whether we export, for obviously we should export, and we have to export a great deal; the issue is how export needs and domestic needs are fitted together. Other major grain exporting countries, like Canada, Australia, and Argentina, really manage their supplies in such a way as to establish what they require for domestic use, and then decide how much to export.

Senator NELSON. Let me ask another question at this point, because I'm not sure I understand these markets and how they work. But, let's assume that we need 35 or 40 percent, overall, of our grains, and let's assume that we make some decision that we are going to assure that goes into the American marketplace. Then the other two-thirds, or whatever is the balance, depending on whether it be soybeans or corn or wheat, is available for the world market. In the world market there is competition for it because there are only a few nations which are producing a surplus.

Then what happens? The price set by world demand in the world market price becomes the domestic price, does it not?

Mr. OKUN. There have been limitations on exports and there can be some gap between the world price and the domestic price. It is hard to maintain a large one, though. I might point out we were ingenious enough to maintain a discrepancy in the other direction for a good many years, Senator. We had something that, perhaps crudely but really accurately, was labeled the bread tax, which essentially was a fee that millers paid on the domestic milling of wheat. The proceeds of that were in turn distributed to all wheat producers, whether they sold for domestic or for export use and thereby we kept a spread where our domestic price was above the world price.

If we wanted to, we could run a bread subsidy, so to speak, just do it in reverse, and give the millers tickets for what they mill and reward them, rather than asking them to pay a tax. To some extent, however, Senator, we are still running a major export promotion program. We have agricultural attachés in our embassies whose job

it is to see how much U.S. grain they can sell. Some years they are serving the country and some years their efforts, unfortunately, are too effective. Maybe there are some years that we ought to be using them in Wisconsin or Texas or Colorado to see whether they could do something for domestic agricultural production instead of for trying to see how much they can sell for export elsewhere in the world.

Senator BROCK. Don't you think exports do something for agricultural production?

Mr. OKUN. I think it does something for the farmer; yes. Again, there is no issue as to whether we should export. The issue lies in the range that the chairman used as his illustrative figures, that is, should we keep 30 percent or 35 or 40 percent of our grain production. The difference there is enormous to the American housewife.

In the first 9 months of 1973, we had a 4.3-percent inflation rate on everything but food but a 24-percent rate of inflation on food. That is where we missed the boat; that is where we got into the inflationary mess we are in. We jumped from the three-plus inflation rate of 1972 up to about 8¼ percent in that period. And the largest single villain of that inflation, by far, was the management—or mismanagement—of our agricultural exports in that 1972–73 crop year.

When one looks at the present situation, one has to ask: Haven't we learned anything? Are we really playing the same game again?

Senator BROCK. If I may point out, we have three different estimates each month on the size of the domestic crop. They vary each time. But, on no occasion has the surplus been less than twice what we are proposing to ask for.

Then why do you say that we are doing great damage?

Mr. OKUN. What we are proposing to ask for remains to be seen. I think all I am suggesting basically is that we decide how much we need at home and then decide how much we can afford to export. It really does seem to me, Senator, that the characterization I have used is an accurate one for the last 3 years: The American housewife has been at the back of the line and the importers from elsewhere have been at the front of the line in their access to the American food supply. There is something wrong with that picture. The amounts involved are not very great. The price sensitivity of those products, however, is enormous, and their influence on meat prices is enormous. This is an area that has received far less attention than it deserves in the overall inflation picture. I think again, that compared to this issue, the screaming about the 1973 deficit, is just vastly misplaced. That deficit was far less harmful than those grain sales.

Now, I am not predicting that we will repeat that mistake or that we will have a 24-percent rate of food inflation; I am saying we are leaving ourselves vulnerable to such mistakes. We have nothing to assure us it won't happen again. We have no mechanism and we are operating on the basis of forecast, prayer and hope, rather than being in a position to say that is what we need and that is what we are going to have.

Senator BENTSEN. Let me say with respect to agricultural attachés that I have talked to them in foreign countries, and I have found very few of them whose objective has been to increase American exports. Most have been there to try to teach those people how to do

a better job in raising their own crops and feed their people, or get an exchange of information as to control of the spread of fungus or insects, in other words, agricultural information for the benefit of our own country. I really haven't seen much in the way of salesmanship on the part of agricultural attachés.

Senator HASKELL. Let me ask one question. My understanding of the wheat situation is this. The estimates that we have point to something like a 1 billion bushel crop and that our domestic consumption will be roughly in the area of one-third, as Senator Nelson said. Now, this is an awful lot of wheat to export. Now, I gather you are not against exporting. So what you advocate is some system of estimating domestic needs and exporting the balance. Is that your suggestion?

Mr. OKUN. Yes; I think that is the most reasonable way I can think, of accomplishing that goal. And as far as I know, it works quite well in Canada.

Senator HASKELL. One more question. In the year 1975, my understanding is that we haven't even come close to exporting two-thirds as of now.

Mr. OKUN. No, we have not. No, this issue still is in our hands. We are capable of making that determination.

Eighteen months ago, we were hanging breathlessly to determine whether the export sales had over-committed our crop. There was a real question of whether our people would have to break contracts, because the whole process was, at that time, completely uncoordinated. There is better reporting now, so there is a little bit more information on how much sales amount to at any point in time. I think we may be able to monitor it better, but we still do not have a Federal technique of exercising any kind of control on this.

Now, there are a lot of indirect influences.

Senator HASKELL. That was going to be my next question. My understanding is that the Agricultural Act of 1973 set up a monitoring system so that we could tell when we were in danger, but you do not feel that that, in and of itself, is adequate? Would that be correct?

Mr. OKUN. I am not sure what the full powers are, what the act authorizes to be done when that danger point is reached. I also have some concern about who determines what the danger point is. It seems to me that my criteria of danger is not a question of an absolute scarcity at home, but a scarcity that is sufficient to add significantly to the inflation rate. I mean, the deterioration in the last 3 months, I am suggesting, means that a reasonable bet on what will happen to food prices today or over the next year would be 5 percentage points higher than I would have said, or most economists would have said, at midyear. And the reason is that we are expecting additional sales to be resumed and there are reports now that suggest that even with a moratorium on the Russian sales, there have been significant increases over and above any kind of normal levels in sales to other eastern European countries that in the past, have imported grain from the Soviet Union.

So, I don't think anybody has a basis for feeling confident that the existing system is adequate or is going to be implemented in an adequate way. It may be potentially adequate.

I think, in part, it is a matter of how diligently it is implemented. Many of these sales are basically negotiated with the Government;

if the Government wants to lubricate them and promote exports, it can do so. That is the way, in the past, it has been pursuing this policy. My impression is that the views within the administration on this score are by no means uniform and monolithic and that some of my economist friends in the administration are detectably less enthusiastic about additional exports at this point than is the Department of Agriculture.

Senator HASKELL. I guess it all comes down—and I don't want to prolong this—I guess it all comes down to whether the present monitoring system is or is not adequate for forestalling what you are talking about. I won't pursue this any longer, but I think that is the issue.

Mr. OKUN. Right. I think, Senator Haskell, I might divide that issue into two parts: First, to give the President adequate power, and second, to assess how likely it is that he will use the authorized power.

Senator HASKELL. Of course, you can lead a horse to water but you can't make it drink.

Mr. OKUN. Yes, but there are mechanisms by which legislation could instruct, rather than empower, certain Executive actions, and that might be what is necessary in this case. I don't sit here as an expert on agriculture. It has been a unique experience in the last 3 years that everybody, who pretends to be an observer of the overall economy, is suddenly forced to become a grain and a fuel expert. These tails have been wagging the dog, and I think they are still not getting enough attention in the overall inflation picture. And I tried to emphasize that this is one of the most worrisome areas I know of.

Senator NELSON. Let me ask one more question. I am just trying to understand how this works.

Let's assume we can, which I think we can, identify and estimate pretty accurately what our supply of any commodity is. Our inventory system is very good in going into and indicating the amounts in every county in the country. But, the next 30 days might change things, because of a drought or flood or uncontrolled insect infestation.

Anyway, I think in any single week our experts can make pretty good estimates or guesses, as to corn, wheat, and so forth. Now, assuming you do identify the amount of grains that we need for consumption, and the surplus that we ought to have stored in case of adverse weather in the succeeding year; and those two uses amount to 60 percent of all soybeans, wheat, corn, and other grains, leaving 40 percent to export.

Now, the demand worldwide is probably larger than our available supply—and it probably will be in wheat this year. Now, do you somehow or another believe you can insulate our domestic market price from the world price? Would you do that arbitrarily? How would you arrange that?

In other words, even if you do reserve out our production, what we are going to use and store domestically, if there is a shortage, doesn't the world price determine pretty much the domestic price?

Mr. OKUN. That is a piece of economic analysis, Mr. Chairman, which is very astute. Under those circumstances, you would expect a two-price system to develop: An international price and a domestic price. And as you are implying, there are difficulties. You would need a regulatory system to maintain a spread, just as we now have with

respect to oil where we don't permit the export of our $5.25 old oil, and as I pointed out, just as we did in the opposite direction some years ago. There are techniques, like the use of tickets or option vouchers and so forth, which can prevent this from becoming a magnet to pull grain away in violation of the law.

But, by and large, we think of ourselves as having a law-abiding population. And if they are told that this is what you can export, and you have to have an authorization to do so, or if they are told, as in the Canadian case, that essentially the Government would participate in the determination of export sales through a marketing board, then the differential in the world price over the domestic price need not be a magnet sucking away those domestic supplies. It is not elegant. I am not suggesting that, any more than the maintenance of a multiple price system on oil is elegant.

But, when I balance the inelegance of that kind of a system with the potential for double-digit food inflation, I am ready to take that inelegance.

Senator BROCK. You are aware that there is a constitutional prohibition against export taxes and we have a rather considerable problem in trying to devise a system in which we can introduce higher prices to the world market than domestic prices. Even if it were possible, would it not be of some concern to you, if we are going to be of any assistance at all to those who need food in the rest of the world, for us to limit our own production by a falsely regulated market action?

Mr. OKUN. I am glad you gave me the opportunity to clarify that, because I do think we have a responsibility. I think we have a responsibility to poor nations, and I think we have a responsibility to be a reliable supplier to reliable customers.

Senator BROCK. We hardly have that reputation now.

Mr. OKUN. To the extent that we don't, it stems really from just one bad incident—the "not another soybean shall cross the Pacific" edict of June 1973. That certainly did us more damage than anything else, and that was the wrong way to do it.

But, I think on the other hand, Senator, in perspective, the United States has shown immense willingness to be passive in this area, to accept orders, to fill them from abroad, to put the rest of the world essentially on the top of the pile. I don't know whether that is idiocy or generosity, but it is an incredible policy which has not been appreciated by the rest of the world. We have more power over food than the Arabs have over oil. And, thank heavens, we are not using it that way, and I wouldn't want to see us use it that way. But to use none of that power, to be totally passive, to be actually indifferent, indeed to show preference to foreign buyers over domestic buyers, seems misguided.

Senator BROCK. Nobody is suggesting that. Senator Haskell's question is absolutely pertinent, I think. Is the law inadequate today? If so, how?

Under the law, as it exists today, the President can stop exports and he has done so. We have extended sales and——

Mr. OKUN. To the Soviet Union.

Senator BROCK. Yes; and that is the particular problem area. You are talking about millions of bushels of corn, etc., there.

Mr. OKUN. Senator Brock, the fact of a runup of grain prices from midyear to today of about $1 a bushel can only be explained by the expectation of those markets that we are going to accept a significant further increase in domestic food prices. If those markets thought that those powers were going to be used to stabilize food prices, we wouldn't have that.

And what my friends, who are agricultural experts, what they tell me is that if you run today's grain prices through cattle, poultry, eggs, and milk, over the next year, you've got a very substantial increase in those prices without any further increase in grain prices. So, if we are going to use that power effectively, I think it ought to be made clearer that we will. I think we have seen some evidence of concern in the President's position of a moratorium on grain prices. I list this as a worry.

I am not predicting disaster in this area, but I am concerned about it, and I do ask the question of whether we will take the action that is necessary to insure that this source of inflation is contained in the next year.

Senator NELSON. Go ahead, please.

Mr. OKUN. I will go back to the second on my "four-F" list, which is fuel.

The stalemate between the Congress and the President over the future of oil price controls is distressing. In my personal judgment, the President's proposal for a very gradual 39-month decontrol was a fairly reasonable one, and I regret that the Congress did not accept it as a basis for compromise.

On the other hand, the President's veto of an extension of existing controls was a serious mistake that threatens us with more inflation than conceivably could have been saved by all of his previous vetoes. I keep hoping that a satisfactory compromise will be hammered out; but rarely have I seen a time when the reasonable people on both sides of an issue have seemed so ineffective, and the effective people so unreasonable. A combination of abrupt decontrol and an OPEC price rise of 10 percent would take nearly $20 billion out of the pockets of the American fuel consumer over the coming year, leaving him that much less to spend, and add roughly 1¼ percentage points to the inflation rate. That would intensify recession and inflation at the same time, a rare occurrence in economics. Two-thirds of that total could be eliminated by an effective compromise on a slowly phased decontrol.

In stressing food and fuel inflation, I am expressing the judgment that an acceleration of general inflation is neither a current fact nor an imminent threat. Nonetheless, the response of prices in most industrial sectors to the recession was rather disappointing. A competitive market is supposed to operate both ways, pushing down prices in response to excess supply as reliably as it pulls up prices in response to excess demand. That clearly has not happened. It raises some serious questions about how competitive our economy is, and it creates opportunities for vigorous policies of price-wage restraint—short of a return to comprehensive direct controls—to help curb inflation.

The third item on my list is the Federal Reserve. During the past 3 months, monetary policy has been extremely hawkish in a battle to curb the vigor of recovery. Short-term interest rates have been pushed up by policy actions by a full percentage point of 100 basis points

since mid-June, with adverse effects that are already evident on inflows to thrift institutions and on the fragile recovery of homebuilding. Whether judged by that sharp rise in short-term interest rates or by the remarkably low—perhaps as low as 3 percent—annual growth of the money stock, Federal Reserve policy in the third quarter must be classified as the most restrictive ever pursued in the infancy of an economic recovery. The recent spurt in interest rates clearly results from holding out the liquidity needed to finance an appropriately brisk economic expansion rather than from any crowding out due to Federal debt financing.

I simply do not understand why any Federal Reserve officials believe that the recovery needs to be slowed down, how they expect tight money to have a valuable anti-inflationary influence at a time of the highest unemployment rates and the lowest operating rates in a third of a century, or how they can view monetary restraint as an appropriate response to food and fuel inflation after the bitter lessons of 1974. But given the views that seem to be reflected in current Federal Reserve policies, and given the likelihood that private credit demands will strengthen in the months ahead, interest rates must be expected to rise into the disintermediation zone, where it pulls money away from the thrift institutions and aborts the housing recovery. With a scarcity of funds for homebuilders and other small businesses, economic growth most probably would sag undesirably during the course of 1976.

Finally, I am concerned about fiscal policy. As I have indicated, the tax cuts and transfer payments that bolstered consumer income this year contributed mightily to the recovery that we are now experiencing. Those antidotes to recession are a minor part of the present huge Federal deficit; the major part stems from the poison of recession itself, and what that did to people's personal incomes and business incomes and consequently to Federal revenues. The economic system is still suffering from that poison; and, while it does not need stepped up doses of antidotes, it cannot be taken off its supportive medicines entirely.

I might say, after complaining about the way oil policy is coming out, that I think fiscal policy came out reasonably well this year. I think the process of negotiations and some of the compromises left us in a reasonable situation. Some of those instances where the vetoes were sustained, I think they are best left unpassed, and some of the cases where the President yielded a good bit, I think Congress made some wise decisions. I think the President made a wise decision to go along with them, too. So, this is one area where I think we are doing pretty well.

Ideally, in my judgment, a combined program of supportive monetary policies and gradually less stimulative fiscal policies could, by aiming at an average of 8-percent growth of real GNP, carry the economy to about a 5½ percent unemployment rate and to a balance in the Federal budget early in calendar 1978, which is 2½ years away. I think the attempt to achieve budgetary balance sooner or to achieve it in spite of a flagging recovery or a restrictive monetary policy or through rapid declines in unemployment, seem quite infeasible under the circumstances and are likely to be as self-defeating as the misguided crusade for a balanced budget in the early stages of the 1973–75 recession.

The detailed tax decisions for 1976 that you are going to have to make this fall should be guided by the best possible evidence on the outlook for Federal spending and for monetary policy, and I am not ready to provide just what I think should be done on taxes for 1976. But I do feel confident in saying that it would be disastrous fiscal policy to allow the present law to expire and thus permit personal income taxes to rise abruptly at a rate of $10 billion at the end of this year. Indeed, a continuation of those tax cuts seem to be a minimum and safe measure to recommend at this point.

I would also favor the extension of the increase in the corporate surtax exemption from $25,000 to $50,000 that was enacted for 1975, as well as the small cut in the "normal" tax rate. With that and a 10-percent rate on the investment tax credit—already enacted for 1976—I would view the tax program as appropriately balanced between consumers and businesses.

In saying that, I am impressed by the severe impact of recession and fuel inflation on the real disposable income of American families. The resulting cutback in real consumption, in turn, produced the setback in plant and equipment investment during the past year and a half. Business investment in plant and equipment is today at least $40 billion below the levels that would have emerged in a normal prosperity situation.

Senator NELSON. You mean, $40 billion per year?

Mr. OKUN. Forty billion dollars per year. The actual decline from late 1973 evaluated in current prices is about $30 billion. And if we had prosperity instead of recession, we certainly would have had a rise of at least $10 billion over the past year and one-half. That is why I say the main problem today of American businesses, both small and large, and the main incentives to investment is a customer shortage, not a capital shortage or a tax overburden. And the alleviation of that customer shortage should be the top priority goal in Congress' determination of tax legislation for 1976.

Now, all in all, I offer you a mixed set of views: I am optimistic on the short-run outlook for recovery, and am gravely concerned about the longer run. I am particularly concerned that the good news that I expect over the next few months should be properly interpreted as a healthy but temporary rebound. If the makers of fiscal and monetary policy interpret these signals of recovery as evidence that we have a self-sustaining boom that perhaps needs even some restraint, then that recovery is bound to be short-run.

I thank you.

Senator NELSON. Thank you, Mr. Okun. Do you have any questions, Senator?

Senator BROCK. Mr. Okun, I have a somewhat mixed reaction to your statement, but I am a little bit interested in your statement about the investment tax particularly. I think I tend to agree on the individual's side, simply because one of the things you did not mention was the drag on spending by the largest single element, which was not food or fuel last year, but it was taxes; taxes were the largest increase on the consumer's pocket and more than anything else. Of course, you are getting the salary increases and perhaps they have to be considered. But they are not commensurate with the level of

inflation and they are also putting people into higher tax brackets and eating more money up.

Mr. OKUN. Exactly. Inflation acts to increase the real tax burden and salaries are not keeping up with the inflation.

Senator BROCK. Yes, it works both ways. We are botching it up very badly for the middle-income family. That also applies to the small businessman. I wonder if you wouldn't feel that we could improve the taxation on small businesses a little more than we have. The way I propose it, and I think some of us on the committee supported this effort to raise the exemption to $100,000 early this year. I still feel that is an entirely reasonable goal.

I wonder if you have any comments or objections to that?

Mr. OKUN. I would certainly share your view that it is a reasonable goal, whether we do it this year or next. I suppose—now I am entering an area that I don't know very much about—that there have always been concerns about the surtax examption on corporations as incentives to partition businesses, establishing chainstore-type arrangements and so forth. I suppose you really are helping the small business rather than helping somebody to hide behind a small business mantle in some fashion. I suspect that if there were better insurances against a misuse or abuse of this system, that there might be more sympathy for your proposal.

Senator BROCK. There are a number of protections in the law against that now. If they are enacted, we might shore them up. But at least I feel you would get a whole lot more benefit for small business with this. And even if there are occasional aberrations in applications, I think they would not be so significant as to be of great damage. But, if we need to tighten it up, we can do it.

The basic point is that small businesses are having trouble because of the inflation and recession, trouble in accumulating capital and they are much oppressed by the tax system as it applies to them. I think we could help a great deal by raising that exemption to $100,000. That could be, by no description, called a large business.

Mr. OKUN. Right.

Senator BROCK. And I think there is one other point on that, and that is the possibility of something I again suggested earlier this year, and that is a graduated tax which would have much benefit on the small businesses. It might deal with your concerns about the splintering of corporations in order to take advantage of this.

Mr. OKUN. You would have a smoother scheduling and a less abrupt jump in the rates, which would be an easier thing to handle, I suspect.

Senator BROCK. You mentioned the recession as being somewhat stranger than previous recessions in that we do not have the price breaks. I think you said that that might raise a question of competitive strength, and whether or not competition works.

Again, I don't think there is any question about competition in the small business area. The question I have for you is this. I personally question whether our antitrust policies are even close to being adequate. I question whether we have perhaps adequate descriptions in the law of what competition really is. I even more question whether the courts, as presently constituted, are adequate to pursue this. I am

much intrigued by the possibility of courts that specialize as tax courts as they do in antitrust matters, and whether that would work.

Mr. OKUN. My only comment is that it has been my observation that large businesses are very conscious of how any administration conceives of and uses the antitrust tool. That may be a significant deterrent. I think some cases today, where the law seems adequate and court challenges should stand up, are not being pursued vigorously. In other cases, the Justice Department is critically aware that even if it could win, it would take about 8 years. Consequently it quite understandably and reasonably will save its crusades for cases that have a shorter payoff. This might be a reason for wanting to clarify the laws to eliminate the need for four rounds of appeals before the meaning of the law could be established.

Senator NELSON. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

I have just a comment. I very strongly agree with you, Mr. Okun, that the monetary policies are such that they can be very restrictive to recovery from the recession, and that high interest rates have very little impact on the cost of fuel or commodities, which have been the principal things that contribute to inflation and do tend to choke off the recovery from a recession. I think that returning to a restrictive monetary policy is very shortsighted indeed. I can't help but be concerned by the prediction of the Chemical Bank of New York that 90-day Treasury bills which are now at 6.4 percent will be at 7 percent by the end of this year, and 8 percent a year from now. That certainly contributes to meaning you are going to have less long-term mortgage money available for the housing market.

On the question of fuel, I think what you run into, Mr. Okun, is a situation of tactics, and they go from two sides, trying to work for political advantage, and that is a tragic situation, really—and I voted, frankly, to sustain the President's veto, not because I want to see oil decontrolled overnight, for I think that would be a serious mistake, but to try to force a compromise, which must be brought about because the people of this country are tired of confrontation between the Congress and the President. There is enough blame to go around on both sides. People are not really interested in whether it is the President's plan or the Congress' plan. They just want a national energy plan. And I agree that the 39 months was a fairly reasonable start for the compromise. I would like to have seen that at 48 months, where we could phase this thing in and make the appropriate adjustments on fuel. Hopefully, we will still be able to bring that about.

But I get pretty discouraged sometimes.

Mr. OKUN. Well, don't be. It is very important. Let me just encourage you to keep at it, Senator.

Senator BENTSEN. Now, there are a number of us who would like to see some of the strong opposing forces get together and we are going to continue to work at it.

Thank you very much.

Senator NELSON. Your testimony has been valuable. Thank you, Mr. Okun.

Our next witness is Professor Roy Schotland, professor of law, Georgetown University. Professor Schotland, your statement will be

printed in full in the record. You may present it in whichever manner you please.

[The prepared statement of Professor Schotland in full follows:]

STATEMENT BY ROY A. SCHOTLAND, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY, WASHINGTON, D.C., ON SMALL BUSINESS' TAX AND FINANCIAL PROBLEMS

SUMMARY

I. Why Small Business' Problems Have Become More Severe:

A. Discriminatory taxation, only beginning to be seen and understood.
B. Inflation and increased economic volatility.
C. Capital shortage.
D. Increased regulatory requirements.
E. Declining real personal income, more competitive pressure on small business.

II. Impacts:

A. Concentration increases, overall competition declines.
B. Even bankruptcies increase: 1974 to 1975 rise in business bankruptcies is 45%, more than twice as large an increase as last recorded, in 1949.

III. What to do:

A. Extend Tax Reduction Act, at least for small business.
B. Reduce tax inequities:
. . . reduction of small firms' rates.
. . . the investment tax credit discriminates against labor and small business.
. . . both labor and small business would be aided, and tax equity would be improved, by a job tax credit.
. . . both labor and small business would be aided by allowing more retained earnings.
C. Reduce personal income tax shelters:
. . . they hurt small business by distorting away the flow of funds particularly well suited for investment here.
D. Small business "extension agents:"
. . . like Agriculture's.
. . . to meet Senator Javits' point about limits of the SBA.

IV. The need to expand, not merely shift, capital flows—and to improve debt-equity ratios:

A. Is there a capital shortage—and does it matter to small business?
. . . the utopians (e.g., Brookings study), the blind believers (e.g., Professor Eisner, Walter Wriston) and Pangloss (e.g., Walter Heller).
. . . The shrinkage of savings and of firms which marshall savings.
. . . Secretary Simon's Abuse of a Real Problem.
. . . The NYSE Study.
. . . Recent bulletins from the capital shortage front.
B. What is to be done?
. . . Secretary Simon's proposed treatment of corporate dividends will further weaken corporate balance sheets (see FRB Governor Henry Wallich and FORTUNE editorial).
. . . Corporate dividends, at least for small, publicly held corporations, should be re-invested by stockholders, and if so stockholders' tax should be deferred.
. . . new savings vehicles: the "Bentsen Plan Funds" (S. 666) should be expanded and directed not only to housing, but equally to small business, and partly for general investment.
. . . need to study Brazil's experience with innovations in marshalling capital.

STATEMENT BY ROY A. SCHOTLAND, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY, WASHINGTON, D.C.

I. Why Small Business's Problems Have Become More Severe

Your June Hearings on Small Business Tax Reform, and February Hearings on Small Business Tax Needs, are truly an impressive assembly of the many and

varied challenges uniquely confronting small business. It is worth emphasizing recent events increasing the severity of those challenges, and a sharply changing recognition of the problem.

A. REPRESSIVELY DISCRIMINATORY TAXATION

First, it is only in the past two years that, thanks to the work of this Select Committee, people have begun to realize how dramatically our tax laws impose greater burdens on small firms than on large. The tax rate on corporations, according to general understanding and a simple reading of the Tax Code, is 48%. But in fact, the effective tax rate of small companies is about 15% higher than what the majors pay, for majors are aided by many complex special provisions. Senator Bible drew the first public attention to this in April 1973, and your Hearings this year, with figures public only since the SEC's December 1973 disclosure requirements, have greatly detailed just how extraordinary is the situation. It is regressive enough to have a single rate for both small and large firms, with only the most limited recognition—the first $25,000—of need for progressive treatment. But it goes from simple regressiveness, to actual repressiveness, to tax smaller firms even at *higher* rates. I urge you to have your staff, with the aid of FTC, SEC and IRS, up-date the 1971 table on effective rates which Senator Bible used in 1973 and which is reproduced in your February Hearings, p. 345; and those data, which go by firms' asset size, should be matched by a table scaled by income size.

The figures showing this discrimination are so important but so relatively little known that I urge you to prepare a concise Committee Print pulling together the data in your Hearings, presenting the overall picture and details of this discrimination, so that your Committee and small businessmen themselves will have a concise presentation to bring the message home to other Members of Congress.

B. & C. INFLATION, ECONOMIC VOLATILITY, AND CAPITAL SHORTAGE

Other recent events increasing the need for legislation to redress unfair impacts on small business, can be canvassed briefly. Inflation is not entirely the fault of the Federal Government, but there is quite a connection between the two, and therefore the Federal Government has an increased responsibility to sectors harmed by Government action, particularly housing and small business. Inflation, and especially on-again off-again policies increasing the economy's volatility, naturally impact harder on weaker firms, and when interest rates are high, weakness and smallness converge. Not only do small firms face virtually unprecedented interest rates, 4 and 5 percentage points higher than the already lofty prime. In addition to the well-known drying up of the equity markets, loans too are becoming harder to get as the rough economy necessarily makes lenders more cautious and as banks themselves face difficulty in getting the capital to support easy lending.

Consider just how devastating high interest rates are to smaller firms—and high interest rates are not the invention of Arthur Burns, but essentially reflect that demand for capital is much higher than supply, that is, capital shortage. Few businesses can earn over 15% net return on assets: therefore, if a small firm must pay 13 or 14% for borrowed funds, even a strong small firm would have little margin, and for most small firms, it simply won't pay to borrow. Therefore small firms are in the main unable to grow, unlike large firms, which can borrow at much lower rates and enjoy what little remains of access to new equity capital. In the last year, the total of outstanding business loans has shrunk by about 10%, an extraordinary contraction. Some of that shrinkage results from larger firms' replacing bank debt with longer term debt, but it is the rare small firm that can make private placements, let alone sell bonds. I urge your Committees, with the aid of the Federal Reserve Board, to develop figures showing how much of the shrinkage in bank loans has involved small firms, and to explore what has been the resulting impact on small firms.

D. INCREASED REGULATION

In addition to Federal responsibility for those most hurt by Federal fiscal and monetary policy, the past few years have seen a great increase in regulatory requirements. Most regulation brings important protection as well as costs: in spite of much current talk, we will and should keep most regulation, but we must stop ignoring regulation's impact on small firms, and we must take steps to redress that impact.

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II. Impacts of Increased Problems for Small Business

A. CONCENTRATION

To reduce concentration once it has occurred is, everyone knows, enormously difficult. To keep concentration from increasing is obviously the better course, yet it is clear from the declining share of profits and assets in small and medium firms, that we have not done enough to keep concentration not only from rising, but rising sharply. And if the "soaring Sixties" saw small and medium manufacturers lose one-third of their share of profits and 40% of their share of assets, where do you suppose we'll be by 1980—nearer 1984, in too many senses.

B. BANKRUPTCIES

The most recent sign of the severity of what's happening is seen on business' obituary page, the bankruptcy figures. Total bankruptcies increased in fiscal 1975 by 34%, more than in any year since 1949. But business bankruptcies increased even more sharply 45%, an increase more than twice as large as the worst rise since 1949. And actually 1948 and 1949, which saw high percentage rises in bankruptcies, were in comparison to 1975 like rashes compared to an epidemic, for the total figures of bankruptcies back in the 1940's were so small that a jolt could cause a sharp percentage rise: the total in 1975 is fully ten times the total in 1949, and the 1974-to-1975 increase alone is almost three times the 1949 total.

The near future holds little promise. With interest rates staying high and discretionary income steadily shrinking, only a strong general recovery for a sustained period will bring more than a pause in small business' decline, and who expects an early, strong and sustained recovery?

III. What to do?

A. EXTEND TAX REDUCTION ACT

The many economic and social arguments for extending the Tax Reduction Act are particularly applicable to small business, not only because of the present state of our economy, but also as an at lease temporary, rough equity pending more complex work to redress the existing inequities.

As for whether the small business aspects of the Tax Reduction Act should be extended temporarily or permanently, this depends on how clearly answers develop for reducing those other tax inequities, and on whether such answers can be implemented as simply as the Tax Reduction provisions you have already commendably adopted.

B. REDUCE TAX INEQUITIES

Your Hearings make clear how important is work on three leading possibilities for making equitable tax treatment for small business. *First*, reduction in rates is clearly needed, and its simplicity is especially appropriate for smaller firms. *Second*, virtually everyone agrees that the investment tax credit discriminates against small firms, which are more likely to be labor intensive rather than capital intensive. Whether or not the investment tax credit is kept in force, our employment needs as well as our interest in a tax law which does not distort economic decisions away from employing workers, and also our interest in equitable growth for small firms whether or not capital intensive, clearly warrant most serious study of a job tax credit, suggested in your Hearings by Professor Eisner and others. At present we subsidize new equipment investment via the tax credit, but not only is there no similar support for creating new jobs, instead each new job carries fringe payroll taxes over 10%. A job credit might well develop by expansion or analogy from the existing treatment for Work Incentive Expenses, Sections 40, 50A and 50B. *Third*, again for growth of small firms' capital and jobs, more retention of earnings should clearly be allowed.

C. REDUCE PERSONAL INCOME "TAX SHELTERS"

In addition to the inequities surrounding many "tax shelters", too many of those provisions distort the flow of funds and economic activity, so that e.g., we suffer gluts of condominiums and the entire disaster area known as REITs. A glut in one place inevitably means a shortage elsewhere. Small business is relatively quite risky, and one of the leading sources of capital for such firms consists precisely of those upper-income individuals who, because of tax shelters, are made reluctant to invest in small firms as compared with, e.g., real estate. While

it is too early to say where the Ways & Means Committee will come out of their current efforts, I strenuously urge that you in this Body keep in mind small business, and the strength of investment decisions based on economic merits rather than tax advantage, when you decide which aspects of personal tax shelters are economically justifiable and equitable.

D. SMALL BUSINESS "EXTENSION AGENTS"

Our agricultural sector has had decades of successful experience with extension agents. In your June Hearings, Senator Javits pointed out that the SBA not only has very limited lending authority, but is less helpful than many bankers because bankers often furnish expert financial and management guidance as well as loans, guidance which small firms can rarely afford or rarely get access to. The past decade has seen voluntary programs emerge with retired successful business executives helping small firms. Has consideration been given to strengthening the SBA's Management Assistance Program via a small business extension service, formed by drawing upon the experience of such voluntary programs and of the Agricultural Extension Service?

IV. The need to expand, nor merely shift, capital flows—and to improve equity-debt ratios

A. IS THERE A CAPITAL SHORTAGE—AND DOES IT MATTER TO SMALL BUSINESS?

"Capital shortage" is simply short-hand for saying that we have a smaller supply of capital—relative to the demand for it—than we have experienced in recent history, a period in the United States which goes back to before 1900. Three kinds of answers have been expressed by persons denying we have any such shortage. One kind of answer is utopian, a second kind comes from the blind believers in what they call the free market, and the third is Panglossian.

The Utopian Answer

The utopian answer (to use Business Week's word), exemplified by the Bosworth-Duesenberry-Carron study for Brookings, and the Brinner-Sinai study for Data Resources, admits that we are close to a severe problem, but tell us we have nothing to worry about if only the Federal budget is brought into balance in a year or two, and kept there. It is always reassuring to know of intelligent people who believe in utopia, but especially reassuring to learn that utopia is just around the corner. Unless you believe that our economic and political picture will change about $75 billion worth in about the next year, or two, you can forget about those utopian studies.

The Blind Believers' Answer

The second group denying we face a capital shortage, people like Professor Eisner (the first witness at your June Hearings) and Walter Wriston, believe so blindly in what they think is a free market, that they think, to quote Eisner, "it doesn't make sense to talk of such a shortage". That is, there cannot be a shortage of capital, there can only be higher prices for it, and that cannot be undesirable because market prices merely reflect what people want. If people just don't want to save enough to keep interest rates low enough for the survival of such sectors as housing and small business, then, in Professor Eisner's carefully measured terms, "that's just tough" (Business Week, Sept. 22, 1975, p. 44). Whatever is, is right. Walter Wriston makes a more persuasive statement of similar arguments. But if you had the best access to capital and were best situated to pay high rates, any capital shortage wouldn't hurt you or your customers, whatever such rates might do to your competition and small firms.

The Panglossian Answer

The most interesting denial that any capital shortage exists is the Panglossian, exemplified by Walter Heller's August Wall Street Journal article (Aug. 19, p. 12). He shares the utopians' admitted reliance on a Federal surplus, though for one thing he seems to push back its due date, and for another he counts on such a change in attitudes toward spending held by Members of Congress, that it would be a change in the character of our political system. Consider just some of the economic realities the Panglossians are ignoring.

First, they think that if aggregate manufacturing capacity is now underutilized, it must follow that there are no significant new investment needs. Focusing on aggregate manfacturing capacity, they simply ignore known facts as to needs in such sectors as energy or steel, let alone the truly revolutionary dimension of capital needs for agriculture and the trauma in construction.

Second, the Panglossian notion that we've been doing rather well, and so will continue well enough, ignores major changes over the last few years. For one the more affluent 1960's brought forth increased concern for quality of life, and so we are making unprecedented investment in areas like pollution control and in safety, making it wrong to look at past years' investment figures without major adjustments. But instead of an increased ability to meet these increased costs, our investment capacity has been steadily shrinking. Gross business savings, as a percent of GNP, declined in all but two years since 1965, as did total return on assets of nonfinancial firms. Gross business fixed investment, which Walter Heller apparently thinks the premier measurement, has held steady, but steadily more reliant upon borrowed funds: internal corporate funding has declined (as a percentage of business investment) in all but two years since 1965, and the equity-debt ratio (of manufacturers) has weakened in all but *one* year since 1965. Also, nonfinancial firms this year are more dependent on short-term debt, relative to long-term, than at any time since World War II, except for the December 1974 bottom. [For thorough analysis and figures showing just how much more fragile are our financial structure and the large majority of balance sheets, see Professor Hyman Minsky's articles in the Senate Banking Committee's 1975 Compendium of Papers on Bank Regulation, and in the latest issue of *Challenge*.] Not only have public offerings suffered a well-known drying up, but the percentage of offerings by smaller firms has declined in all but two years since 1965.

The Shrinkage of Savings and of Firms which Marshall Savings

Parallel to this decline of business savings has occurred a weakening of both personal savings and of our main mechanisms for marshalling savings, the banks, investment bankers and broker-dealers. The past two years have seen discretionary income shrinking significantly, and according to a Salomon Brothers study out just this month, per capita household financial assets (adjusted for inflation) are down, as of *June* 1975, 26% below their 1968 high! As for the firms whose business it is to marshall savings, the flight of firms and capital from the securities industry has been so bad that the parochial Alan Greenspan thought them the worst sufferers of all in these troubled times. And the banks have run out of room to let us fall back on them: bank regulators are not along in believing banks must themselves add new capital or else shrink their lending, but for banking just to *preserve* the *present* ratios if lending grows with the economy—and if it doesn't, how will the economy grow; and if *it* doesn't . . .—well, banks need an average of about $15 billion per year until 1985, in new capital.

Secretary Simon's Abuse of a Real Problem

The capital shortage is something of a fad at the moment, but that doesn't mean it isn't a real problem. I have been pointing to this as one of our major problems first in early 1973, before the oil shock (Conference of State Bank Supervisors, April), again at Senator Bentsen's February 1974 Hearings on increasing capital availability and financial competitiveness, and again a year ago to the American Bankers Ass'n. Trust Division. Of course saying the same thing early and often doesn't mean it's the right thing. But neither is it the wrong thing just because it is being used by Secretary Simon and others who believe that Government should help the rich since, as Simon actually said to Ways & Means on July 31, helping big savers will "in the end" help all savers. For example, I consider the Secretary's proposed tax umbrella over corporate dividends to be hollow politics and horrid economics, as the disagreements with it expressed by Governor Henry Wallich and by Fortune Magazine (editorial, Sept. 1975, p. 94), show well. Capital shortage and deteriorating balance sheets mean we should encourage retention of earnings and reinvestment of dividends, not tax breaks for the well-to-do in the false hope that enough will trickle down to raise equity prices, and maybe someday something will trickle beyond the wealthy and the major corporations. If Simon weren't simply using the capital shortage problem, he would expand the proposed dividend treatment he has suggested only for electric utilities (July 8, Ways & Means testimony), *deferring* stockholders' tax on *reinvested* dividends, the reinvestment to be taxed later at *ordinary* income rates. Such treatment would involve only a deferral, not a loss, of Federal revenues, and would be *the easiest* way to increase equity investment. Why not spread such treatment, at least to publicly held small companies?

The NYSE Study

Perhaps the most frequently criticized statement pointing to the capital shortage has been the New York Stock Exchange's. I don't often defend the NYSE, but three points must be made.

First: While some have attacked the NYSE projections of investment needs as being a mere shopping list more like a child's letter to Santa than realistic needs, it is striking that the Brookings Study's need projections are only about 5% lower, so the real difference is not in the need projections but in the utopian assumptions.

Second: Let's compare some recent capital needs projections with earlier ones. Just two years ago, McGraw-Hill estimated the steel industry would need $4.5 billion a year by 1985 (Business Week, Sept. 22, 1973). Last week U.S. Steel's President said his industry needs $5 to $6 billion a year between now and 1980 (Washington Post, Sept. 19, 1975, p. *D11*). McGraw-Hill estimated electric utilities would need $41 billion a year by 1985, but this month Continental Illinois estimated about a $50 billion annual need by 1985 (Business Week, Sept. 22, 1975). Last, McGraw-Hill estimated petroleum would need $12.6 billion a year by 1985, ConIll's study says domestic petroleum investment alone will have to be about $38 billion a year, three times the estimate of only two years ago.

Third: The NYSE, in addition to being an interested party, has made bad goofs before, and their capital needs projections may be only the latest goof. But I'm reminded of some goofy projections they put out just 10 years ago, estimating the growth of their own stock trading volume. They set a figure for ten years ahead, 1975, which many attacked as wildly high. That figure was hit not in 10 years, but in just 3, 1968, and the too modest projections were a large part of the reason for the terrible back-office crisis of 1969–70. We'd better get very serious about figures on projected capital needs, and of course on action to meet those needs, or the back-office crisis will be seen, somewhat rightly, as a teapot tempest.

Recent bulletins from the capital shortage front

Just three last indications that there is a capital shortage. First, don't high interest rates say a great deal, or are there some serious people who believe Arthur Burns is entirely responsible? Second, remember last Spring's fad in finance, the fuss over "crowding out"? In light of the extraordinary recent rash of cancelled public offerings, the near-record rates Federal offerings are paying and the impossible burdens confronting state and local units, is there any longer doubt about crowding out? I would like to insert here a statement by Henry Kaufman of Salomon Brothers, in the Wall Street Journal, Sept. 15, 1975, p. 15:

> Even wider consequences are foreseen by Henry Kaufman of Salomon Brothers, who recalled that "a very vociferous debate occurred earlier this year concerning the possibility that the huge budget deficit would force the Treasury to crowd out other prospective borrowers and this hinder rather than encourage economic recovery. Crowding out didn't materialize to a significant extent in the first half of the year when the economy was contracting and the inflation rate was decelerating, but it is surfacing with the emergence of some real economic growth, and acceleration in inflation and the huge Treasury financing demands," he said.
>
> "Many medium-rated corporations have postponed or canceled attempts to market their new securities during the past two months, and savings flows to deposit institutions are slowing appreciably," Mr. Kaufman said. "Commercial banks have relaxed their efforts to enlarge their capitalization base through external financing," he added.
>
> His assertion about "crowding out" appears reasonable considering that only about $1.36 billion of new corporate bonds have been scheduled for public sale this month, down sharply from an average of $3.18 billion in the first eight months of this year. A mere $830 million have been listed for sale in October thus far.

Third, just consider this past Sunday's New York Times Business section: AT&T is offering shares at below book value, because its balance sheet is 50% weaker than 10 years ago. Crocker National, merely a $10-billion bank holding company, sold shares at 25% below book value—no major American bank had ever before sold shares below book at all. And Bankers Trust, merely a $20-billion bank holding company, offered preferred shares at a 10% yield.

If these giants must resort to those steps, is it so hard to see just how severely small firms are being crowded, down and out?

B. WHAT IS TO BE DONE?

To increase the supply of savings, incentives which are both direct and equitable, not Simon's trickle-down give-aways, must be developed.

"Bentsen Plan" Funds

For example, Congress is to be praised for expansion of the Keogh Plan and even more for development of the new IRA's and ESOT's. I have already noted the need to encourage dividend re-investment, with tax deferral, not reduction. I enthusiastically support the "Bentsen Plan Funds" idea in S. 666 for savings for higher education, although I believe the Senator has been too modest in the $50 credit he proposes and too limited in aiming such funds into only housing. I urge you all to give the most serious consideration to S. 666. The Small Business Committee particularly should change the Bentsen Plan funds from entirely housing to, in my opinion, 25% in housing mortgage vehicles, 25% in small and medium business, and the balance according to investment judgment.

Brazil's innovations in marshalling capital

Your Committees, with the aid of Treasury, should seriously study Brazil's extraordinary innovations in marshalling capital and particularly equity capital, even for special needs like development of Brazil's Northeast—they did so well with tax incentives for savings that some observers believe they increased the willingness to pay taxes! Brazil's Decree-Law 157 and "open capital companies" are included in work soon to be released by the World Bank. May I insert as an Appendix some spectacular data about the success of Brazil's capital raising?

* * * * * * *

J. Irwin Miller, one of our leading industrialists, two or three years ago wrote an article called "Can We Afford Tomorrow?" We would be in trouble if the answer is No. But it is largely up to your Committee's to make sure that small business is able to meet the costs of getting to tomorrow.

BRAZIL'S FINANCIAL SAVINGS, 1964-74

[current cruzeiro dollars]

	Savings accounts	Time deposits [1]	Acceptances	Housing bonds	Government securities [2]
1964			330		73
1965			[illegible]	9	463
1966	18	141	[illegible]	47	1,434
1967	[illegible]	[illegible]	2,10[illegible]	[illegible]	[illegible]
1968	[illegible]	1,0[illegible]	4,[illegible]	[illegible]	[illegible]
1969	[illegible]	1,[illegible]	6,172	1,16[illegible]	[illegible]
1970	2,0[illegible]	4,[illegible]	9,7[illegible]	2,007	10,111
1971	[illegible]	9,319	14,380	[illegible]	16,446
1972	7,713	16,903	22,3[illegible]	[illegible]	25,173
1973	14,1[illegible]	[illegible]	37,12[illegible]	[illegible]	36,144
1974 [3]	23,677	31,151	46,304	8,303	47,433

[1] Excludes small amount of unindexed time deposits.
[2] Federal Government securities only.
[3] Preliminary.

Source: Central Bank of Brazil.

TAX-INCENTIVE MUTUAL FUNDS AND ORDINARY MUTUAL FUNDS, 1968-74

[In millions of current cruzeiro dollars]

	Tax-incentive mutual funds, net worth	Ordinary mutual funds, net worth
1968		
1969	221	615
1970	380	610
1971	774	3,[illegible]
1972	788	2,100
1973	1,414	1,851
1974	1,391	1,530

Notes: For background see (1) David Trubek: "Law, Planning and the Development of the Brazilian Capital Market," New York University Graduate School of Business Bulletin, April 1971; (2) Walter Ness: "Financial Markets Innovation as a Development Strategy: Initial Results from the Brazilian Experience," 22 Economic Development and Cultural Change 453, April 1974.

Source: Central Bank of Brazil.

STATEMENT OF ROY A. SCHOTLAND, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY

Mr. SCHOTLAND. Thank you very much. It is an honor to discuss these problems with you and especially to be present at Mr. Okun's broad illumination. I feel I bring only a little sprinkle, or maybe at best, a beam or two of light. I will move selectively and briefly, I hope, through my prepared statement and submit it at the end for your record.

I have a few comments on why recent events have increased the severity of small businesses' problems. We have seen increased recognition, or rather the beginning of increased recognition, of those problems. I want to comment on the already tangible impacts and give some proposals for action by your committees and staff; several proposals in the tax area of legislation and one outside that area.

I would like to concentrate on an analysis of the overriding problem, which is why we are, in my opinion, all here. Our vibrant society has many needs and aspirations, but for the first time in generations, our society has a decreasing ability to meet those challenges. I would like to comment on that.

I would also like to close with two proposals again in the area of tax legislation to increase our savings directly, not be trickle-down, but directly, so as to increase the society's resources to meet its challenges.

My first point and my next early ones are the same as what Senator Brock has just been emphasizing. It has only been in the past 2 years, I think, thanks to the work of the Select Committee, that people have begun to realize how dramatically tax laws impose greater burdens on small firms as compared with larger firms. There is a general impression the tax rate is 48 percent across the board, except for the mild changes at the bottom. Senator Bible first drew attention to this in April 1973, and your hearings this year, with figures made public only since the SEC's December 1973 disclosure requirements, have greatly detailed just how extraordinary this situation is. It is regressive enough to have a single rate for firms of all sizes, with only the most limited recognition at the bottom, of any need for progressive treatment.

But, it goes from simple regressiveness to actual repressiveness, to tax smaller firms at higher rates, which is what we are doing. I urge you to have your staff, with the aid of the Federal Trade Commission, the Securities and Exchange Commission, and the Internal Revenue Service, update the 1973 effective rates which Senator Bible used and which is reproduced in your February hearings. Indeed, I think these figures are so important that I urge the Select Committee to put together a concise committee print, assembling the information presented at those hearings, so that your committee and the small businessmen will have a concise presentation to bring the message home to other Members of Congress.

It is an area of increasing recognition that there are acute and increasing problems like inflation and particularly our volatile economic situation, and this naturally impacts the most on weaker firms, which are paying 4 and 5 percentage points above the already almost historically high prime rate.

The equity markets have been a desert for several years. Loans are becoming harder to get.

Consider just how devastating high interest rates are to smaller firms. And with all respect to the very difficult problems of where monetary policies ought to be, higher interest rates are not entirely the invention of Arthur Burns, but essentially reflect that demand for capital is much higher than supply, that is, in the going language, a capital shortage, or as one of your witnesses this morning will point out more accurately, we are talking about a savings shortage.

Few businesses can earn over 15 percent net return on assets. The small firm must pay 13 or 14 percent for borrowed funds, and even a strong small firm would have little margin, and for most small firms, it simply won't pay to borrow.

Therefore, in the main, small firms have been unable to grow, unlike large firms, which can borrow at the prime or much closer to it, and enjoy what little remains of access to new equity capital. In the last year, the total of outstanding business loans has shrunk by about 20 percent, historically an extraordinary contraction. Some of that shrinkage results from larger firms replacing bank debt with long-term debt, but it is the rare small firm that can make private placements, let alone sell bonds.

I urge your committees, with the aid of the Federal Reserve Board, to develop figures showing how much the shrinkage in bank loans has involved small firms, and to explore what has been the impact on those firms.

Senator Bentsen and Senator McIntyre have discussed the impact of increased regulation. I think we all know that increased regulation puts disproportionate burdens on small firms. And I predict that contrary to much of the current talk, we will not significantly reduce the total regulatory requirements. I think certainly we have to take steps to redress the impact on smaller firms.

Earlier this morning, I gave to one of your staff a copy of a portion of recent questionnaires sent to the Federal Bank Regulatory Agencies by the House Banking Committee, inquiring in some detail into the processes they have for reducing, simplifying, and updating their reports. I would think many committees with oversight responsibilities ought to be considering similar questions to agencies within their jurisdiction.

Senator Brock also pointed, at least as I understood it, to the problems that emerge from concentration, and the last discussion was precisely along that line. We know, as Dr. Okun was certainly saying and few would disagree, the terrible problems of reducing concentration once it has occurred and this is not just a matter of what the law is but all kinds of problems, including equity to existing arrangements. Obviously, it is better to keep concentration from increasing. Yet, it is clear from the declining share of profits and assets in small and medium firms, that we haven't been doing very well in keeping concentration from rising. If the "soaring Sixties" saw small and medium manufacturers lose one-third of their share of profits and 40 percent of their share of assets, where do you suppose we will be by the 1980's?

The most recent sign of the severity of what is happening is seen on businesses' obituary pages, the bankruptcy figures. Total bank-

ruptcies increased in fiscal 1975 by 34 percent, more than any year since 1949. But, business bankruptcies increased even more sharply, 45 percent, an increase more than twice as large as the worse rise since 1949.

The near future holds little promise. With interest rates staying high and discretionary income steadily declining, only a strong general recovery for a sustained period will bring more than a pause in small businesses' decline.

What is to be done? First, the Tax Reduction Act must be extended. The many economic and social arguments for doing so are particularly applicable to small business. As to whether it should be permanent or temporary, in my opinion, that depends on how clearly answers develop for reducing tax law inequities; reducing the inequities now existing with small firms, and also on whether the answers to reduce inequities can be implemented as simply as the tax reductions you have already commendably adopted.

There are three leading possibilities for making more equitable tax treatment for small business. A reduction in rates is clearly needed and its simplicity is especially appropriate for small firms. Also, virtually everyone agrees that the investment tax credit discriminates against small firms, which are more likely to be labor-intensive rather than capital-intensive. Whether or not that credit, the investment tax credit, is kept in force, our employment needs as well as our interest in a tax law which does not distort economic decisions away from employing workers, and also our interest in equitable growth for small firms, whether or not capital-intensive, clearly warrants most serious study of a job-tax credit, suggested in your hearings by Professor Eisner and others.

At present we subsidize new equipment investment via the tax credit, but not only is there no similar support for creating new jobs, instead each new job carries fringe payroll taxes of over 10 percent. A job credit might well develop by expansion or analogy from the existing treatment for work incentive expenses, sections 40, 50A, and 50B.

Third, again for growth of small firms' capital and jobs, more retention of earnings should clearly be allowed.

Last, at this point we need to reduce personal income tax shelters. Too many of those provisions distort economic activity so that, for example, we suffer a glut of condominiums and the entire disaster area known as REIT's. A glut in one place means a shortage in another. Small business is relatively quite risky, and one of the leading sources of capital for such firms consists precisely of those upper-income individuals, who, because of tax shelters, are made reluctant to invest in small firms as compared with real estate, for example. And while it is too early to say where the Ways and Means Committee will come out of their current efforts, I strenuously urge that you in this Body keep in mind small business, and the strength of investment decisions based on economic merits, rather than tax advantage, when you decide which aspects of tax shelters are economically justifiable and equitable.

Outside the tax area, next we should consider the agricultural side, which was spoken of at some length in your earlier hearings.

In your June hearings, Senator Javits pointed out that the SBA not only has very limited lending authority, but it is less helpful than many bankers because bankers often furnish expert financial and management guidance, as well as loans guidance, which small firms can rarely afford or rarely get access to. The past decade has seen voluntary programs emerge in which retired, successful business executives have been helping small firms. Has consideration been given to strengthening the SBA's management assistance program via a Small Business Extension Service, formed by drawing upon the experience of such voluntary programs and of the Agricultural Extension Service?

The overriding need underlying all these problems, if I can mix the images, is to expand investment capital flows and also to improve debt-equity ratios.

There is a capital shortage, capital savings shortage, and it matters to small business much more than large business. Three kinds of answers have been expressed by persons denying we have any such shortage.

First, to use Business Week's latest issue's language, is the utopian answer, exemplified by the recent study for Brookings, and for Data Resources. These admit that we are very close to a severe problem, but tell us we have nothing to worry about if only the Federal budget is brought into balance in 1 or 2 years and kept there. It is always reassuring to know of intelligent people who believe in utopia, but especially reassuring to learn that utopia is just around the corner. Unless you believe that our economic and political picture will change about $75 billion worth in about the next year, you can forget about those utopian studies.

The second group denying we face a capital shortage are the blind believers. These are people like Professor Eisner and Walter Wriston, who believe so blindly in what they think is a free market, that they think, to quote Professor Eisner, "It doesn't make sense to talk of such a shortage." That is, as he says, there cannot be a shortage of capital, there can only be higher prices for it, and that cannot be undesirable because market prices merely reflect what people want. If people just don't want to save enough to keep interest rates low enough for the survival of such sectors as housing and small business, then, in Professor Eisner's carefully measured terms, "That's just tough." Whatever is, is right.

Walter Wriston makes a more persuasive statement of similar arguments. But, if you had the best access to capital and were best situated to pay high rates, any capital shortage wouldn't hurt you or your customers, but would hurt smaller firms and competing smaller banking firms.

The most interesting theory that exists is the Panglossian, exemplified by Walter Heller's August Wall Street Journal article. He shares the utopians' admitted reliance on a Federal surplus, though for one thing he seems to push back its due date, and for another he counts on such a change in attitudes toward spending held by you and your colleagues in Congress, that I submit it would be a change in the character of our political system. Consider just some of the economic realities the Panglossians are ignoring.

First, they think that if aggregate manufacturing capacity is now underutilized, it must follow that there are no significant new investment needs. Focusing on aggregate manufacturing capacity, they simply ignore known facts as to needs—again, as so stressed earlier this morning—in the agricultural sector, where the capital needs are revolutionary in dimension, and the terrible needs in energy and steel, just to name some examples.

Second, they have the notion that we have been doing rather well, and so will continue well enough, ignoring major changes over the recent years. For one, the more affluent 1960's brought forth increased concern for the quality of life, and so we are making unprecedented investment in areas like pollution control and occupational safety and health, making it wrong to look at past year's investment figures without major adjustments. But, instead of an increased ability to meet these increased costs, our investment capacity has been steadily shrinking. Gross business savings, as a percentage of GNP, declined in all but 2 years since 1965, as did total return on assets of nonfinancial firms. Gross business fixed investment, which Walter Heller apparently thinks the premier measurement, has held steady, but is steadily more reliant upon borrowed funds: Internal corporate funding has declined as a percentage of business investment in all but 2 years since 1975, and the equity-debt ratio of manufacturers has weakened in all but one year since 1965.

This year, nonfinancial firms are more dependent on short-term debt, relative to long term, than at any time since World War II, except for the bottom just 6 months ago. Not only have public offerings suffered a well-known drying up, but the percentage of offerings by smaller firms has declined in all but 2 years since 1965.

Parallel to this decline of business savings, has occurred a weakening of both personal savings and of our main mechanisms for marshaling savings. The past 2 years has seen discretionary income shrinking significantly. Real disposable income is down about 5 percent since 1973, so discretionary income must be down much more. The rate of personal savings has been static, and I submit that is a product of fear. According to a Salomon Brothers study out just this month, per capita household financial assets (adjusted for inflation) are down, as of June 1975, 26 percent below their 1968 high. As for the firms whose business it is to marshal savings, the flight of firms and capital from the securities industry has been so bad that the parochial Allen Greenspan thought them the worst sufferers of all in these troubled times. And the banks have run out of room to let us fall back on them: Bank regulators are not alone in believing banks must, themselves, add much new capital or else shrink their lending, but for banking just to preserve the present ratios, if lending grows with the economy, will mean banks will need an average of about $15 billion per year until 1985, in new capital.

I think what Walter Heller is really getting at is what a great many people agree with, although of course, not all, is that the capital shortage is something of a fad at the moment, but it is being used by Secretary Simon and numerous others who believe, to put it bluntly, that the Government should help the rich, as Secretary Simon actually said to the Ways and Means Committee on July 31, namely, that helping big savers will "in the end" help all savers.

For example, I consider the Secretary's proposed tax umbrella over corporate dividends to be hollow politics and horrid economics, as the disagreements with it expressed by Governor Henry Wallich and by Fortune Magazine, show well. Capital shortage and deteriorating balance sheets mean we should encourage retention of earnings and reinvestment of dividends, not tax breaks for the well-to-do, in the false hope that enough will trickle down to raise equity prices, and maybe someday something will even trickle beyond the wealthy and the major dividend issuing corporations.

If Simon weren't simply using the capital shortage problem, he would expand the proposed dividend treatment, which he has suggested, but only for electric utilities, deferring stockholders' tax on reinvested dividends, with the reinvestment to be taxed later on at ordinary income rates. I think this is a fascinating and valuable proposal. It would involve only a deferral and not loss of Federal revenues and would be, in my judgment, clearly the easiest way to increase equity investments. I urge your committees to consider spreading that treatment, at the very least, to publicly-held smaller companies.

A comparison of recent capital needs projections and considering whether this is a real problem, would be of interest. Just 2 years ago, McGraw-Hill estimated the steel industry would need $4.5 billion a year by 1985. Last week, United States Steel's president said his industry needs $5 to $6 billion a year between now and 1980. McGraw-Hill estimated electric utilities would need $41 billion a year by 1985, but this month Continental Illinois estimated about a $50 billion annual need by 1985. McGraw-Hill estimated petroleum would need $12.6 billion a year by 1985, and CONILL's study says domestic petroleum investment alone will have to be about $38 billion a year, three times the estimate of only 2 years ago.

Next, just three last indications that there is a capital shortage. First, don't high interest rates say a great deal, or are there some serious people who believe Arthur Burns is entirely responsible, not only for the marginal increase, but for the whole thing, that is, but for Arthur Burns we would have either low or normal interests? Second, remember last spring's fad in finance, and the fuss over "crowding out"? In light of the extraordinary recent rash, almost unprecedented, of cancelled public offerings, the near-record rates Federal offerings are paying and the impossible burdens confronting State and local units, is there any longer doubt about crowding out? I would like to insert here, for the record, a recent statement by Henry Kaufman of Salomon Brothers in the Wall Street Journal.

Third, just consider this past Sunday's New York Times business section: A.T. & T. is offering shares at below book value, and this is unprecedented, because its balance sheet is 50 percent weaker than 10 years ago. Crocker National, merely a $10 billion bank-holding company, sold shares at 25 percent below book value and no major American bank had ever before sold shares below book value at all. Bankers Trust, merely a $20 billion bank-holding company, offered preferred shares at a 10 percent yield.

If those giants must resort to those steps, is it hard to see just how severely small firms are being crowded, down and out?

We must increase the supply of savings, by means of incentives which are both direct and equitable.

For example, Congress is to be praised for expansion of the Keogh Plan and even more for development of the new IRA's and ESOT's. I have already noted the need to encourage dividend reinvestment, with tax deferral, not reduction. I enthusiastically support the Senator Bentsen plan funds, which is an idea in S. 666, to fund savings for higher education, although I believe the Senator has been too modest in the $50 credit he proposes, and too limited in aiming such funds into housing only.

I urge you all to give the most serious consideration to this bill. The Small Business Committee especially should change the Bentsen plan funds from entirely housing to, in my opinion, 25 percent for housing through thrifts, 25 percent for small and medium business and the other 50 percent according to investment judgment.

This would be quite similar to several innovations which Brazil has used with very impressive success. I append two tables showing dramatic figures, adjusted for inflation, on the marshaling of capital and particularly equity capital in Brazil. The World Bank is now doing a very good job of studying the Brazilian devices. I urge these committees, with the aid of Joint Economic and Treasury, to do the same kind of work. I again append some material on that.

J. Irwin Miller, one of our leading industrialists, 2 or 3 years ago wrote an article called "Can We Afford Tomorrow?" I take it we agree we would be in trouble if the answer is no, but it is largely up to your committees to make sure that small business is able to meet the cost of getting to tomorrow.

Thank you, Mr. Chairman.

Senator NELSON. Thank you very much for a very thoughtful statement. I just had one question here on the deferral of the tax on invested dividends. What page was that? Oh, page 14.

You say "deferring stockholders' tax on reinvested dividends, the reinvestment to be taxed later at ordinary income rates." Once it is reinvested, how do you subsequently tax it?

Mr. SCHOTLAND. Well, in the first place, that is precisely Secretary Simon's proposal in his July 8 testimony to Ways and Means with respect to electric utilities. So I take it the Treasury believes it can be worked out. I am not certain of what they had in mind as to working it out, but I would expect that there would be an adjusted basis in the investment and a record kept of the proportions that had gone in by dividend investments, and those portions taxed at a different rate, upon sale, from the rest. But, I take it, since he proposed it for electric utilities, it is the Treasury's judgment that it should work.

I think it should happen for electric utilities. I applaud his proposal there for all my disagreement with him in other places, but I think it should happen in a lot of other areas, and particularly in this one.

Senator NELSON. You say "taxed at the regular rate." How does that differ from the tax paid now?

Senator BROCK. If I may interrupt?

Senator NELSON. Yes.

Mr. SCHOTLAND. Please.

Senator BROCK. I mean, the way the proposal works, as I understand it, is that now, of course, dividends are taxes at ordinary tax

rates. If you sell the stock, of course, you sell it on a capital gains basis. What would happen is the corporation or the requesting stockholder would reinvest the dividends for the stockholder and, in effect, it would be a separate account, a capital account; if and when the stockholder called him and says "I want my stock and I want to sell it out." And then the separate account is taxed at his normal, present, ordinary income rate and the capital account or the equity investment of purchase of stock is taxed at a capital gains rate. This requires a separate accounting system.

Mr. SCHOTLAND. Indeed, we largely have it already, because of the voluntary dividend reinvestment plans which will record how much has come back, if you choose to have it reinvested.

Senator BROCK. It is very much in parallel with the existing programs?

Mr. SCHOTLAND. Yes. Mr. Chairman, I don't see how people can say there is a savings shortage and particularly with deteriorating balance sheets and the equity markets dried up and so forth, and then turn around and make a proposal which encourages corporations to reduce retained earnings. Let us face it, what is the easiest way to keep equity and who is more likely and what is easier than just saying "don't send me the check, which is taxed at my marginal tax rate, but keep it in the corporation, and I will pay later, if and when I sell it." The when, of course, is often after retirement, or, unless we get rid of the stepped-up basis at death, much of this would go.

So, the deferral here would be of great value to the taxpayer, but in the last analysis, there would be little loss to the Federal Government. I believe that, just as we have had experience in other places, that by increasing the equity, it would increase total investment, and it would increase productivity.

Senator NELSON. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

On page 2 of your statement, you say that the investment tax credit discriminates against labor and small business. Would you elaborate on that?

Mr. SCHOTLAND. I will try to, Senator. Yes, I believe that the committee has had some excellent detailed information put forth, making clear the degree to which small business is less capital-intensive and increasingly more service-oriented than larger businesses. Since the investment tax credit is available only for equipment and only for firms which are using relatively larger amounts of equipment, it does nothing to help a firm which uses little or no significant capital. Therefore, jobs are created only if the equipment calls for new jobs and the equipment actually may discourage new jobs.

Several of your witnesses have put forth, in some detail, the proposal for a job-tax credit. Now, whether that job-tax credit should be available only as an alternative to the investment tax credit, so as truly to reduce the inequity, or, in addition, which would be yet a more severe revenue loss, is a question on which I have no answer.

Senator BYRD. How do you feel towards the investment tax credit as such?

Mr. SCHOTLAND. I believe at the present time, Senator, it should be continued, in spite of the fact I am troubled about the extent to which it does encourage yet more debt.

Senator BYRD. Now, you mentioned reduction of small firm's rates of taxation. What do you think is an appropriate figure?

Mr. SCHOTLAND. I think I would prefer, Senator, on that to defer to people who are experts in taxation.

Senator BYRD. Now, you say both labor and small business would be aided by allowing more retained earnings. The present law really is a great deterrent to small business, is it not?

Mr. SCHOTLAND. I believe you are right.

Senator BYRD. The level of retained earnings that are permitted, in other words?

Mr. SCHOTLAND. I agree with you, Senator.

Senator BYRD. And as contrasted with the very large companies, there is, as a practical matter, as I see it, no real limit on retained earnings?

Mr. SCHOTLAND. I again believe you are right.

Senator BYRD. No effective limit, that is.

Mr. SCHOTLAND. Exactly.

Senator BYRD. Now, how would you define small business, or to put it another way, when does a business cease to be a small business?

Mr. SCHOTLAND. Well, Senator, I guess that depends upon the purposes. If we are trying to work out an exemption from OSHA requirements, I would expect that would be very different from——

Senator BYRD. I was thinking more along the tax line.

Mr. SCHOTLAND. But what I mean is it would depend again. For example, we might allow retained earnings to go much higher in a publicly held small company than a close company, or we might decide that there is not a serious problem there and the close company could be treated the same way. But, whether the measure should be assets or the number of employees, I think this needs to be worked out.

What I am trying to emphasize is that I think these things are so seriously worth the working out, that I think these are the areas in which legislative action must occur.

Senator BYRD. I think your statement is most interesting and I note you are not too much inclined to the view that our economic and political picture will change by about $75 billion worth in the near future?

Mr. SCHOTLAND. Again, I agree with you.

Senator BYRD. I certainly don't see a change of $75 billion worth. Thank you, sir.

Mr. SCHOTLAND. Thank you.

Senator NELSON. Senator Javits.

Senator JAVITS. Not right now. I will yield to Senator Brock.

Senator BROCK. Obviously, I liked your statement, because I agreed with everything you said, and I appreciate it. I have just a couple of points on the regressivity of taxes on small business, and it is regressive, for I think small businesses pay—for I think we can demonstrate they pay a higher effective rate of taxation than larger businesses in this country.

My own predilection has been toward the graduated approach. But failing that, I have proposed, and some on the committee have proposed, an effort to raise the surtax exemption to $100,000. I think that is absolutely necessary.

Mr. SCHOTLAND. Yes; I agree entirely. By the way, the hearings do contain some good data from the National Federation of Independent Businessmen on the proposed rates.

Senator BROCK. Yes; I have seen that.

In reference to Senator Byrd's question with regard to the investment tax credit, I don't see how we can remove the investment tax credit at this time, given the need, I think, for modernization in a number of areas. But I think the point is well taken that the investment tax credit is discriminatory against those who are less capital-intensive, and that is primarily small businesses. They are almost, by definition, labor-intensive.

I might point out that, again, I have a bill that would provide an employment tax credit for hiring unemployed up to 14.9 percent for the first year. The reason I came to that figure is that your social security and medicare tax on the individual and the employer is 11.7 percent and the average unemployment compensation tax is 3.2 percent, and the combination, obviously, is 14.9 percent. That is one of the figures arrived at. But, I think that is at least a step at trying to provide some equity in the two situations. And I agree that both—well, not in the case of the employment tax credit, but I agree the investment tax credit does have one built-in disadvantage, and that is the tendency to be opposed to equity financing. And I don't think we have adequately dealt with that problem.

I also do think we have got to take some steps to increase the level of savings in this country. I do agree with your statement that it is not a shortage of capital but a shortage of savings, and I think we should do something about that, because that is the benefits from which we get our capital.

Oh, I would like to have you comment, if you feel you can, on one other question, and that is the concern that I have, particularly in regard to the fact that we are now, whether we like it or not, in the international marketplace, and we've got to compete. And I think our depreciation schedules are absolutely archaic. I question whether or not it is logical to depreciate on the basis of costs or on the basis of recovery or replacement of fixed assets, which is a system used by most of our trading partners in the industrial world. It seems to me our present system is retardent of reinvestment and is counterproductive in that sense in terms of jobs.

Mr. Schotland. You asked for a comment, Senator, and I guess I have two. One is, I am sure we are all very pleased and impressed by the recent balance-of-payments figures. I think they say that for all the problems business has, we are doing very well relatively and for lots of reasons I agree.

Senator Brock. With considerable help from my farmers.

Mr. Schotland. Yes, sir. Still, the manufactured goods are competing quite successfully, first.

Second, if we do change the depreciation rate, and I grant you there is a strong case for it, but again we have a significant revenue loss there. I think the higher awareness of the smallness of our total pie is such that we have to make very, very painful decisions about just where we are going. I would rather see something like deferral of reinvested dividends, which will meet a strong argument—though I don't fully agree with it, about inequities about double taxation, and so forth, and it will increase equity investment, just as would the depreciation schedule, and will increase equity investment, which I think is one of our most important problems. If we haven't learned anything from New York City, I hope we will at least learn that there is a time when debt gets a little high.

Senator Brock. Thank you.

Senator NELSON. Senator Packwood.

Senator PACKWOOD. You make reference to the fact that the Federal deficit was not a significant factor in capital accumulation. Well, I was reading your statement rather hurriedly, but you pooh-poohed also those who said that simply balancing the budget will take care of our capital formation problems.

Mr. SCHOTLAND. Senator, what I meant to say is I don't think it is about to happen, that is, I don't think we are, as Senator Byrd was just saying, about to bring about $75 billion of change in a year or two.

Senator PACKWOOD. You are just writing that off as utopian because it is not going to happen, in other words?

Mr. SCHOTLAND. I can see many reasons why we ought to bring it into balance, and I can see other reasons why we ought to do something like get all the existing cars off the road, even if it takes a heavy Federal subsidy to provide a new fleet of cars. Maybe we ought to be more expansionary.

Senator PACKWOOD. So it is not a major factor in your mind?

Mr. SCHOTLAND. I have no doubt that we are going to continue to be running significant deficits. Now, whether they will continue to get praise from Dr. Okun, when he says that he thinks that present fiscal policy is rather successful, is another question.

Senator PACKWOOD. You pooh-poohed Secretary Simon's arguments also as to the trickle-down theory. Would you consider it to be a trickle-down theory if we reduced the corporate profits tax to 40 percent for big and small corporations?

Mr. SCHOTLAND. Well, it depends on what other changes are being made. I do, in the statement, call for a reduction of the tax rates. I would rather see it happen for smaller corporations for several reasons. One, I think it is more feasible. I think it will address the existing inequities that are hurting small business. I think it is going to have a much lower revenue loss.

Senator PACKWOOD. But this is a genuine theory to help capital formation?

Mr. SCHOTLAND. That is correct, Senator. I think it might be more feasible and more useful to encourage reinvestment of dividends, and to encourage new capital formation in that way. If the tax rate is reduced, we have no guarantee where that money goes. If the equity is increased, we expect it is going into investment. It will be the rare bird that will put it into the bank.

Senator NELSON. Senator Javits?

Senator JAVITS. Yes. I just find your statement extremely interesting and very provocative. I would like to say I like it especially, Professor Schotland, because it shows what you can do with brains and organization and it doesn't necessarily call for new money. And I like that.

Now, I was going to ask you what you have here about my own thoughts respecting small business stimulation through management expertise. Do you have any ideas on the drawing board as to how that might be handled with SBA?

Mr. SCHOTLAND. Well, I think I would start out by examining the Agricultural Extension Service and the voluntary programs that have grown up in just the past maybe 10 years at the outside, wherein retired executives are becoming either full time or part time or even just consultants to small firms. I think here, as in many other cases,

where voluntary activities are occurring, are excellent models for what ought to be made regularized and expanded programs.

Senator JAVITS. I was just going to say the executive assistance programs you mentioned have very heavily been confined to overseas operations, that is, retired management personnel have found it very attractive there. Of course, I had in mind domestic.

Mr. SCHOTLAND. I do, too, Senator.

Senator JAVITS. Go ahead. I interrupted you.

Mr. SCHOTLAND. I believe there have been, though, to put it mildly, although you would know more about New York than I, but I thought there had been programs in New York City where retired business executives have been making themselves available at extremely low cost to small firms. I don't see why this committee and the SBA shouldn't be looking into that and looking into the Agricultural Extension Service, which has been so successful, and saying that this is the kind of thing that ought to be happening here, too. The economies of scale are such that it doesn't make sense to small firms to get these kinds of expertise. But, fortunately, our life expectancy is such on the one hand, and our pension system is such on the other, that a lot of people of enormous utility are leaving their career positions very early. I think we ought to be tapping that potential.

Senator JAVITS. That is very sensible, and we will look into that and all your proposals.

The other thing I was very interested in is your job-tax credit. I tried that once a few years ago on the tax bill and didn't get anywhere. We got some votes, but not nearly enough. Again, I wondered about this. You say it warrants more serious study. Now, have you undertaken or articulated anything like that yourself?

Mr. SCHOTLAND. I haven't, sir. I think we ought to find out how the work incentive program expense deduction has been working, as set forth in section 40, sections 50 A and B, where there is a very restrictive provision along these kinds of lines. And I think by expansion or analogy of that, either to new workers or conceivably to retired people who are on very limited pensions, which is all too often, we might consider special treatment for jobs for such people.

Senator JAVITS. Thank you, Mr. Chairman.

Senator NELSON. Thank you very much, Professor, for your thoughtful statement.

Mr. SCHOTLAND. Thank you.

Senator NELSON. I will submit for printing at this point in the record a letter to Secretary Simon, inviting him to testify before the committee. He couldn't arrange to accept the date, but we will insert it in the record.

[The letter referred to follows:]

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C., September 18, 1975.

Hon. WILLIAM E. SIMON,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: This Committee has been conducting an in-depth study of the business tax structure and its effects on small business. Prior to our initial mid-June public hearings on this subject, conducted jointly with the Subcommittee on Financial Markets of the Senate Finance Committee, we consulted with the Treasury staff with a view toward obtaining testimony when the hearings reconvened in September.

It is the Committee's intention to develop recommendations for inclusion in the forthcoming omnibus tax reform bill from the standpoint of smaller and independent enterprises. Some initial recommendations were offered as discussed in testimony to the House Ways and Means Committee on July 31—a copy is being sent under separate cover, along with the volume of the June hearings, for your full consideration.

The further joint hearings we had projected have now been definitely scheduled for September 23–25 in the Finance Committee hearing room, 2221 Dirksen Senate Office Building, beginning at 9:30 a.m. each day. The Committee staff has been in touch with your staff throughout the summer in order to help develop Treasury input for this inquiry, and specifically in preparation for an invitation for a Treasury representative to testify on September 23.

We want to reemphasize our deep interest in inviting you, or another senior Treasury official, to appear as a witness in these hearings at that time, or at any subsequent time that is practical and convenient for the witness and supporting staff personnel.

Our study has sought to develop data on the differential impact of the tax system on businesses of different sizes. Our hope has been to suggest policies for treating different-sized businesses equitably, according to their circumstances, in order to maximize the contributions of newer, smaller, and independent enterprises to the economy.

It would be most helpful to the Committee if the data supporting this position could be carefully and objectively analyzed, and attention devoted to how the tax system should take into account the problems of differential size, growth, and independence.

As we have stated on many occasions, our Committees will be pleased to work with your staff in exploring these questions, which we regard as vital to our economy, our social structure, and our competitive position in the world.

We have felt from the beginning that it would be highly constructive for the Treasury Department to address these questions.

If the Department's primary emphasis at this time is on formation of capital, it might seek to inform our Committees of what is known about how capital is formed in the non-big-business segment of the economy. Figures we submitted to the Ways and Means Committee tend to show that just over 6,000 corporations have their stock traded nationally, which appears to be an indication of access to major securities markets.

The question which concerns us greatly is how the remainder of U.S. enterprises, which appear to account for at least 43% of business output, one-half private employment, and over half of the significant innovation in this country, finance their beginnings, and, especially their growth, under a tax system which presently seems to tax medium-sized companies at significantly higher rates than larger businesses.

We must soon face the task of writing the report and making its findings and recommendations. Testimony by the Treasury Department would be of great value to us, and to the Senate in our efforts to formulate equitable tax reform legislation.

Very truly yours,

GAYLORD NELSON,
Chairman, Select Committee on Small Business.
LLOYD BENTSEN,
Chairman, Subcommittee on Financial Markets.

Enclosures: As stated (omitted).

Senator NELSON. Our next group of witnesses is a panel of witnesses on the issue of capital formation and capital recovery. The witnesses are: Norman B. Ture, economic consultant, Washington, D.C.; Michael Sumichrast, chief economist, National Association of Home Builders; Roland M. Bixler, president, J.B.T. Instruments, Inc., and chairman of the small business tax policy task force, National Association of Manufacturers; David Barnes, CPA, Coopers and Lybrand, chairman, Tax and Government Regulation Committee, Council on Smaller Enterprises, Cleveland, Ohio; Jerry T. Jones, president, Sonicraft Corp., chairman of the board of directors of the National Association of Black Manufacturers; and Charles W. Rau, director of

taxation, Allis Chalmers Corp., chairman of the Taxation Committee, Wisconsin State Chamber of Commerce.

I wonder if you might simply begin by presenting your statements. I think it would be helpful if you would summarize them, and if each subsequent witness would try to avoid repeating what the previous witness said. Your prepared statements will be printed in the record in full. I assume no one objects to being interrupted with questions, but I think it would be most helpful if the committee members would wait for the presentation of the prepared text. It is 10 minutes after 11 now.

Is it feasible for each of you to present a summary of your statement in 5 minutes each? Is there anybody who couldn't do it in that amount of time?

Mr. TURE. I don't think I could, sir.

Senator NELSON. Anybody else who can't?

Mr. BARNES. I would have a little problem with that.

Senator NELSON. Anybody else?

Mr. BIXLER. It would be difficult.

Senator NELSON. You are like me, I guess. I can give a 2-hour speech very easily, but it is hard to give a 5-minute speech.

Well, let us proceed with those who say they can present it in 5 minutes, and then let's see where we are; and continue with those who need more time.

Who is going to begin for the first 5 minutes?

PANEL DISCUSSION: NORMAN B. TURE, ECONOMIC CONSULTANT, WASHINGTON, D.C.; MICHAEL SUMICHRAST, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS; ROLAND M. BIXLER, PRESIDENT, J.B.T. INSTRUMENTS, INC., CHAIRMAN, SMALL BUSINESS TAX POLICY TASK FORCE, NATIONAL ASSOCIATION OF MANUFACTURERS; DAVID BARNES, CPA, COOPERS AND LYBRAND, CHAIRMAN, TAX AND GOVERNMENT REGULATION COMMITTEE, COUNCIL OF SMALLER ENTERPRISES, CLEVELAND, OHIO; JERRY T. JONES, PRESIDENT, SONICRAFT CORP., CHAIRMAN, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF BLACK MANUFACTURERS; AND CHARLES W. RAU, DIRECTOR OF TAXATION, ALLIS CHALMERS CORP., CHAIRMAN, TAXATION COMMITTEE, WISCONSIN STATE CHAMBER OF COMMERCE

Mr. SUMICHRAST. Mr. Chairman, I don't have a prepared statement, because I just flew back from Hawaii, where I was attending a meeting.

Senator NELSON. Would you identify yourself for the reporter?

Mr. SUMICHRAST. I will answer some of the questions Mr. Herb Spira gave me, supplied me, and I will be very short. The first question——

Senator NELSON. Would you identify yourself?

Senator JAVITS. Who are you, sir?

Mr. SUMICHRAST. Mike Sumichrast, chief economist, National Association of Home Builders.

Senator NELSON. Thank you.

Mr. SUMICHRAST. I have received several questions from your staff and will try to answer them briefly.

Question: Is there a capital shortage?

Without going into a long discussion, I would agree with Joseph H. Pechman that, by any standard, gross private domestic investment in the past decade has been quite high. There is little evidence that the present system has distorted the amount of savings which goes into capital formation over a longer period of time.

Now, in the short range, say, 1 to 3 years, we may have any amount of capital dislocations. This is because of the impact of monetary and fiscal policies on our system. The portion of gross private domestic investment represented by construction has been highly volatile to credit policies. And the portion that is residential construction has been even more prone to react to credit restraints than overall construction or the nonresidential portion.

I would like to provide the committee with two charts illustrating this point. One shows total construction as a percent of GNP, and the second shows residential construction as a percentage of the GNP. Both go back as far as 1915.

Question: Is there a need to go from 10½ percent to 11½ percent of GNP or 15½ percent to 16½ percent?

I think that the lower range of 10½ percent to 11½ percent is quite sufficient. The higher range is, in my opinion, unrealistic and not achievable, given the variety of priorities this society has on its capital formation.

Question: How does housing fit into that?

As you know, gross private domestic investment covers a variety of things. Fixed investment is partly structures and partly producers durable equipment. Now, structures alone also cover a wide variety of items. This is clearly visible in the included table. Residential buildings are the single largest part of what the Bureau of the Census defines as "value put in place." As you can see, this portion accounted for 43.8 percent in 1972 and 34.7 percent in 1974.

Housing competes with other investments for loanable funds. As a small business enterprise, it is unable to compete for funds with large national corporations.

Therefore, a 12–15-percent investment credit would drain money from residential construction.

Question: Distinguish between equity and long-term and short-term types of capital for your industry.

Equity capital in for sale housing is limited for the most part to acquisition of land, and land development cost. The amount of equity required for a typical builder of residential construction is relatively small. He typically borrows money for construction and sells with end mortgages provided by thrift institutions for the buyers.

Short-term capital for construction and land development loans in 1974 was about $60 billion outstanding (see table 2).

In 1973, the long-term mortgage market required $72 billion net; in 1974, a net of $54.4 billion.

Question: Choices for housing.

The best possible way to provide housing is to provide stability in the flow of funds. We have had a very unstable money market in the past 10–15 years, which in turn developed much deeper housing cycles than ever before. We cannot function in a climate of instability or crisis. Construction by its nature requires long-term planning. This can only be done if and when the industry can foresee what will happen to costs and whether or not credit will be available and at what basis.

Question: Comment on multifamily construction.

Multifamily housing has its own peculiar problems which will not be solved in the next year without a significant recovery.

This sector contains both condominiums and rental units in structures that do not meet the single family definition.

In August 1975, multifamily starts were running at a 283,000 annual rate, 68 percent below the 913,000 units for all of 1974.

In 1973, about 210,000 multifamily condominium units were started. Multifamily condominium starts dropped to 130,000 units in 1974, and fewer than 40,000 will be started in 1975. Multifamily condominium activity has been largely concentrated in Florida, California, and a few other recreation/resort areas. Inventories are quite large in these areas and represent a 2- to 3-year supply at current sales rates.

The apartment market continues to be burdened by high financing charges (when financing money is available), by environmental and no grown opponents, and by lagging rent increases.

Apartment developers generally are faced with paying 2 to 6 percentage points above prime for construction financing. The prime rate, currently at 8 percent, puts construction financing charges above 10 percent—not in a range of what is necessary to help apartments back on the road to a strong recovery.

The interest rate problem is further exacerbated by a lack of available funds for both construction and permanent financing. Recently, the two principal sources of these funds for apartment construction have been REIT's and commercial banks. REIT's have little money to lend, and they are busy trying to solve their internal cash flow and liquidity problems. Commercial banks, with large borrowings to REIT's, are reticent to lend.

Environmentalists and no-growth proponents in both the public and private sectors have significantly increased the planning time and requirements for apartment projects in recent years. A developer may have to deal with the permit issuing process for 2 to 3 years, with no guarantee that he will be able to build. Thus, costs are pushed up for both permits and for holding land.

The most severe problem for apartment construction may be that of rent levels. The median rent of apartments completed during fourth quarter 1974 (latest data available) was $201, only 4 percent above the $194 median in fourth quarter 1973. No significant shift has occurred in the distribution of unit size over the period. Therefore, the narrow gap between rent levels in the two periods cannot be explained by a shift to smaller units. Also, no significant change has taken place in where apartment units are built—something that could be a strong factor in narrowing the gap in the median rent levels.

Rent increases have been restricted in spite of the fact that utility and maintenance costs have soared. The two major factors responsible for holding down rents are overbuilding of apartment units in most metropolitan areas during the past 5 years, and the proliferation of rent control programs.

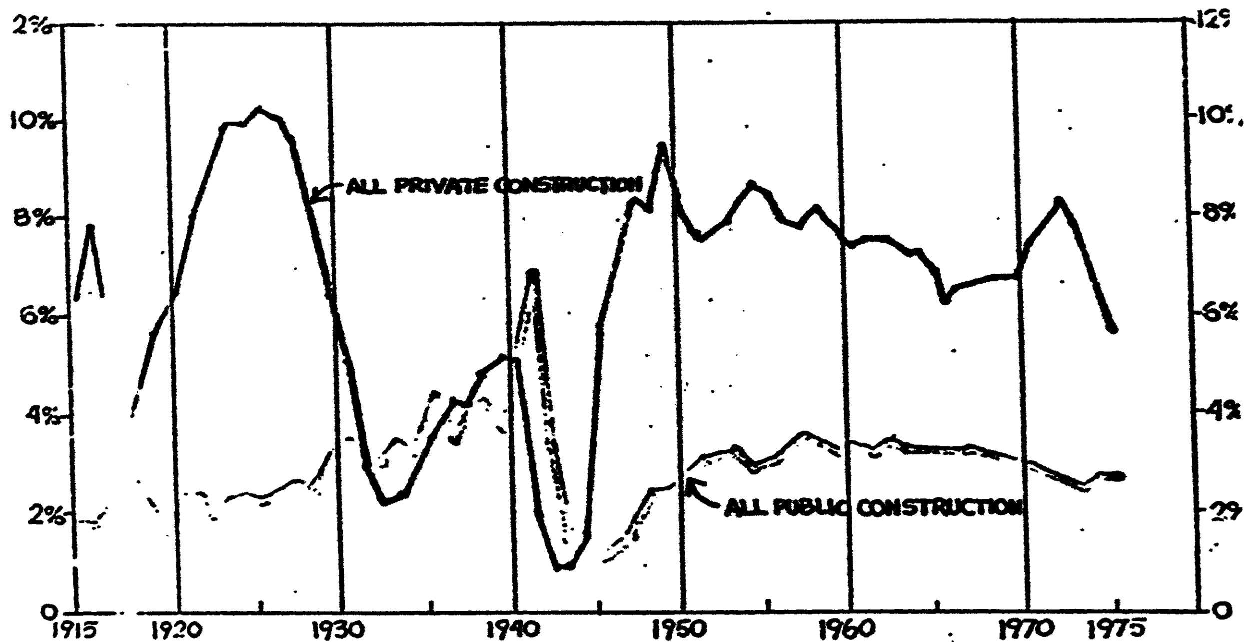
In 1976, the recovery in multifamily starts will be limited and will, to a great extent, be dependent on the HUD section 8 program.

That is about all, Mr. Chairman, for the time being. I would be glad to answer any questions.

Senator NELSON. All right. We will reserve our questions until we hear the rest of the witnesses. Thank you very much.

[The information referred to follows:]

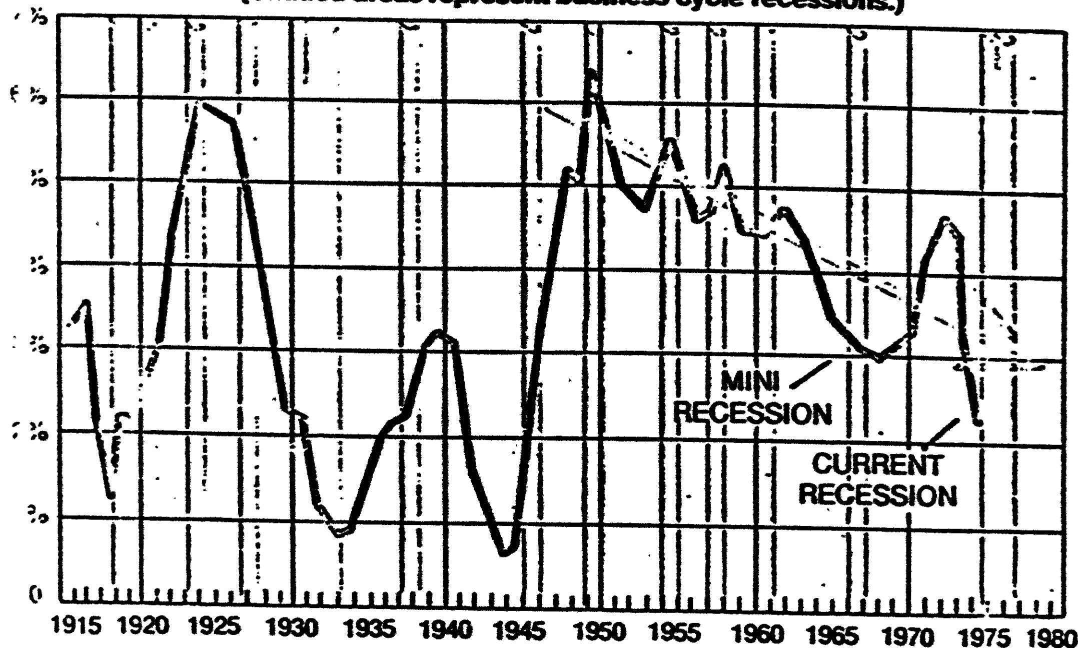
TOTAL NEW CONSTRUCTION AS A PERCENTAGE OF GROSS NATIONAL PRODUCT, 1915-1975



Source: U.S. Department of Commerce
Prepared by NAHB Economics Department

NEW RESIDENTIAL CONSTRUCTION AS A PERCENTAGE OF GROSS NATIONAL PRODUCT, 1915-1969

(Shaded areas represent business cycle recessions.)



NOTE: 1915-1935 private residential only; 1936-1975 private and public.

SOURCE: National Bureau of Economic Research; U.S. Department of Commerce; prepared by NAHB Economics Department.

TABLE 1.—VALUE OF NEW CONSTRUCTION PUT IN PLACE IN THE UNITED STATES, PRIVATELY AND PUBLICLY OWNED, 1972, 1974

[Dollar amounts in millions]

	1972		1974	
	Amount	Percent	Amount	Percent
Total new construction	$124,077	100.0	$134,815	100.0
Total privately owned	93,893	75.7	96,389	71.5
Residential buildings, total	54,288	43.8	46,769	34.7
New housing units	44,879	36.2	36,982	27.4
1-unit structures	27,632	22.3	23,737	17.6
2 or more unit structures	17,247	13.9	13,244	9.8
Additions and alterations to housing units	7,420	6.0	8,046	6.0
Nonhousekeeping buildings	1,989	1.6	1,741	1.3
Nonresidential buildings, total	24,036	19.4	29,726	22.1
Industrial	4,676	3.8	7,745	5.7
Office buildings	5,267	4.2	6,229	4.6
Other commercial	8,195	6.6	9,801	7.3
Religious	844	.7	947	.7
Educational	968	.8	671	.5
Hospital and institutional	3,172	2.6	3,302	2.5
Miscellaneous buildings	914	.7	1,031	.8
Farm nonresidential	1,432	1.1	2,652	2.0
Public utilities, total	13,196	10.6	16,243	12.0
Telephone and telegraph	3,302	2.7	4,281	3.2
Railroad	355	.3	247	.2
Electric light and power	7,582	6.1	9,213	6.8
Gas	1,675	1.3	1,664	1.2
Petroleum pipelines	282	.2	838	.6
All other private construction	941	.8	999	.6
Total publicly owned	30,184	24.3	38,426	28.5
Buildings, total	11,500	9.3	14,990	11.1
Housing and redevelopment	875	.7	1,007	.7
Industrial	534	.4	763	.6
Educational	5,720	4.6	7,311	5.4
Hospital	1,008	.8	1,240	.9
Other public buildings	3,363	2.7	4,669	3.5
Highways and streets	10,429	8.4	12,105	9.0
Military facilities	1,087	.9	1,188	.9
Conservation and development	2,172	1.7	2,781	2.1
Sewer systems	1,702	1.4	2,684	2.0
Water supply facilities	1,076	.9	1,382	1.0
Miscellaneous public construction	2,218	1.8	3,296	2.4

Source: Bureau of the Census, C-30 series: "Value of New Construction Put in Place."

TABLE 2.—HOLDINGS OF TOTAL CONSTRUCTION LOANS AND LAND AND DEVELOPMENT LOANS

[In millions of dollars]

Institution	End of 2d quarter 1974	
	Amount	Percent distribution
Commercial banks	$21,391	37.3
Mutual savings banks	1,519	2.6
Savings and loan associations	12,749	22.2
Life insurance companies	763	1.3
Private noninsured pension funds	28	(1)
Mortgage companies	6,946	12.0
REIT's	12,452	21.6
State and local retirement funds	60	0.1
Federal credit agencies	63	0.1
GNMA pools, FHD blocks		
State and local credit agencies	1,537	2.7
Total, all	57,508	100.0

[1] Less than 0.1 percent.

Source: Office of Economic Analysis, Assistant Secretary for Policy Development and Research, U.S. Department of Housing and Urban Development, "Residential Mortgage Lending Activity."

Senator NELSON. Who else.

Mr. JONES. I will try.

Senator NELSON. Please go ahead.

Mr. JONES. I am Jerry T. Jones, and I am president of the Soni-craft Corp. and chairman of the board of directors of the National Association of Black Manufacturers.

Mr. Chairman, I represent this association which has about 300 small minority manufacturing companies. We are very concerned about the talk of capital shortages and the large amount of capital that is being needed for businesses to expend in the next decade, because we have a problem which is very similar to all small businesses, but yet, at the same time, is a lot more acute.

Our estimate is that if our businesses were to achieve parity, that is, if we were able to attract enough capital for minority businesses to be representative of the total community in the number of businesses per capita, that it would require something like $450 billion for minority businesses alone to achieve parity over the next 10 years. So that we can certainly understand the problems about capital formation.

Historically, minorities have had tremendous difficulties in forming capital. This has been due to the fact that in general they have had low personal income and they have also not had some other opportunities in business that might have allowed them to create capital prior to our present tax structure.

In the last 7 or 8 years, the Federal Government in particular has taken some steps to try and help minority businesses obtain capital and markets so that they can grow. But, what seems to have happened is that as soon as a company is able to become profitable, then the tax structure becomes the major liability to its continued growth. So, therefore, we are really concerned that on the one hand the Government tends to want to help minority businesses to grow and survive, but on the other hand, it limits their capability of future growth and survival.

So we feel that something in the tax laws needs to be done in order to enhance small businesses, for most minority businesses are small, to enhance their ability to grow. Therefore, we recommend some changes in the tax structure in order to make small businesses just a little more able to compete for the real capital that is going to be required in the future.

In order to assure markets for our companies, and to use this capital that we are talking about, we also recommend that a tax credit be given to businesses as an encouragement for them to do business with minorities. Our feeling is that if you look at the total receipts of minority businesses, and the small amount they represent of the total gross national production, that the amount of tax burden that might be imposed by this is so small as to be negligible, but yet we feel that the need to encourage cooperation between the majority and the minority communities is so great that we feel that the country might be willing to undertake this small expense in order to encourage us meeting our national goals.

We also want to go on record, Mr. Chairman, as in favor in principle of the type of job creation legislation that the National Small Business Association has proposed.

Thank you.

[The prepared statement of Mr. Jones in full follows:]

STATEMENT OF

JERRY T. JONES, CHAIRMAN OF THE BOARD

THE NATIONAL ASSOCIATION OF BLACK
MANUFACTURERS, INCORPORATED

WASHINGTON, D.C.

BEFORE THE

SENATE SMALL BUSINESS COMMITTEE

TUESDAY SEPTEMBER 23, 1975

Mr. Chairman and members of the Committee, we thank you for this opportunity to appear before you to discuss some of our concerns about legislation affecting minority and small business. I have with me Mr. Eugene Baker, Executive Director of the National Association of Black Manufacturers.

Mr. Chairman everywhere one looks in the news media and business magazines and periodicals these days one cannot help but see the large amount of discussion about the huge capital required for businesses to grow in the next decade and longer. Business Week just indicated estimates of $4.5 trillion are required for business expansion in the next decade if growth in the business sector is to continue and any place near 4% annually as it did before the present recession.

At our annual meeting in March of this year my friend and colleague Mr. E. Douglas Kenna, President of the National Association of Manufacturers told us about the concerns of that organization on the capital shortages that appears certain.

So the way that tax laws affect the accumulation of capital is a great concern in the business community. It certainly is a concern within the National Association of Black Manufacturers.

The present economic condition termed an economic crisis by all sectors of the community poses grave conditions for small and minority-owned businesses. In recognizing the problems of the major businesses in our country, attention is sometimes diverted from the productive capacity of the small business

sector. Small businesses contribute 39 per cent to the Gross National Product, representing about 43 per cent of the total productive capacity of our country. Sixty-five percent of the non-government sector work force is employed by small businesses.

While there is no intent to minimize the contribution of all business to the well being of our nation, we think that tax parity for the small business community is essential for the continued economic growth of the country.

Studies both inside the government and outside the government has shown that the small business community shoulders an inequitable share of tax revenues. It has also been demonstrated that with the inequitable tax burden coupled with limited resources, the small business community has been in the forefront of innovation.

The economic growth of this country is predicated on the innovative use of capital. The small business community has provided this needed contribution.

In order to achieve growth for small business - a long term desirable goal - it is necessary to structure tax gains in such a way to increase the effective "clout" of small businesses in areas where big businesses dominate and therefore bring about a more competitive and productive economy. We believe a graduated tax would help to achieve this. It may be said

this is a long term solution. We have already admitted the problems of inflation and recession have only a long term viable solution. The future of big business and labor rest upon the shoulder of small business.

I am sure Mr. Chairman that members of this committee are aware of the difficulties minorities have had in accumulating capital. Even when the U. S. economy was expanding at an unsurpassed rate, small and minority businesses had difficulty obtaining capital.

The lack of available capital in minority communities have been well documented by others. The reasons given have been, racial prejudice, bias, and resulting disparities between the minorities and the community as a whole. The lower wages received by minorities, the lower education levels obtainable for minorities has lowered the probabilities of the minority community when taken as a whole to succeed in business.

This lack of probable success has further decreased the likelihood for minorities to obtain capital.

Capital for minority businesses have come primarily from savings the minority businessman was able to accumulate. Minority businesses as other small businesses have not the convenience of selling debentures to raise capital or of selling their stock. This means minority businesses have had an unusually high debt to equity ratio. The low capitalization combined

with the high outlay for principal and interest is a severe burden on minority and small businesses.

Since about 1967 the wisdom to aid minorities obtained some capital and do business with the government has initiated development of programs such as the Minority Enterprise Small Business Investment Corporation and efforts to deposit federal funds in minority banks.

The Small Business Administration developed the 8(a) Program in government contracting and the Department of Commerce instituted programs for the private sector in its' Office of Minority Business Enterprise. The goals of these programs have been to raise capital and develop markets for minority businesses.

The growth of minority business over the last few years has been substantial over what it was prior to 1969.. The growth rate has been higher for minority businesses than for all businesses. Yet the percentage of minority business is much smaller per capita than non-minority businesses. Even so, it was thought that minority business may at last have obtained a foothold in the business community.

The inflation of two years ago and the present recession have caused some of the newly created minority businesses to fail. The historical dearth of capital within the minority communities - composed mostly of savings - have also been eroded by this inflation and washed away during this recession.

Mr. Chairman, the National Association of Black Manufacturers recommends that Congress enact legislation to provide incentives for corporations to do business with minority firms through direct tax relief.

Tax legislation should be enacted which will give corporations an added incentive to do business with minority firms. A recent example of legilsation of this type is the special provision of the New Tax Reduction Act which provides an additional tax break to corporations if they establish an "employee stock ownership plan." The New Tax Law boosted the investment credit allowance from 7% to 10%, and to 11% if a corporation has an employee stock ownership plan. Similar recognition should be given to the need to support Minority Business.

What we are requesting has a number of predecents. The following sections of the Internal Revenue Code, Title 26, are examples of the use of tax benefits used to achieve national goals.

Section 40: 20% tax credit for work incentive programs.

Section 179: 20% additional first year allowance for small businesses on tangible personal property (depreciation).

Section 991-997: DISC. Grants substantial tax benefits which intend to encourage increased production for foreign markets.

Section 38: Investment credit raised to 10% and 11% for firms with employee stock plans.

<u>Section 37</u>: Retirement Income Credit. Encourages people to save for retirement.

<u>Section 35</u>: 3% credit against amounts received as interest on obligations of United States.

Senator NELSON. Thank you very much, Mr. Jones. Does anybody else have a statement they can make in 5 minutes? OK then, Mr. Ture, you can go next. Your statement will be printed in full in the record, as will all the other prepared texts.

[The prepared statement of Mr. Ture in full follows:]

63-200 O - 78 - 5

CAPITAL FORMATION AND CAPITAL RECOVERY

STATEMENT

TO

SELECT COMMITTEE ON SMALL BUSINESS
AND
SUBCOMMITTEE ON FINANCIAL MARKETS,
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

SEPTEMBER 23, 1975

BY

NORMAN B. TURE, PRESIDENT
NORMAN B. TURE, INC.
WASHINGTON, D.C.

My name is Norman B. Ture. I am President of Norman B. Ture, Inc., Consulting Economists in Washington, D.C. I am consulting economist to the National Association of Wholesaler-Distributors (NAW).

Mr. Chairman, I welcome your invitation to appear here today to discuss current and future capital formation adequacy for the U.S. economy. Small business has special capital deficiency problems. On Thursday, I will present a detailed analysis of the capital needs and problems of merchant wholesaler-distributors which will demonstrate these problems of small business. However, it is both useful and necessary to view the situation of small business in the context of the entire economy, so — as requested — I will concentrate my remarks today on the adequacy of overall capital formation.

Capital Adequacy: The Central Economic Problem of the U.S.

The central economic problem facing the United States is whether the rate of capital formation will be adequate to meet the economy's capital requirements over the next decade and longer. Virtually all of the other major issues with which public policy makers are concerned turn on this central problem of capital adequacy. Whether the focus is on attaining energy self-sufficiency, protection of the environment, improving and expanding mass transit systems, raising the housing standards of low and middle-income individuals, providing safer and healthier working conditions, and so on, a basic constraint on achieving these goals is how much capital will be available to meet the growing and varied demands of the U.S. economy. The less rapidly we add to our production capability, the more severely will pursuit of any of these public policy objectives limit our success in achieving other public and private goals.

The Meaning of Capital Requirements and Capital Shortage

The Congress and the public have heard much on the subject of the capital

shortage. So far, most of the attention has been given to estimating capital requirements and the prospective shortfall of actual capital accumulation. These estimates have varied widely for numerous reasons, including differences in basic assumptions, analytical method, and projections of such factors as the rate of inflation, the growth of government spending and deficits, and the magnitude of various capital-intensive government programs. To get a useful perspective on these estimates requires us to be clear at the outset as to what we mean by "capital requirements" and "capital shortage."

The term capital "requirements" does not mean that there is some specific amount of capital that must be on hand at some future time. In fact, there is no unique amount of capital that the economy must have at any given time. It makes sense to talk about capital requirements only in relation to other things, principally the growth in the labor force. We aren't interested in adding to the stock of capital for its own sake; the concern with capital accumulation, instead, stems from the role capital addition plays in providing the opportunity for increases in employment, in productivity, and in real wage rates.

Beginning with a projection of the growth in the labor force, it is possible to estimate by how much the stock of capital must grow if the ratio of capital inputs to labor services in production is to increase at some designated rate. It is this increase in the capital-labor ratio, along with technical progress, which primarily determines the rate of increase in labor's productivity, real wage rates, and employment. If public policy aims at maintaining at least the postwar average rate of increase in labor productivity and real wage rates, while avoiding an un-

acceptable rate of unemployment, then if the growth in the labor force can be reasonably estimated so too can the increase in the stock of capital needed to provide the increase in the capital-labor ratio on which attaining these goals depends.

To this amount must be added the capital requirements imposed on business by public policy mandates rather than market forces. For every dollar of capital addition there must be a dollar of saving. Indeed, it is more accurate to speak of a prospective saving shortage than of a capital shortage. Since total saving in the economy consists of private saving plus government budget surpluses or minus government deficits, it is necessary to add to the captal requirements described above some estimate of government budget results in order to estimate the amount of private saving that will be required. The projected required private saving may be expressed as a share of projected GNP and this required saving ratio then may be examined in the light of the postwar record. A projected required private saving to GNP ratio significantly in excess of that actually realized in the postwar years suggests that we are likely to fall short of meeting our capital requirements.

Estimating Capital Requirements

Over the postwar period, the number of full-time equivalent employees in the private business sector of the economy has increased at an average annual rate of 1.5 percent a year. Associated with this trend, the net stock of capital in the business sector has increased at an average annual rate of about 4.3 percent. The capital-labor ratio, hence, has increased at an average annual rate of about 2.7 percent. In turn, this increase in the capital-labor ratio has contributed to a very nearly equal average annual rate of increase --- 2.3 percent --- in labor's

productivity and real wage rate. Financing the capital outlays required to achieve this increase in the net stock of capital (along with residential investment, net foreign investment, and government deficits) has required total national saving equal, on the average, to about 15.5 percent of GNP; it has required total private-sector saving averaging 15.7 percent of GNP.

If we project the postwar trends in employment and in the capital-labor ratio, over the next 11 years, i.e., through 1985, we shall have to add $675 billion to the net stock of business capital, measured in constant 1974 dollars. Assuming no change in the rate at which business replaces fixed capital facilities, this will require $2.37 trillion of total capital outlays, in constant 1974 dollars.

But this is only the first step in estimating capital requirements. To the amount of capital which must be accumulated to maintain the growth in employment and in labor's productivity and real wage rates there must be added the increase in the Nation's stock of housing to meet private demand and public policy housing goals and the additional capital required to satisfy other government-mandated demands --- to meet environmental standards, to achieve energy self-sufficiency goals, to comply with occupational health and safety standards, to expand and improve mass transit, etc.

In contrast with business capital, much of this government-mandated capital generates no increase in total income. As a consequence, the businesses making these investments can obtain no return on such captial, hence cannot provide rewards for the private saving which must be channeled into such capital formation. The household or business customer doesn't go into the market to buy cleaner air or

water; it's not easy to persuade the customer that a given amount of groceries are worth more because food processors and distributors produced less air or water pollutants. In other words, much of this type of capital makes only a negligible contribution to the market value of the products customers buy. Aggregate sales proceeds for any given volume of output, accordingly, are not likely to increase by an amount equal to the additional costs of the public-mandated capital. Such capital, hence, cannot be financed by business out of the insignificant additional cash flow, if any, it generates. And since it reduces the rate of return on the business' total capital the business faces increasing difficulty in external financing of its capital additions. Unless the aggregate flow of saving, generated internally by business and/or available in the capital markets, increases substantially, we face a serious shortfall in the capacity of business to finance the increases in capital used to produce the goods and services people do buy. This drain must somehow be offset by additional saving. This is not to suggest necessarily that these government-mandated capital outlays are not warranted or that the goals they seek are inappropriate. But it must be recognized that such capital formation cannot be had for free and that it adds substantially to the Nation's total requirements for capital.

How much do such requirements add to those needed to maintain at least the trend rate of growth in productivity and real wage rates? On the basis of very conservative assumptions this additional investment will have to aggregate at least $1.06 trillion through 1985.

Private Saving Requirements

For every dollar of gross private investment, there must be a dollar of gross national saving. Gross national saving is the sum of gross private saving plus government surpluses or minus government deficits. In most of the postwar years, the government sector has been in deficit, hence has reduced rather than augmented gross national saving. Gross private saving requirements, in other words, include not only financing gross private investment but also government budgetary deficits. If it is assumed that government deficits average no more than $10 billion per year over the next decade --- an extremely conservative assumption in view of recent experience and near-term prospects --- the Nation's total private saving will have to aggregate $3.54 trillion in constant 1974 dollars, through 1985.

The aggregate capital requirements are substantially larger if, more realistically, we take account of some continuing inflation. If the price level rises on the average by 3 percent a year through 1985, total requirements aggregate not less than $4.3 trillion. At a 5 percent inflation rate, this total increases to $4.9 trillion.

If gross private saving as a fraction of GNP continues over the next decade at the postwar average rate of 15.7 percent, the total of such saving through 1985 will fall $400 billion short of estimated requirements, measured in constant 1974 dollars. At a 3 percent inflation rate, the gap, conservatively estimated, is almost $500 billion; with inflation at 5 percent, the gap increases to almost $575 billion.

Closing this gap between capital requirements and private saving will require

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

B. Three Percent Inflation

Year	CAPITAL REQUIREMENTS	GROSS PRIVATE SAVING	SAVING GAP
1975	263.8	242.9	20.9
76	282.5	259.6	22.9
77	303.3	277.4	25.9
78	325.8	296.5	29.3
79	350.5	316.8	33.7
1980	377.5	338.6	38.9
81	407.0	361.8	45.2
82	439.8	386.8	53.0
83	476.0	413.4	62.6
84	516.3	441.7	74.6
85	561.3	472.0	89.3
Total	4,303.8	3,807.5	496.3

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

C. Five Percent Inflation

Year	CAPITAL REQUIREMENTS	GROSS PRIVATE SAVING	SAVING GAP
1975	268.9	247.6	21.3
76	293.6	269.8	23.8
77	321.3	293.9	27.4
78	351.9	320.2	31.7
79	358.8	348.8	37.0
1980	423.7	380.1	43.6
81	465.9	414.3	51.6
82	513.0	451.1	61.9
83	565.9	491.5	74.4
84	625.8	535.4	90.4
85	693.5	583.2	110.3
Total	4,909.3	4,335.9	573.4

Estimated Capital Requirements and Private Saving, 1975-1985

(billions of dollars)

A. Zero Inflation

	CAPITAL REQUIREMENTS			GROSS PRIVATE SAVING	SAVING GAP
Year	Nonresidential Fixed Investment Plus Inventory Accumulation	Other Capital Outlays, Including Government Deficits	Total		
1975	174.5	81.6	256.1	235.8	20.3
76	181.6	84.7	266.3	244.7	21.6
77	189.2	88.4	277.6	253.9	23.7
78	197.2	92.3	289.5	263.4	26.1
79	205.3	97.0	302.3	273.3	29.0
1980	213.9	102.3	316.2	283.6	32.6
81	222.6	108.3	330.9	294.2	36.7
82	232.0	115.2	347.2	305.3	41.9
83	241.5	123.3	364.8	316.8	48.0
84	251.5	132.7	384.2	328.7	55.5
85	262.0	143.5	405.5	341.0	64.5
Total	2,371.3	1,169.3	3,540.6	3,140.7	399.9

an increase in the total private sector saving rate from the 15.68 percent postwar average to 17.67 percent, if we assume a zero inflation rate through 1985. At a 3 percent inflation rate, total private sector saving would have to increase to 17.72 percent of GNP. And if inflation is at 5 percent, the private saving rate will have to increase to 17.75 percent. At no time in the postwar years has the gross private saving rate equaled even the lowest of the estimated required rates.[1/]

There is no assurance that gross private saving will continue at the postwar trend rate, let alone that it will increase by the indicated amount. A glib answer is given by those who casually dismiss the capital shortage problem. They assert that if the private saving rate were inadequate, the market rate of interest would rise and private saving would increase. But this answer confuses cause and effect; the higher interest rates would be the market's reflection of the shortfall of saving, hence capital formation, from the levels that would provide the trend rate of increase in the capital-labor ratio; at the lower than trend capital-labor ratio, the return per unit of capital, hence interest rates, would rise. Conceivably we might all be content with the volume of capital formation as determined solely by free market forces. But we obviously are not; through government action, we insist on additional capital to meet public rather than private, market-determined demands. And there is no guarantee that under the present tax laws the market-determined flow of

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1/ The estimated required saving rates in the inflation cases err significantly on the low side. The estimated amount of private saving does not include downward inventory valuation adjustments which would reduce business saving under the 3 percent and 5 percent inflation cases from the postwar average rate of such saving. Moreover, the estimated saving implicitly assumes that capital recovery allowances would increase above the annual zero inflation amounts in the same proportion as the inflation rate. Since capital recovery allowances are based on historical rather than replacement costs, this assumption overstates the amount of this component of private saving under the 3 percent and 5 percent inflation cases.

saving would be adequate to provide a rate of increase in the capital-labor ratio, hence labor's productivity and real wage rates, which would be acceptable.

Another glib answer is that any inadequacy in private saving might and should be made up by the Federal Government's running budget surpluses, instead of deficits. This prescription is based on the belief that the growth in Federal spending will decelerate while Federal revenues will increase. In the light of the fiscal experience for many years past, and particularly that of recent years, it is scarcely realistic to project any significant slowdown in the rate of growth of government spending, however desirable that may be. Hence, achieving budget surpluses would have to depend on a very substantial acceleration in the growth of tax revenues. Some part of this growth, presumably, would be generated by increases in total economic activity, but the principal source of the increase in Federal tax revenues would, according to this view, come from the elimination or reduction of so-called tax "expenditures". Apart from the fact that the estimates of the additional revenues to be obtained thereby are woefully unrealistic (because they are based on the assumption that the affected taxpayers would be completely unresponsive to the increases in their taxes), the principal flaw in this approach is that the increase in taxes would almost entirely represent additional taxes on the return to private saving, thereby accentuating the existing anti-saving tax bias. At best, private saving might be expected to fall by no more than the estimated increase in revenues; more realistically, the decline in private saving would significantly exceed any ultimately realized increase in Federal tax revenues. Whatever one's view about the desirability of reducing tax "expenditures", it is mere wishful thinking to project any

increase in the National saving rate from doing so. Achieving a higher rate of gross national saving by Federal surpluses, therefore, is not a realistic solution.

Consequences of Shortfall in Private Saving

What will happen if actual saving falls short of these "requirements"? In all likelihood, the capital formation shortfall would be largely in the investment in the machinery, equipment, plants, working capital, etc., which increase the real output of marketable goods and services. If the private saving rate were to continue only at the postwar trend rate, the saving shortfall, in 1985, assuming no increase in the price level, would be $64.5 billion. This would be almost 25 percent of the estimated amount of the capital formation needed to maintain the trend rate of increase in the capital-labor ratio. The adverse impact of a shortfall of this magnitude on labor's productivity and real wage rates clearly would be enormous.

Some would argue that we should all prefer to realize a larger proportion of our advance in living standards in the form of a more congenial environment and more publicly-provided services and amenities and accept a slower advance in our ability to produce and buy the goods and services which fill our market baskets. Perhaps this is an acceptable trade-off for the more affluent individuals in our society; it seems unlikely, however, that most of the labor force would be willing to accept any significantly lower rate of gain in ability to buy the products for sale in the marketplace and to save in exchange for more of the output provided by the government-mandated capital, or that most of the economically disadvantaged who aspire to enlarged opportunities for gainful employment would be content to trade away such enlarged opportunities for, say, a cleaner environment. It is

unrealistic, therefore, to suppose that these government-imposed demands for capital can be substituted for market-determined capital formation instead of increasing the rate of aggregate capital formation.

Increasing Private Saving: A Challenge for Public Policy

The imperative for changes in public policies to reduce the burden on private saving and capital formation is inescapable. The foremost challenge facing the Congress is to deal realistically with the surging demands for a higher rate of private saving. If this challenge cannot be met, one or more of the high-priority objectives of economic policy will have to bear the brunt of the failure.

In meeting this challenge, the Congress and the Executive branch will confront serious problems. The greatest difficulty probably will be to overcome the accumulation of many years of doctrinal notions that any changes in the law to reduce the disproportionate tax burden on saving and investment is a "loophole" or tax "break" for business or rich individuals. Tax changes to permit all of us to save a larger proportion of our incomes, however, are not issues of business vs. individuals, or business vs. labor or consumers, or rich vs. poor. The issue, instead, is how rapidly we advance employment opportunities, labor's productivity, and real wage rates and how much we expand our capacity to meet the public sector's surging claims on total production capability.

Components of National Saving

To deal effectively with this problem, it is useful to begin by examining the components of the nation's total saving. The following tables, taken from the Department of Commerce's national income account estimates, show gross national saving, gross private saving, and the major components of gross private saving in relation

to gross national product in the years 1947-1974.

Government sector drain on National saving

One fact emerges immediately from examining these data: in only 13 of the 28 years in this postwar period has the government sector contributed positively to the Nation's total saving. The Federal government has added to rather than subtracted from total saving in only 11 of these 28 years. And over the entire period, the government sector has reduced aggregate saving by a total of $38.8 billion; the Federal government has drained a total of $62.8 billion from the Nation's aggregate saving in these 28 years. Moreover, the Federal deficits in prospect for this calendar year and in the next year or more will reduce the Nation's aggregate saving by enormous amounts.

It is obvious, of course, that the government sector drain on total saving has resulted in large part from the extraordinary growth in government spending --- more than 9.2 percent a year, on the average, since 1947. So long as government spending continues to grow at that rate, it is unrealistic to assume that government revenues can grow even more rapidly to generate budget surpluses and thereby add to, rather than subtract from, total saving. Providing the increased flow of saving required to meet our captial needs, therefore, will depend on whether the private sector increases its saving rate.

A second impressive fact these data reveal is that while the fraction of GNP which has been saved by the private sector has varied widely, at no time in the postwar years has it reached the rate which will be needed to meet the capital needs discussed earlier. For the entire period, private saving has averaged 15.68

Sources of Gross Saving, 1947-1974
(billions of dollars)

Year	Gross National Product	Gross National Saving									
		Total	Government Surplus or Deficit (-)		Private Saving						
							Business				
			Total	Federal	Total	Personal	Total	Unincorp. Business Capital Recovery Allowances	Corporate Saving		
									Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1947	231.3	42.0	14.4	13.4	27.5	7.3	20.2	6.4	5.8	8.0	13.8
48	257.6	49.9	8.5	8.4	41.4	13.4	28.0	7.5	7.0	13.4	20.4
49	256.5	35.9	- 3.2	- 2.4	39.0	9.4	29.7	8.6	7.9	13.2	21.1
1950	284.8	50.4	7.9	9.1	42.5	13.1	29.4	9.5	8.8	11.0	19.8
51	328.4	56.1	5.8	6.2	50.3	17.3	33.1	10.9	10.3	11.8	22.1
52	345.5	49.5	- 3.8	- 3.8	53.3	18.1	35.1	11.7	11.5	12.0	23.5
53	364.6	47.5	- 6.9	- 7.0	54.4	18.3	36.1	12.5	13.2	10.5	23.7
54	364.8	48.5	- 7.0	- 5.9	55.6	16.4	39.2	13.3	15.0	11.0	26.0
55	398.0	64.8	2.7	4.0	62.1	15.8	46.3	14.1	17.4	14.8	32.2
56	419.2	72.7	4.9	5.7	67.8	20.6	47.3	15.2	18.9	13.2	32.1
57	441.1	71.2	.7	2.1	70.5	20.7	49.8	16.3	20.8	12.7	33.5
58	447.3	59.2	-12.5	-10.2	71.7	22.3	49.4	16.9	22.0	10.5	32.5
59	483.7	73.8	- 2.1	- 1.2	75.9	19.1	56.8	17.9	23.5	15.4	38.9
1960	503.7	77.5	3.7	3.5	73.9	17.0	56.8	18.5	24.9	13.4	38.3
61	520.1	75.5	- 4.3	- 3.8	79.8	21.2	58.7	19.0	26.2	13.4	39.6
62	560.3	85.0	- 2.9	-3.8	87.9	21.6	66.3	19.9	30.1	16.3	46.4
63	590.5	90.5	1.8	.7	88.7	19.9	68.8	20.9	31.8	16.1	47.9
64	632.4	101.0	- 1.4	- 3.0	102.4	26.2	76.2	22.2	33.9	20.1	54.0
65	684.9	115.3	2.2	1.2	113.1	28.4	84.7	23.4	36.4	25.0	61.4
66	749.9	124.9	1.1	- .2	123.8	32.5	91.3	24.4	39.5	27.3	66.8
67	793.9	119.5	-13.9	-12.4	133.4	40.4	93.0	25.9	43.0	24.2	67.2
68	864.2	128.3	- 6.8	- 6.5	135.2	39.8	95.4	27.7	46.8	20.9	67.7
69	930.3	144.0	8.8	8.1	135.2	38.2	97.0	29.6	51.9	15.4	67.3

Sources of Gross Saving, 1947-1974
(billions of dollars)

Year	Gross National Product	Gross National Saving										
		Total	Government Surplus or Deficit (-)		Private Saving							
							Business					
									Corporate Saving			
			Total	Federal	Total	Personal	Total	Unincorp. Business Capital Recovery Allowances	Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1970	977.1	143.1	-10.1	-11.9	153.2	56.2	97.0	31.3	56.0	9.8	65.8
71	1054.9	152.2	-18.5	-21.9	170.7	60.5	110.2	33.3	60.4	16.2	76.6
72	1158.0	173.3	- 5.1	-17.5	178.5	52.6	125.9	36.6	66.3	23.3	89.6
73	1294.9	214.4	- 3.5	- 5.6	210.9	74.4	136.5	39.6	71.2	25.7	96.9
74	1397.4	207.5	- 6.3	- 8.1	213.8	77.0	136.8	42.8	76.7	17.3	94.0

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Sources of Gross Saving as Percent of Gross National Product, 1947–1974

Year	Gross National Saving	Gross Private Saving						
		Total	Personal	Business		Corporate Saving		
				Total	Unincorp. Business Capital Recovery Allowances	Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1947	18.2	11.9	3.2	8.7	2.5	2.5	3.5	6.0
48	19.4	16.1	5.2	10.9	2.9	2.7	5.2	7.9
49	14.0	15.2	3.7	11.6	3.4	3.1	5.1	8.2
1950	17.7	14.9	4.6	10.3	3.3	3.1	3.9	7.0
51	17.1	15.3	5.3	10.1	3.3	3.1	3.6	6.7
52	14.3	15.4	5.2	10.2	3.4	3.3	3.5	6.8
53	13.0	14.9	5.0	9.9	3.4	3.6	2.9	6.5
54	13.3	15.2	4.5	10.7	3.6	4.1	3.0	7.1
55	16.3	15.6	4.0	11.6	3.5	4.4	3.7	8.1
56	17.3	16.2	4.9	11.3	3.6	4.5	3.1	7.7
57	16.1	16.0	4.7	11.3	3.7	4.7	2.9	7.6
58	13.2	16.0	5.0	11.0	3.8	4.9	2.3	7.3
59	15.3	15.7	3.9	11.7	3.7	4.9	3.2	8.0
1960	15.4	14.7	3.4	11.3	3.7	4.9	2.7	7.6
61	14.5	15.3	4.1	11.3	3.7	5.0	2.6	7.6
62	15.2	15.7	3.9	11.8	3.6	5.4	2.9	8.3
63	15.3	15.0	3.4	11.7	3.5	5.4	2.7	8.1
64	16.0	16.2	4.1	12.0	3.5	5.4	3.2	8.5
65	16.8	16.5	4.1	12.4	3.4	5.3	3.7	9.0
66	16.7	16.5	4.3	12.2	3.3	5.3	3.6	8.9
67	15.1	16.8	5.1	11.7	3.3	5.4	3.0	8.5
68	14.8	15.6	4.6	11.0	3.2	5.4	2.4	7.8
69	15.5	14.5	4.1	10.4	3.2	5.6	1.7	7.2

Sources of Gross Saving as Percent of Gross National Product, 1947-1974

Year	Gross National Saving	Gross Private Saving							
		Total	Personal	Business					
				Total	Unincorp. Business Capital Recovery Allowances	Corporate Saving			
						Capital Recovery Allowances	Retained Profits	Total (Cash Flow)
1970	14.6	15.7	5.8	9.9	3.2	5.7	1.0	6.7
71	14.4	16.2	5.7	10.4	3.2	5.7	1.5	7.3
72	15.0	15.4	4.5	10.9	3.2	5.7	2.0	7.7
73	16.6	16.3	5.7	10.5	3.1	5.5	2.0	7.5
74	14.8	15.3	5.5	9.8	3.1	5.5	1.2	6.7

percent of GNP, with a low of 11.9 percent in 1947 and a high of 16.8 percent in 1967. Clearly, major changes in the tax system are needed if the required increase in the private saving rate is to be achieved.

Contribution of business saving

Another impressive fact shown by these data is that business saving has accounted for an increasing proportion of the economy's total saving. In 1947, business saving was 48.1 percent of gross national saving; by 1974, it had increased to 65.9 percent of the total. This large and growing contribution of business saving to the total saving in the economy should be kept clearly in mind in evaluating tax reform proposals which would, one way or another, increase total business tax burdens. Any such increase must erode business saving and necessarily retard the increase in total saving in the economy.

Gross business saving, as measured in the national income accounts, consists of the capital consumption allowances of unincorporated businesses, corporate retained profits, less adjustment for changes in the value of inventories, and corporate capital consumption allowances. Of the growth in business saving shown above, by far the most important and most rapidly increasing component is the amount shown as capital recovery allowances. While total saving in 1974 was about 5 times that of 1947, capital recovery allowances in 1974 were almost 10 times those of 1947. And in 1974, this component of business saving accounted for almost 58 percent of total saving, more than twice the fraction in 1947. It is against these hard data on the importance of capital recovery allowances as a source of the Nation's total saving that the Congress should evaluate such tax "reform" proposals as eliminat-

ing ADR. The factual record provides unmistakeable evidence of the contribution of past legislation and administrative actions, including the accelerated depreciation provisions in 1954, the guidelines lives in 1962, and the ADR in 1971, to the nation's total saving; it also attests to the effectiveness of further improvements in capital recovery allowances in increasing aggregate private saving and capital formation.

In sharp contrast, retained corporate net profits have added only modest amounts to total private saving. As a share of the GNP originating in corporations, pretax profits, adjusted for inventory valuation changes, have shown a marked downward trend over the entire postwar period; in the five years 1947-1951, the ratio of profits to gross corporate product ranged between 20 percent and 23 percent, while in the last five years the ratio has been between 11.8 percent in 1970 and 13.6 percent in 1973, when profits allegedly soared out of sight. This ratio has been falling since the first quarter of 1973; in 1974 it was down to 12.4 percent, lower than at any other time in the postwar period, except for 1970. Measured in current dollars, corporate profits adjusted for changes in inventory valuation increased from $25.6 billion in 1947 to $105.6 billion in 1974 or roughly four times. The increase in income taxes was $44.4 billion or 55½ percent, of the $80.0 billion increase in pretax profits, while the increase in dividend payouts was $26.4 billion, a third of the increase in pretax profits. Retained profits rose from $8 billion to $17.2 billion, little more than twice.

The growth in corporate capital recovery allowances has scarcely been adequate to offset the declining share of profits in corporate GNP and the increase in corporate profit taxes. Corporate cash flow, i.e., net retained earnings plus

capital recovery allowances, as a share of corporate GNP shows no positive trend over the postwar period. Since the mid-1960's, this ratio has been falling; in 1974, it fell to 10.8 percent, the lowest level since 1947.

Urgency of Tax Revisions to Reduce the Burden on Saving

These data highlight the urgency of tax changes to augment business capital recovery allowances and to reduce corporate income tax liabilities if the Nation's saving and capital formation requirements are to be met. The cost of failure to do so will be measured in fewer jobs and lower real wages than otherwise would be realized, in lower levels of achievement of public policy goals, or both.

I do not mean to suggest that changes in the tax system to reduce the burden on saving and capital formation should be confined to business taxes. On the contrary, reducing the disporportionately heavy tax burden on personal saving is also urgently required. As the table shows, personal saving represents a declining share of the Nation's total saving. Reducing the share of disposable personal income used for consumption by even a very modest degree, for example, from 92½ percent to 90 percent or by 2.7 percent, would increase personal saving at 1975's estimated level of disposable income by more than $26 billion. Tax changes to bring about this result by giving the taxpayer a larger claim on the economy's future income would have the collateral benefit of reducing his dependency on government programs to provide for his retirement and temporary financial setbacks.

There are any number of tax changes which would reduce the existing tax burden on individual saving and bring about an increase in the personal saving rate. These tax changes need not be confined to or even be primarily directed to upper-

bracket taxpayers. For example, suppose taxpayers were given a tax credit for increases in the amount of their total saving in the taxable year. The credit might be allowed at a rate, of say, 20 percent, with an upper limit of, say, $1,000 on a joint return. A very substantial part of these tax benefits would go to persons of modest incomes. Statistics of Income data for 1972, for example, show that 50 percent of the total income representing the yield on savings was reported on returns with less than $20,000 of adjusted gross income.

Responsibility for meeting our future saving and capital requirements should not be limited to one or another part of the private sector. All of us will have to get in on the act. By the same token, no one type of tax change will be adequate to meet the extraordinarily diverse demands for capital throughout the U.S. economy. The tax change which would most quickly increase the saving and capital outlays of, say, large manufacturing enterprises would not necessarily be most directly effective for, say, the small wholesaler-distributor. And the tax revisions which would most effectively reduce the existing tax barriers to additional saving by the upper bracket individual stockholder will not necessarily be the most efficient means to allow low-income individuals to increase their saving in the forms they prefer. Since the need for increases in saving and investment is not confined to any one particular group of individual or business, a long list of tax changes is needed to insure that all individual and business taxpayers will have greater inclination and ability to save and invest.

Tax Changes to Improve Financial Market Performance

Concommitant to the requirement to alleviate the excessive tax burden on private saving and investment is the need to reduce impediments to the efficient

operation of the Nation's financial markets. With respect to tax policy, the need is to reduce, if not eliminate, the existing tax distortions which change the signals which the financial markets would otherwise provide as to the best allocation of any given amount of saving among alternative capital formation uses.

The corporation income tax *per se* grossly distorts the allocation of saving. The tax constitutes a heavy excise on the returns to corporate equity, layered on top of the extra tax on individual saving which is inherent in our income tax. Not only does it bias the allocation of saving, it also distorts the capitalization of corporate businesses by discriminating against new external equity as compared to debt financing. The resulting pressure toward excessive debt increases risk and the cost of capital above the levels that would otherwise prevail.

Some progress toward integrating the individual shareholder's and the corporate tax is urgently desirable in the interests of reducing existing tax distortions. The simplest measure to this end, obviously is to reduce the corporation income tax. In addition, reducing the double taxing of dividends whether by allowing corporations to deduct their dividend payouts or by permitting shareholders to claim a credit for the corporate tax paid on the dividends, would contribute to reducing these distortions as well as to increasing total private saving.

One of the most serious tax impediments to efficient financial market performance is the tax treatment of capital gains and losses. The tax on capital gains is properly viewed as an additional tax on the returns to saving; the tax on capital gains on corporate securities is a heavy third layer excise on the returns to saving invested in corporate business. The limited deductibility of capital losses further

increases the risk of equity investment and raises the cost of capital.

In addition, the tax on gains is a substantial excise on the transfer of saving from one investment to another. Accordingly, it significantly increases the cost of capital transactions and by freezing asset holdings, impedes the financial markets from efficiently performing their important function of valuating the worth of companies.

Optimumly, capital gains and losses should be entirely eliminated from the income tax; indeed this would be essential if the basic tax bias against saving were eliminated by excluding current saving from taxable income while fully taxing the subsequent gross returns on the saving. Short of this basic change, there are a number of changes which would move in the right direction. Among these are the proposals to exclude the first $1,000 of gains each year, to defer the tax when the gains are rolled over into new investment, to reduce the amount of gains included in income the longer the asset had been held, to increase the offset of capital losses against ordinary income, and to liberalize the carryover of capital losses.

As this brief review indicates, the list of changes to reduce the existing tax inhibitions to saving and to permit the financial markets to perform more effectively is long and diverse. The obstacles facing the enactment of these tax changes must not be minimized. Neither, however, should any of us lightly dismiss the costs in terms of retarded growth in productivity, employment, and real wage rates in failing to reduce the present excessive tax burden on private saving and capital formation.

Mr. TURE. I am Norman B. Ture. I am president of Norman B. Ture, Inc., consulting economist in Washington, D.C. I am also consulting economist to the National Association of Wholesaler-Distributors.

Mr. Chairman, I appreciate your invitation to appear here today to discuss current and future capital formation adequacy for the U.S. economy. In that context, small business has special capital deficiency problems. On Thursday, I will present a detailed analysis of the capital needs and problems of merchant wholesaler-distributors which will demonstrate these problems of small business. However, it is both useful and necessary to view the situation of small business in the context of the entire economy, so—as requested—I will concentrate my remarks today on the adequacy of overall capital formation.

CAPITAL ADEQUACY: THE CENTRAL ECONOMIC PROBLEM OF THE UNITED STATES

In my judgment, the central economic problem facing the United States is whether the rate of capital formation will be adequate to meet the economy's capital requirements over the next decade and longer. Virtually all of the other major issues with which public policymakers are concerned turn on this central problem of capital adequacy. Whether the focus is on attaining energy self-sufficiency, protection of the environment, improving and expanding mass transit systems, raising the housing standards of low- and middle-income individuals, providing safer and healthier working conditions, and so on, a basic constraint on achieving these goals is how much capital will be available to meet the growing and varied demands of the U.S. economy. The less rapidly we add to our productive capability, the more severely will pursuit of any of these public policy objectives limit our success in achieving other public and private goals.

THE MEANING OF CAPITAL REQUIREMENTS AND CAPITAL SHORTAGE

The Congress and the public have heard much on the subject of the capital shortage. So far, most of the attention has been given to estimating capital requirements and the prospective shortfall of actual capital accumulation. These estimates have varied widely for numerous reasons, including differences in basic assumptions, analytical method, and projections of such factors as the rate of inflation, the growth of Government spending and deficits, and the magnitude of various capital-intensive Government programs. To get a useful perspective on these estimates requires us to be clear at the outset as to what we mean by "capital requirements" and "capital shortage."

The term capital "requirements" does not mean that there is some specific amount of capital that must be on hand at some future time. In fact, there is no unique amount of capital that the economy must have at any given time. It makes sense to talk about capital require-

ments only in relation to other things, principally the growth in the labor force. We aren't interested in adding to the stock of capital for its own sake; the concern with capital accumulation, instead, stems from the role capital addition plays in providing the opportunity for increases in employment, in productivity, and in real wage rates.

Beginning with a projection of the growth in the labor force, it is possible to estimate by how much the stock of capital must grow if the ratio of capital inputs to labor services in production is to increase at some designated rate. It is this increase in the capital-labor ratio which, along with technical progress, primarily determines the rate of increase in labor's productivity, its real wage rates, and employment. If public policy aims at maintaining at least the postwar average rate of increase in labor productivity and real wage rates, while avoiding an unacceptable rate of unemployment, then if the growth in the labor force can be reasonably estimated so too can the increase in the stock of capital needed to privide the increase in the capital-labor ratio on which attaining these goals depends.

Over the postwar period, the number of full-time equivalent employees in the private business sector of the economy has increased at an average annual rate of 1.5 percent per year. Associated with this trend, the net stock of capital in the business sector has increased at an average annual rate of about 4.3 percent. The capital-labor ratio, hence, has increased at an average annual rate of about 2.7 percent. In turn, this increase in the capital-labor ratio has contributed to an average annual rate of increase—2.3 percent—in labor's productivity and real wage rate. Financing the capital outlays required to achieve this increase in the net stock of capital—along with residential investment, net foreign investment, and Government deficits—has required total national saving, on the average, of about 15.5 percent of GNP; and it has required total private-sector saving averaging 15.7 percent of GNP.

If we project the postwar trends in employment and in the capital-labor ratio, over the next 11 years; that is, through 1985, we shall have to add $675 billion to the net stock of business capital, measured in constant 1974 dollars. Assuming no change in the rate at which business replaces fixed capital facilities, this will require $2.37 trillion of total capital outlays a year, in constant 1974 dollars.

Senator NELSON. May I interrupt you? We are having some problems with time constraints here. I will have to limit everybody's presentation to 10 minutes. Our main concern, I think, is to get some idea about what can be done to aid small businesses in capital formation and capital recovery. Now, the statistics you are presenting, we have received in considerable detail from a number of witnesses in previous hearings. They are very good and helpful, but could you address yourself to those aspects of your statement, that relate specifically to what the Small Business Committee and many of the Finance Committee—since this is a joint hearing—can do, and what can be

done to assist small businesses—such as changes in the tax law to help them with capital formation and capital recovery. Otherwise, we are going to run out of time this morning before we get to that.

Mr. TURE. I appreciate your time constraints. Let me preface my response to your specific inquiry by pointing out that the problem with which the economy as a whole must deal, and that is every single part of the economy, including small business, medium-size business, and large businesses, and households as well, and the Government sector, too, the problem is primarily concerned with whether or not there will be an adequate flow of saving in the private sector. For every single dollar of capital formation, irrespective of who forms that capital, there has to be a dollar of saving. Existing tax laws of the United States, at the Federal, State, and local levels, are enormously biased against savings by private households and by businesses. It has been observed on a number of occasions that the amount of tax that is imposed at all levels of Government on a dollar of savings and capital formation vastly exceeds the amount of tax on a package of cigarettes, or a dollar's worth of cigarettes, or vastly exceeds that on a dollar's worth of alcoholic beverage. It is as if, inadvertantly, or by intention, we have imposed a vastly higher burden on savings and capital formation that we have on such things as cigarettes and liquor, as if we treat savings and capital formation as less important than cigarettes or liquor. If we are to close the savings gap, which I estimate with a very modest inflation rate of 3 percent a year between now and 1985, as in the area of $500 billion, then that savings must come from the private sector, because there is no reasonable prospect, however desirable it may be, for the Federal Government to start running surpluses at any order of magnitude that will contribute significantly to adequate savings.

If we are to close that savings gap, the private sector is going to have to close it. It will be necessary, if they are to be able to do so, for there to be major changes in the structure of the Federal tax system, as well as in the States and local tax system. And our focus today is on Federal taxes. If you look at the components of national saving, as shown in the official national income accounts prepared by the Department of Commerce, one of the things that you will find very striking is that over the entire postwar period, the Government sector has not been a major contributor to adequate savings in the economy. On the contrary, it has been a drain. And the Federal Government has drained a fairly substantial amount; it has drained $62 billion to $63 billion over the last 8 years, ending with fiscal 1974. And the Federal Government's drain on the total savings of the economy for fiscal years 1975, 1976, and 1977 is very likely to run into the hundreds of billions of dollars. So the problem is to find a way in which tax changes in fact can be made to reduce the excessive weight of taxation, the excessive burden of taxation on private sector saving and capital formation.

A second impressive fact, in looking over the record, is that business saving represents a very substantial part of the total private sector saving and that is the most rapidly growing component of that saving. Particularly significant in this context is that of the business sector's saving—the most important part has been in the area of capital recovery allowances. There is a lot of attention being paid by the Ways and Means Committee during this year, and I imagine next year, and in the Congress as a whole, to tax reforms aimed at doing something about such provisions as the asset depreciation range, the investment tax credit, and other provisions that are aimed at accelerating the speed with which a business entity, either large or small, may recover its investment in fixed capital.

Many tax reformers believe these are excessive and that they ought to be drastically modified. I would call your attention to the fact that any such modification, whatever other benefit you may see in it, dollar for dollar will reduce the saving undertaken by businesses, large, small or in between. And if you are in agreement that, in fact, one of the central problems we do face is an inadequacy of private sector saving, the single way in which any effort to reduce capital consumption allowances for business ought to be viewed as a direct reduction in the capacity and the incentive of the private sector to save.

I do not mean to suggest that it is only in the business sector that tax changes to reduce the burden on saving ought to be undertaken. Indeed, one of the things that the historical records shows you is that the contribution of personal household saving to total saving has been diminishing throughout the entire postwar period with a few exceptions.

Suppose the average household reduced the proportion of its disposable income used for consumption from 92.5 to 90 percent; that is only 2.7 percent reduction, but at the 1975 estimated level of disposable income, this would increase household saving by $26 billion. That would be a significant contribution to increasing the private sector's aggregate saving. There are any number of tax changes that would reduce the existing burden on individual and on business saving.

I would offer the following urgent recommendation that it is essential for all parts of the private sector to increase its saving rate and this should suggest that it is desirable to develop a long list of tax changes which would be suitable to that purpose.

Senator NELSON. Thank you very much.

Our next statement will be from Mr. Roland Bixler, president of J.B.T. Instruments, Inc., and chairman of the Small Business Tax Policy Task Force of the National Association of Manufacturers.

Your statement will be printed in full in the record.

[The prepared statement of Mr. Bixler in full follows:]

STATEMENT BY ROLAND M. BIXLER,
CHAIRMAN, TASK FORCE ON SMALL BUSINESS TAX POLICY
OF THE NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE JOINT HEARINGS OF THE
SENATE SELECT COMMITTEE ON SMALL BUSINESS
AND THE SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS

September 23, 1975

Introduction

Mr. Chairman, members of the Small Business Committee and the Financial Markets Subcommittee, my name is Roland M. Bixler. I am President and co-founder of J-B-T Instruments, Inc., a small manufacturer of electronic components located in New Haven, Connecticut. Our company employs about 225 people, and in an industry where much larger companies play the leading roles, I am proud to be able to say that we marked our 35th anniversary earlier this year.

As a small businessman in a manufacturing industry, I have long been very interested in the actions and policies of the federal government as they affect the ability of businesses of all sizes to produce the goods and services which the economy demands of us. So, I am pleased to be here today representing the Taxation Committee of the National Association of Manufacturers as the Chairman of its Task Force on Small Business Tax Policy.

The NAM is a broad based trade association with approximately 13,000 member companies. I have found that many people are not aware that over 85% of all NAM manufacturing members are "small businesses," that is, they have 500 or fewer employees. With members of all sizes in every manufacturing industry around the country, the NAM has a broad member constituency whose interests and views we represent.

General Tax Policy

While recognizing that distinctions between the interests of large and small businesses are often more illusory than real, our Taxation Committee's Task Force on Small Business Tax Policy does study federal tax policy and

recommend changes therein with a view towards particular small business problems, specifically the ability of smaller firms to generate internal capital which is needed for modernization and expansion of their facilities, their markets, and their payrolls.

Since the NAM was invited to testify today on a particular subject, I will not discuss in detail all of the items of tax policy which we believe should be supported or are in need of reform. I do, however, want to list them quickly to indicate the areas which are of particular interest to us. These items include:

(1) a permanent increase in the corporate surtax exemption to $100,000 or more (at least the temporary increase to $50,000 in the Tax Reduction Act of 1975 should be made permanent);

(2) reductions in the corporate tax rate -- both normal tax and surtax -- but without creating additional "notches" or graduation (the three tier rate structure created by the 1975 Act should be returned to two tiers);

(3) a permanent and stable investment tax credit of at least 10%, with liberalized rules for applying the credit to structures and for extending the carryover periods;

(4) the continuation of DISC which provides significant cash flow benefits that assist U. S. firms to overcome the array of tariffs, subsidies and other artificial devices used by foreign countries to protect local industry (many small and medium-sized firms are developing export only because of DISC);

(5) and, finally, a basic reform of our capital recovery policy which I shall discuss shortly.

Each of these items should be considered by the Congress as tax legislation is acted upon.

Mr. Chairman, I also want to recall your attention to the NAM's Tax Impact Project Report which was the subject of our testimony during your hearing on June 19. The project was undertaken to develop a more comprehensive approach to the economic analysis of tax proposals than that used in the traditional direct impact revenue estimates. Since such direct impact estimates assume that tax changes take place in a vacuum, their secondary and "feedback" effects on investment, employment and GNP are ignored in public discussions of tax bills. As a result, the actual net revenue effects, which are generally opposite those publicly discussed, do not receive any congressional consideration.

The concept of estimating overall economic impact is an important one. The report was included in your record for June 19 along with our testimony. I commend it to your attention. We will be glad to respond to any questions which you and your staff have.

The topic which we have been invited to discuss today is the concept of capital recovery allowances as an alternative to the depreciation structure as currently used in the Internal Revenue Code. In particular, we support the program presented in H.R. 7543, "The Capital Recovery Act of 1975."

Existing Depreciation Policy

By way of providing some background, let me briefly discuss the depreciation system in the Code. The Code purports to tax businesses (either individual or corporate) on the amount of income realized. To arrive at the taxable income figure, it is necessary to deduct the costs incurred to produce income, such as for wages and salaries, for materials, and for plant and equipment. Labor and material expenses are deductible in full in the year paid, but the costs for plant and equipment are not. It was determined that deductions for these expenses should be spread over a longer period.

Historically, U. S. tax law has utilized the "useful life" concept for such recovery. The capital cost of an asset is recovered by deducting a percentage of such cost from the taxpayer's gross income every year for a pre-determined number of years. This is referred to as "depreciation" because it is based, theoretically, on the number of years over which the productive value of the property will fall to zero (or its salvage value). In theory, the basic depreciation system will recover the invested capital (less salvage value) by the end of the property's prior determined "useful life."

Problems With "Useful Lives"

One serious problem with the useful life concept is that its theoretical full recovery of invested capital does not work in the real world of inflation and technological change. The impact of even single-digit inflation results in the recovery of substantially less than real capital value of productive assets with any appreciable life span. The longer the depreciable life assigned to an asset class, the more devastating the effect of inflation.

Manufacturing industries are particularly affected because the minimum depreciation period for most manufacturing assets is at least nine years. Factories and buildings with depreciable lives of well over 20 years are treated even worse.

Over the years, a number of modifications have been made to the basic, straight-line depreciation concept. Accelerated methods for calculating the depreciation deduction now enable a taxpayer to recover more of the historical cost during the early years of an asset's depreciation period. The Class Life System allows the use of one depreciable life for many different types of assets which are used in the same business activity. And the Asset Depreciation Range (ADR) allows the depreciable life of an asset class to be increased or reduced up to 20% from its administratively fixed guideline life.

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While these changes appear to have modified the "useful life" concept by allowing a more rapid cost recovery system, they are still applied within a concept which assumes it is possible administratively to determine in advance the precise number of years that any asset will be useful and that the cost can be fully recovered in this way. One disturbing example of the continuing stranglehold of the "useful life" concept was Revenue Procedure 72-27, issued August 23, 1974, which created a new class for steam and electric generation and distribution property by pulling such assets out of the overall manufacturing asset classes in which they had been situated previously. By so doing, the IRS greatly extended the depreciable lives of such property and did so under the so-called "liberalizations" of ADR.

Another serious problem with depreciation in general -- and ADR in particular -- is the complexity of the system. A good deal of time is spent by tax lawyers and accountants keeping track of the assets which are purchased during the year, the costs incurred, the 130 asset classes, the amount of depreciation taken previously, the amount allowable currently, the salvage values, the amounts realized on sale or disposition of the assets and the taxable gains, if any, which must be recognized. Large companies have whole staffs which are responsible for such calculations for these purposes.

Small companies cannot easily afford to hire full-time qualified persons, but that does not lessen the record-keeping burden. Although no one company is to likely to have assets in every class, even the smallest operations may need to keep track of seven or eight classes to cover structures, machinery, special equipment, cars, trucks, land improvements, office furnishings and information systems. With any diversity at all, the numbers would go higher and the total

work involved is compounded further by the need to keep "vintage accounts" for each class of assets purchased in separate taxable years.

To compound the small businessman's problem, the Treasury regulations on depreciation are extensive, some 100 pages in major tax services. The asset classes take several more pages to list, and Revenue Rulings on these matters must also be monitored. Finally, the classes and lives are always subject to administrative change.

Thus, it is not surprising that ADR is not universally used. Depreciation is complicated enough, but the asset classes and the guideline lives and rules for ADR election only make matters worse.

In short, Mr. Chairman, depreciation as we know it -- whether simple, straight line amortization or 20% ADR with accelerated methods of calculations -- is outmoded. It is too complex and costly. It is counterproductive from an economic point of view.

Capital Recovery Allowances

We believe a simple, efficient capital recovery allowance system is the answer. We need to move our thinking away from a fixation with "useful lives" and attempts to predetermine how long an asset can be efficient in producing income. We should substitute a concept of recovering invested capital as rapidly and efficiently as possible so that it can be reinvested in our businesses.

We urge you to give very serious consideration to the program as outlined in H.R. 7543. Essentially, the proposed system would be an optional alternative to depreciation. It would be available for all tangible personal property and other tangible property with specified uses, if that property would otherwise be subject to depreciation or amortization. This would include buildings and their

structural components, research facilities, warehouses and storage facilities, if such property is used as an integral part of or in connection with manufacturing, production or extraction of minerals, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services. This would also include pollution-control facilities.

The system would allow machinery and equipment to be written off in five years while buildings and structures would be written off in ten years. The investment tax credit would still be applicable. The full cost of the property would be recovered because no salvage value would be deducted. The maximum allowed deduction schedules for both the five-year and the ten-year write-off periods would be based on accelerated methods. The taxpayer could take all, any part, or none of the maximum deduction for a given year. Unused portions of the maximum deduction could be carried forward indefinitely to succeeding taxable years and could be used in addition to the maximum allowed deduction for such years.

The system would be applicable to costs as they are incurred or paid, rather than when eligible property is placed in service. If costs are incurred or paid in different taxable years, the costs for each year would be added to the five-year or ten-year vintage account for that year. A full year's deduction would be allowed, regardless of the date on which the cost is incurred or paid. The taxpayer could elect the system with respect to any section 189 property while using conventional depreciation or amortization for any other such property, but the election could be revoked only with the consent of the Commissioner.

Economic Impact

The principal benefits of the system would be its favorable impact on the value of recovered capital and internal cash flow of businesses. Short,

fixed recovery periods would reduce the eroding effect on our capital base of inflation over long depreciable lives. This would also allow more rapid recovery and reinvestment in new projects which would strengthen productivity, increase employment opportunities and tend to promote a continuing increase in our general standard of living. In other words, the economy would make somewhat better use of the supply of capital available during a given period of time. Capital formation is a critical concern, and adequate recovery of existing capital is a key feature of any capital formation policy.

In order to attempt to determine the impact which this proposed system could have on our economy, the NAM commissioned Norman B. Ture, Inc., economic consultants in Washington, D. C., to do an analysis of its economic impact. The complete results and methodology used are presented in the Appendix, but I would like to hit the highpoints for you.

While an obvious effect of the capital recovery allowance system would be to reduce taxes on business income and thereby increase internal cash flow, this would not be an end in and of itself. The proposed system would indicate to the business community that national policy was moving away from a hindrance of adequate cost recovery and toward increasing internal cash flow available for modernization and expansion needs. In addition, it would increase the financial ability of business to react to pressures of the marketplace for increased and modernized supply capacity. The Ture analysis indicates that the impact of the system would be significant and positive in nature.

Capital Outlays. If the proposed system had been fully effective in 1975, capital outlays (in constant 1974 dollars) would have increased $15.5 billion beyond what is otherwise expected. (Since actual capital outlays are

expected to decrease in real terms in 1975, the system would reverse the current trend.) For the period 1975-1985, capital outlays would increase $169.3 billion above what is expected under the status quo.

Employment. Under the proposed system, employment in the capital goods and construction industries alone would be increased substantially, by an estimated 180,000 jobs in its first year of application. After three years, the increase would be 290,000. The effect of new production jobs in these industries would spread to supportive areas of the economy, and the overall employment increase could be expected to be much higher.

Federal Revenue Impact. The effect of increased economic activity in the capital goods and construction industries would be to increase total business and personal income. Taxes on this income would more than offset the expected initial reduction in taxes under the proposed system.

Based on taxation of both business and individual income, federal revenues would have shown a net revenue gain in calendar 1975 of some $6.4 billion more than can be expected without the change. Revenue gains would continue to be generated and, for the period 1975 through 1985, federal revenues would be increased more than $79 billion in constant 1974 dollars as a result of the increased economic activity flowing from the system.

As was noted and discussed in the Tax Impact Project Report, the type of revenue estimate generally used in connection with tax proposals is not this net revenue figure. Instead, the traditional estimates assume that a provision will be enacted, repealed, altered, etc., in a vacuum and that no compensating changes in economic activity would result. Particularly with respect to provisions affecting available capital and productive investment, this is obviously an unrealistic procedure and presents a misleading appraisal.

Under the traditional direct impact method, there would be an estimated revenue loss in constant 1974 dollars of approximately $14.8 billion for 1975, $25.6 billion for 1976, rising to $34.5 billion in 1979 and then declining.

U. S. in Relation to Other Industrialized Nations

It is also important to be aware of what our major industrialized trading competitors are doing in the cost recovery area. For example, Canada recently has tried a two-year write-off period for machinery and equipment which the Liberal government has now decided to make a permanent feature of their tax system. The United Kingdom allows a 100% write-off for machinery in the first year. Other industrialized countries employ different rapid recovery mechanisms. The United States, as of now, ranks low in comparison with these competing countries.

To illustrate the differences among various systems, consider this updated version of a hypothetical example which was included in supporting evidence prepared by Dr. Pierre A. Rinfret in conjunction with his appearance as a participant in a panel discussion before the House Ways and Means Committee on February 7, 1973. Assume that $10 million investments have been made in each of six industrialized foreign nations and in the United States. The investments are identical in their allocations to land, building, manufacturing assets, office equipment, and transport equipment. It is assumed that the investments qualify for the most favorable treatment under each country's system of depreciation, credits, and grants. The following table compares the effects under the various systems, including the United States under both pre-1975 law and the proposed system.

Capital Recapture of a Hypothetical $10 Million Investment

	First Year		Fifth Year	
	Amount Recaptured	Percent of Investment Recaptured	Amount Recaptured (Cumulative)	Percent of Investment Recaptured
United Kingdom	$9,408,000	94.1%	$9,920,000	99.2%
West Germany	8,849,000	88.5	9,284,000	92.8
France	5,057,500	50.6	9,134,021	91.3
Italy	2,804,000	28.0	8,990,000	98.9
Canada	5,080,000	50.8	8,810,432	88.8
Japan	5,895,000	59.0	7,047,039	70.5
United States (Current Law)	2,072,169	20.7	5,943,567	59.4
United States (Proposed Capital Cost Recovery System)	3,601,100	36.0	8,918,600	89.2

Conclusion

To conclude, Mr. Chairman, our cost recovery system -- namely depreciation -- is an outmoded concept. It sanctions the erosion of our capital base. It is unjustifiably complex. Its liberalizing modifications are not universally useful, and they are subject to administrative changes. It is out of step with modern cost recovery policies. And it inhibits more efficient use of existing capital supplies.

In contrast, the capital recovery allowance concept is simple and efficient. It focuses on greater recovery of real capital costs instead of "useful" lives. It would increase internal cash flow and encourage positive economic benefits as well as result in net increases in federal revenues flowing from those economic benefits.

Capital recovery allowances would be a significant, constructive tax reform. We encourage to study the system presented in H.R. 7543, to consider the benefits which it could generate and to recommend to your Senate colleagues that the system be enacted.

APPENDIX:

SUMMARY OF ANALYSIS BY NORMAN B. TURE, INC.

Economic Impact of the Proposed Capital Recovery Allowance System

	Estimated Increase in Capital Outlays (Total in billions of 1974 dollars)	Increase in Employment in Capital Goods and Construction Industries (in thousands)	Increase in Business Sector Net National Product (in billions of 1974 dollars)
1975	15.5	180	15.5
1976	20.0	240	16.7
1977	23.3	290	16.1
1978	17.7	160	13.7
1979	19.3	160	14.5
1980	13.5	150	16.7
1981	10.0	150	18.4
1982	10.4	120	18.3
1983	12.7	160	18.5
1984	13.2	170	20.1
1985	13.7	170	20.6

	Increase in Business Sector Gross National Product (in billions of 1974 dollars	Net Revenue Impact (in billions of 1974 dollars)	Initial Impact Revenue Effects (in billions of 1974 dollars)
1975	59.0	6.4	-14.8
1976	75.9	7.3	-25.6
1977	88.7	7.2	-31.7
1978	89.0	6.5	-34.0
1979	89.4	6.5	-34.5
1980	85.2	7.1	-32.5
1981	79.7	7.5	-30.4
1982	72.9	7.3	-28.5
1983	68.5	7.4	-26.8
1984	67.4	7.9	-24.9
1985	64.9	8.1	-22.9

A PROPOSED CAPITAL RECOVERY ALLOWANCES SYSTEM

Procedures for Estimating Initial and Net Revenue Effects, and Effects on Output, Investment, and Employment

I. Introduction

The proposed amendments to the Internal Revenue Code would allow businesses to elect capital recovery deductions in lieu of depreciation allowances for machinery and equipment and certain structures. The capital recovery allowances would be specified fractions of an asset's cost over a fixed number of years without reference to "useful life". Norman B. Ture, Inc., was asked to estimate the impact of the proposed system on Federal revenues, output, capital outlays, and employment. This paper explains how the estimates were derived.

II. Estimation Procedure

A. Overview

The details of the estimation procedure are described below; a sketch of the process should clarify the discussion. First, stocks of capital and amounts of gross investment are projected annually through 1985 under present law for equipment and nonresidential structures. The gross investment series is multiplied by the percent increase in depreciation deductions under the proposed system, then by the marginal tax rate, to yield the <u>initial impact revenue loss</u>, i.e., the decrease in tax liabilities on the assumption that the change in the tax law would have no effect on capital outlays, employment, output, or any other relevant

economic magnitude. Next, the effect of the proposal on the cost of capital and the increase in the desired stock of capital in response to the reduced cost of capital is calculated. Then the increase in capital outlays needed to reach the larger desired stock of capital is computed. An increase in business sector gross national product due to the larger stock of capital in service relative to present-law projections is found using a production function.[1/] A net revenue impact is estimated, using the relationship between revenue increases and changes in gross national product originating in the business sector. Finally, increases in employment in capital goods producing industries and in nonresidential construction are derived by examining the marginal change in employment associated with past changes in outlays for equipment and structures.

B. 1974 Net Stocks (Table A)

The analysis begins with estimates of 1974 net stocks of equipment and structures, derived from unpublished Bureau of Economic Analysis data, using double declining balance (DDB) depreciation, service lives equal to .85 of the Bulletin F lives, assets purchased from government valued at second-hand prices, and current cost 2 valuation for structures. It was assumed that all equipment and 12.7 % of structures [2/] were section 1245 assets, eligible

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[1/] For the production function, see Norman B. Ture, Tax Policy, Capital Formation and Productivity (NAM, 1973).

[2/] Equal to 10 % of industrial structures, 25 % of utility structures, and all petroleum and natural gas well drilling and exploration structures, based on 1972 constant cost 2 distribution in Fixed Nonresidential Business Capital in the United States, 1925-73 (National Technical Information Service, 1974).

under current law for the investment tax credit and the 20% Asset Depreciation Range and eligible under the proposed system for five-year capital recovery; that 28.4% of structures (all remaining industrial and utility structures) were eligible for the proposed 10-year write-off; and that the remaining 58.9% of structures would be ineligible and would remain subject to present tax treatment.

C. Projections of Present-Law Stocks and Investment, 1975-85

Stocks of equipment and structures were projected through 1985 (in 1974 dollars) under the assumption that their trend rate of growth from 1974 levels would be the same as their 1947-72 trend rates of 4.2 % and 3.6 %, respectively. Further, it was assumed that real gross investment in 1975 would fall by 10 % from 1974 levels (implying no change in nominal terms, if inflation averages 10 % for the year), then increase at a rate which would raise the net stock to its long-term growth path by 1977 (equipment) or 1979 (structures). Replacement investment, which has closely approximated depreciation of net stock, was assumed to equal the average ratio of computed depreciation to net stocks of recent years; as found in Fixed Nonresidential Business Capital, these ratios are 21.1 % for equipment and 6.77 % for structures.[3/] A further constraint was added: that net investment falls by no more than 20 % in any one year (the largest postwar drop was about 15 %).

[3/] The ratio for any year is the depreciation for that year divided by the net stock at the end of the preceding year.

When combined with the assumed 10 % decrease in gross investment in 1975, this meant that 1975 replacement investment was also constrained, to slightly less than the average ratios (18.0 % for equipment, 6.24 % for structures). The average ratios were used for all subsequent years, however. The assumed declines in 1975 investment, large by postwar standards, were chosen to introduce a conservative bias to the estimates of the net impacts in 1975.

Series for 1245 stocks and investment were then derived by adding 12.7 % of the structures stock and investment figures to the corresponding equipment numbers for each year. The implied replacement rate for 1245 assets was 19.3 % (16.5 % in 1975).

These stock and investment data include work in progress which is not yet in service. It was assumed that equipment and 1245 structures take, on the average, one year to place in service; other structures were assumed to require three years on the average. Thus, any investment in equipment in a given year was assumed to go into service the following year. The current year's stock in service equals net stock less net investment for that year, or the previous year's net stock. In other words, for equipment, the stock and investment placed in service were the same as the previously computed net stock and investment lagged one year.

For structures the adjustment was more complex. It was assumed that the net replacement investment in a year consisted of three parts, which would be placed in service in 0-1 years, 1-2 years, and 2-3 years. Construction begun in a given year was assumed to continue at the same rate for the

next two years. Thus , the amount of investment in 1974, say, that would be placed in service 2-3 years hence was assumed to be the same as the amount in 1975 that would go into service 1-2 years later and also the same as the amount in 1976 that would go into service in 0-1 years. Once the three-way division was made for 1974, the division for all subsequent years was known: since two of the parts in a given year were predetermined, the third part had to sum to the year's net investment.

For example, investment in all private nonresidential structures totaled $52.2 billion in 1974. It was assumed that $19.0 billion of this was spent on structures that would go into service in 0-1 year ($9.5 billion each in 1974 and 1975), $15.0 billion on structures that would be placed in service in 1-2 years ($7.5 billion each in 1975 and 1976) and $18.2 billion that would be in service in 2-3 years ($9.1 billion each in 1976-77). Then the 1975 total investment of $47.0 billion was assumed to be divided as follows: $15.0 billion going into service in 0-1 years, $18.2 billion in 1-2 years (both continuing at 1974 levels), leaving $13.8 billion started in 1975 and going into service in 2-3 years. Moreover, the total investment finished and placed in service in 1975 by assumption had to equal one-half each of (1) the 0-1 year amounts from 1974 and 1975, (2) the 1-2 year amounts from 1973 and 1974 (which equals (1), and (3) the 2-3 year sums from 1972 and 1973 (also equal to (1), or $51.0 billion = $\frac{1}{2}$ 3(19.0 + 15.0) .

Relationship between Gross Investment and Investment Placed in Service for Structures under Present Law

(billions of 1974 dollars)

	Gross Investment	Investment Placed in Service in 0-1 years	1-2 years	2-3 years	Total Investment in Service
1974	52.2	19.0	15.0	18.2	
1975	47.0	15.0	18.2	13.8	51.0
1976	54.0	18.2	13.8	22.0	49.8

The stock in service in a given year equalled the net stock minus the net investment from that year and from the two previous years that was not yet in service. Equivalently, net stock in service equalled the previous year's net stock in service plus the current year's net investment placed in service.

D. Calculation of Decrease in Cost of Capital

1. 1245 Property

Next the change in the cost of capital was calculated for 1245 property and for structures eligible for 10-year write-off. For both types, a marginal tax rate of 48% was used with all future values discounted at 12%. The possible effects of the proposal in changing the mix of asset acquisition, i.e., from relatively long-lived to relatively short-lived, were ignored; this assumption does not preclude a reduction in the replacement cycle.

According to unpublished Treasury information, the average tax life for 1245 property, after a 20 % ADR reduction, is approximately 12 years, implying an "actual" useful life of 15 years. It was therefore assumed that 1245

property has a useful life of 15 years, at the end of which it is disposed of with no taxable gain. It was assumed that it takes one year from the time of order to place such assets in service and that equal progress payment are made after six months and one year. Income, investment credit, and depreciation deductions under current law begin once the equipment is placed in service. Under the proposal, capital recovery allowances would begin for half of an asset's value after one-half year, when the first payment is made, and after one year for the other half. Then the cost of capital, y, (=the annual pretax income required to warrant the investment) under present law and under the proposal for an asset which costs $1,000 may be found from the following equations.

Present Law

$$500\left[(1.12)^{-\frac{1}{2}} + (1.12)^{-1}\right] = (1.12)^{-1}\left[.52\sum_{i=1}^{15}(1.12)^{-i}y + .48\sum_{i=1}^{12}(1.12)^{-i}D_i + (1.12)^{-1}C\right]$$

Proposed System

$$500\left[(1.12)^{-\frac{1}{2}} + (1.12)^{-1}\right] = (1.12)^{-1}\,(.52)\sum_{i=1}^{15}(1.12)^{-i}y + .48(.5)\sum_{i=1}^{5}(1.12)^{-i}\,CRA_i\left[(1.12)^{-\frac{1}{2}} + (1.12)^{-1}\right] + (1.12)^{-1}C.$$

where D_i is the present depreciation deduction in year i, C is the investment credit, and CRA_i is the proposed cost recovery allowance.

2. Structures

For structures, it was assumed that the tax life and the actual life both equal 33 years under present law. Depreciation is currently claimed on a 150% declining balance basis with switchover to straight line. Payments

are made in equal installments after 1,2 and 3 years; the structures begin contributing to income and depreciation deductions at the start of the fourth year. Under the proposal, capital recovery allowances on one-third of the cost would begin after one year, on another one-third after two years, and on another one-third after three years. Each third would have a ten-year write-off period. The relevant equations are as follows.

Present Law

$$333 \sum_{i=1}^{3} (1.12)^{-i} = (1.12)^{-3}\left[.52\, y \sum_{i=1}^{33} (1.12)^{-i} + .48 \sum_{i=1}^{33} (1.12)^{-i} D_i \right]$$

Proposed System

$$333 \sum_{i=1}^{3} (1.12)^{-i} = (1.12)^{-3}(.52y) \sum_{i=1}^{33} (1.12)^{-i} + .48 \sum_{i=1}^{3} (1.12)^{-i}\left[.333 \sum_{i=1}^{10} (1.12)^{-i} CRA_i \right]$$

An implicit assumption of these four equations is that the purchaser either holds the asset until the end of its useful life and then realizes no taxable gain from disposition, or that the asset is sold for an amount, net of tax on recapture and capital gain, which equals the present value to the seller of the remaining after-tax income and depreciation stream.

E. Calculation of Net Stocks and Investment under the Proposed System

Once the cost of capital has been computed, the percentage increase in desired holding of capital, dK/K, may be ascertained from the relationship

$$\frac{dK}{K} = \frac{\frac{dy}{y} \cdot \eta_d}{1 - \frac{\eta_d}{\eta_s}}$$

where dy/y is the percentage change in the cost of capital, η_d is the elasticity of demand for capital (assumed to equal -1), and η_s is the elasticity of supply of savings (very conservatively chosen to equal ½).

Under these assumptions, $\frac{dK}{K} = -\frac{1}{3}\frac{dy}{y}$. The percent changes in cost of capital (dy/y) and in desired stocks of capital (dK/K) calculated from the above equations are as follows.

Percent Change in Cost of Capital and Desired Stock

1245 property	dy/y	-14.9
	dK/K	5.0
Structures	dy/y	-21.9
	dK/K	7.3

In order to calculate the effect on the actual net stock, it was assumed that these increases in desired stock would be fully realized after three years in the case of section 1245 property and after five years in the case of industrial and utility structures. Thus if the proposed five-year write-off were effective from January 1, 1975, the 1975 stock of 1245 property would be approximately 1.7% higher than under present law, the 1976 stock 3.3% higher than otherwise, and 1977 and subsequent year's stocks, 5.0% higher. Similarly, enactment of the proposed ten-year write-off for industrial and utility structures would raise those stocks above previously projected levels by 1.5% in 1975, 2.9% in 1976, 4.3% in 1977, 5.8% in 1978, and 7.3% in 1979 and thereafter.

Once the new net stocks under the proposed system had been derived, it was possible to calculate new investment schedules. Replacement investment was left unchanged in 1975; thereafter it was assumed to equal 19.3% (1245 assets) or 6.77% (eligible structures), as before, of the new, larger net stock in the preceding year. Investment and net stocks placed in service were calculated as described above. The resulting projections of investment under the proposal were added to the projections of investment for other nonresidential structures under present law to yield series on total investment under the proposal.

F. Estimation of Employment Increases

The increase in employment in producers' durable equipment industries was found by multiplying the annual increase in 1245 investment under the proposal over that projected under present-law by .0000191, which equals the marginal increase in employment in those industries in recent years per 1974 dollar of investment. The corresponding ratio for structures was .0000096. These ratios were derived from yearly changes in gross private domestic investment and employment in equipment and nonresidential structures as compiled by the Bureau of Labor Statistics (unpublished data).

It should be stressed that these estimated employment gains are for those two sectors only, and do not imply that overall employment will show a corresponding increase. No assumption is made as to whether the additional employment projected for these sectors will be drawn from other sectors or from the unemployed.

G. Estimates of Gross and Net Business Product

Gross business product (GNP originating in the business sector) has grown at an average real rate of 3.8 % over the 1947-73 period. It was assumed that without the proposed system, GBP would continue on this path for the next decade, with the following exceptions: (1) in 1975, GBP will decline by 1.2% (in 1974 dollars); this is the consensus of private economists for the change in GNP in 1975;[4/] (2) in 1976 and 1977, GBP will climb by 6.4% per year, so that it will have averaged 3.8% for the 1974-77 period. Thereafter, GBP is assumed to rise 3.8% each year.[5/] (Table A)

It was assumed that the increase in stocks of capital resulting from the proposal would cause output to rise correspondingly. Assuming that there is no change in the rate of technological progress or in the rate of increase of the labor force, the percent increase in a given year's potential net business product (NBP) over its projected value would be approximately .31 times the percent increase in net capital in service. This number equals the elasticity of output with respect to capital as computed in Norman B. Ture, op. cit. Gross business product (GBP) is equal to net business product plus capital

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4/ It therefore is a conservative forecast of the decline in GBP, since gross government product, the other major component of GNP, is not likely to decline as much as total GNP. Official estimates project a 3.3 percent decline in real GNP in 1975. Cf. Budget of the United States Government Fiscal 1976, p. 41.

5/ In contrast, the economic assumptions underlying Federal budget projections show real GNP increasing 4.8 percent in 1976, 5.6 percent in 1977, and 6.5 percent annually in 1978-1980. Ibid.

consumption allowances; therefore, the increase in a given year's potential GBP would equal the increase in NBP plus the increase in capital consumption allowances above the level of depreciation allowances projected under current law. In the years 1975-76, when actual NBP is assumed to be below its potential (trend) level, additional stimulus will be provided by the increased investment, even though this investment is not in service. Thus, it was assumed that in 1975 the increase in NBP just equals two-thirds of the increase in outlays plus the increase from the small amount of additional capital in service. Thereafter, it is assumed that any additional capital outlays would be drawn from some other sector and that the increase in NBP above present law projections would be due solely to the increase in the total amount of capital in service.

H. Net Revenue Estimates

Net revenue estimates are the difference between estimated revenues under present-law and under the proposed system, taking into account the changes in gross and net business product associated with the proposal.

Total federal revenues under present law and for the proposed system were estimated as the summation of tax receipts from three sources: income taxes on income from capital (corporate profits, interest, rents, and proprietor's income);[6/] income and payroll taxes on labor income (wages and salaries and indirect business taxes (mainly federal excise taxes). To determine the appropriate tax rates to be applied to each source, it was necessary to divide national income

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[6/] Also included are Federal estate and gift taxes.

and federal revenues into the three categories. National income is readily divisible, but since personal income tax and nontax receipts apply to income earned from capital as well as labor, use of a single average tax rate would understate the rate paid by those receiving income from capital who are in higher tax brackets than the population as a whole. Partial segregation of these capital-income recipients is provided by the 1966 and 1969 editions of Statistics of Income - Individual Income Tax Returns, which classifies taxpayers by major source of income. In each of those years, the average tax rate (tax after credits as a percent of adjusted gross income) for those whose major source of income was capital (business or professional net profit, partnership net profit, dividends included in adjusted gross income, or net gain from sale of capital assets) was approxiamtely 1.67 times as high as for those whose major source of income was salaries and wages.[7/] This ratio was used to find the average tax rates on capital and labor income, t_K and t_L respectively, in the equation

$$T = t_K K + t_L L, \text{ where}$$

T = the sum of personal tax and nontax receipts plus contributions for social insurance,

K = the sum of proprietors' income, rental income of persons, and net interest included in national income, and

L = compensation of employees.

7/ The separation of income sources was nearly but not entirely complete. For those reporting salaries and wages as a major source, other sources supplied approximately 3 percent of adjusted gross income; for those with one category of capital income as a major source, other sources accounted for 17-19 percent of adjusted gross income.

"Personal capital-income" tax revenues, $t_K K$, were added to federal corporate profits tax accruals. The sum was divided by the sum of personal capital income (K) and corporate profits to yield an overall capital tax rate. These calculations were made for 1971-74. In that period, the labor tax rate climbed from .166 to .190 (reflecting the rise in social security rates and the effect of inflation in pushing individuals into higher income tax brackets), while the capital tax rate varied from .323 to .331. By plotting the logarithm of the labor tax rate against labor income, the labor tax rate was found to rise, on average, 5.7 percent for every $100 billion increase in employee compensation.

The projected present-law GBP found in section G was divided into labor and capital shares, using the 69:31 ratio found in Ture, op. cit. Projected present-law depreciation was subtracted from the capital share to yield a net capital share. To this was applied a tax rate of .32 in 1975 and 1976, .325 in 1977 and 1978, and .33 thereafter, representing a recession-year drop and slow return to the .33 rate of 1974. The average tax rate on the labor share rose from the 1974 level of .19 at the rate of 5.7 percent per $100 billion change in labor income; from a low of .189 in 1975 to .24 in 1985. The marginal rate, that is, the rate on the increment of labor income, associated with these changes in average rate was found to be .33. Finally, an indirect business tax rate of .019 (the rate in both 1973 and 1974) was applied to GBP. Total present-law federal receipts equalled the summation of these three components.

This three-part revenue estimation was carried out for the proposed system. The increase in GBP resulting from the increase in net capital in service raised the revenue from labor income and from indirect business taxes relative to present law. The same increase raised the gross capital share, but since net capital income was reduced by the larger capital recovery allowances, revenue from capital income was lower than under present law.

Total capital recovery allowances equaled the sum of four parts: allowances on 1245 property purchased after 1974, allowances on industrial and utility structures purchased after 1974, depreciation on the 1974 stock, and depreciation on post-1974 structures not eligible for the proposed system. The allowances for eligible property for each year were computed by multiplying the first year allowances by that year's investment, multiplying the second year allowance by the previous year's outlays, and so forth back to 1975, then summing the products. Depreciation on 1974 stock was the same as under present law in 1975; thereafter it was assumed that the year end stock equaled the previous year's stock less the current year's depreciation, where depreciation was at the same rate as in 1974. Depreciation on post-1974 ineligible structures was assumed to be the same as under present law.

The total capital recovery allowance was added to net business product to get GBP, described in Section G. GBP was then multiplied by

.31 to yield gross capital income. From this was subtracted the capital recovery allowance to yield net capital income, which was multiplied by the same capital tax rates as under present-law to derive capital tax revenues.

Labor income was found by multiplying GBP by .69, as before. The excess of labor income over present-law was then multiplied by .33, the marginal tax rate on labor income. This product was added to present-law labor tax revenues to yield labor tax revenues under the proposed system.

To the total of capital and labor tax receipts were added indirect business tax and nontax receipts, again assumed to equal .019 of GBP, to yield total revenues for the proposed system. The data shown in the net revenue table were derived by deducting the estimate of present-law revenues from the estimates of revenues under the proposed system.

I. Initial Impact Revenue Estimates

The initial impact revenue estimates were based on present-law projections of gross investment; that is, the estimates relied on the extremely unrealistic assumption that these decreases in the cost of capital would not induce any additional investment. It was assumed that no property for which any payment had been made prior to 1975 was elibible for the proposal. Therefore in 1975-77, the loss was confined to that fraction of toal investment devoted to projects started after 1974. In general the revenue loss in a given year equalled .45 (the average effective tax rate according to Treasury data) times the product of investment in that year and the percent increase in recovery allowance for such investment

plus the products of eligible investments from previous years times the percent change in recovery allowances for those vintages.

For 1245 property, the difference in recovery allowances equalled the average of (1) the difference between the new five-year schedule and the present-law twelve-year schedule and (2) the difference between the present-law schedule lagged one year and the new schedule. The second difference represented the earlier write-off permitted for the one-half of asset cost that was paid for in the present year but not placed in service until the beginning of the following year. It should be noted that after the five-year write-off ends, no further deductions are permitted under the proposal; hence, revenue losses on 1245 property begin to diminish in 1980.

For eligible structures, the difference in the recovery allowance was separated into the differences between the proposed ten-year write-off and present 33-year write-off lagged one, two, and three years. These represented the difference between payments made at the end of the third, second, and first years and depreciation that is currently not permitted until the building is placed in service at the start of the fourth year. These three differences were multiplied respectively by the current year's investment amounts that are going into service in 0-1, 1-2, and 2-3 years.

The revenue change in year i may be expressed thus:

<u>1245 property</u>

$$R_i = .45 \; I_i \left(CRA_1 - \frac{D_1 + 0}{2}\right) + I_{i-1} \left(CRA_2 - \frac{D_2 + D_1}{2}\right) + \ldots\ldots + I_{75} \left(CRA_{i-74} - \frac{D_{i-74} + D_{i-75}}{2}\right).$$

Structures

$$R_i = .45\ I_{i,01}\ (CRA_1 - 0) + I_{i,12}\ (CRA_1 - 0) + I_{i,23}\ (CRA_1 - 0) +$$
$$I_{i-1,01}\ (CRA_2 - D_1) + I_{i-1,12}\ (CRA_2 - 0) + I_{i-1,23}\ (CRA_2 - 0) + \dots +$$
$$I_{77,01}\ (CRA_{i-76} - D_{i-77}) + I_{77,12}\ (CRA_{i-76} - D_{i-78}) + I_{77,23}(CRA_{i-76} - D_{i-79})$$
$$I_{76,12}(CRA_{i-75} - D_{i-77}) \pm I_{76,23}(CRA_{i-75} - D_{i-78}) +$$
$$I_{75,23}\ (CRA_{i-74} - D_{i-77})$$

where R_i is the initial impact revenue loss or gain in year i, I_i is investment in equipment in year i, CRA_1 is the first year's proposed capital recovery allowance, D_1 is the first year's current depreciation allowance, $I_{i,01}$, $I_{i,12}$, $I_{i,23}$ are investment in structures in year i that go into service within 0-1, 1-2 and 2-3 years, respectively. Note that investment in structures in 1976 that is placed in service within one year and 1975 investment placed in service within two years are not eligible for the proposed recovery (since initial payments were made before 1975) and are omitted from the last lines of the equation for structures.

Table A

Projections of GNP and Net Stocks of Privately Owned Capital in the Business Sector, 1974-1985

(Present law)

	Business Sector GNP	Stocks of Equipment	Stocks of Structures
	(billions of 1974 dollars)		
1974	1,177.9	434.5	499.6
5	1,163.8	443.9	515.4
6	1,238.1	467.1	534.5
7	1,317.3	491.6	554.4
8	1,367.4	512.2	574.9
9	1,419.4	533.7	596.2
80	1,473.3	556.2	617.7
1	1,529.3	579.5	639.9
2	1,587.4	603.9	663.0
3	1,647.7	629.2	686.9
4	1,710.3	655.6	711.6
5	1,775.3	683.1	737.2

Addendum to Statement of Roland M. Bixler

In response to an NAM request for data concerning the use of the Asset Depreciation Range (ADR) by corporate taxpayers, the Treasury's Office of Industrial Economics has supplied the results of a 1973 survey on this topic. The tables supplied by OIE indicate that ADR was not a very widely used system in 1973, the third taxable year in which it was available.

Although ADR was applied to approximately 60% of new investments in sec. 1245 property, only 1.5% of corporate firms elected to use ADR. Approximately 34% of the non-electing firms noted that ADR did not materially shorten existing depreciation periods and almost 22% stated that ADR was too complicated to understand or too burdensome in its accounting and reporting rules.

These results indicate that, while ADR has been of benefit to many companies, it has not uniformly simplified and increased the speed of capital cost recovery. As long as the depreciation concept of "useful life" remains the basic philosophy of cost recovery, these problems probably will continue.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

September 22, 1975

Mr. Cliff Massa III
National Association of Manufacturers
1776 F Street, N. W.
Washington, D. C. 20006

Dear Mr. Massa:

This is in response to your letter of August 28th in which you request certain data on the use of ADR by corporations.

Attached are data from a survey conducted in 1973. In general, the ADR election rate is very high for large corporations and very small among smaller corporations (See Table I). The percentage of investment covered by ADR election is about 60% for all corporations (83% for the 360 largest corporations) see Table II. Table III indicates the reasons given for nonelection of ADR. The two major reasons being : (1) the lack of significant asset acquisitions and (2) depreciation periods under ADR are not materially more advantageous than presently used periods.

We regret that data in the same detail is not available at present for manufacturing corporations only and hope that the attached will be sufficient for your needs.

Sincerely,

Philip Brown

Philip Brown

Table I

Number of Firms in Population, Number of Firms Electing ADR and Percentage Electing ADR by Size of Total Assets.

Size of Total Assets	Total Number of Firms in Population	Firms Electing ADR	
		Number	Percent
< 500T	979,534	8851	0.9
500T - 1M	71,837	1486	2.1
1M - 5M	69,739	2831	4.1
5M - 10M	10,954	772	7.1
10M - 50M	13,159	992	7.6
50M - 100M	1,965	308	16.1
100M - 200M	1,104	252	22.9
200M - 300M	446	154	34.5
300M - 600M	473	192	40.6
600M - 1B	295	99	33.6
> 1B	360	226	63.1
Total	1,149,866	16155	1.5

Table II

Percent of 1971 Investment in Section 1245 Property and Method of Depreciation by Size of Total Assets.

Size of Total Assets	1971 Total Investment (Section 1245 Property) (%)	Method of Depreciation	
		ADR (%)	Facts and Circumstances (%)
< 500T	0	0	0
500T - 1M	.3	0.9	99.1
1M - 5M	10.6	25.7	74.3
5M - 10M	3.7	3.8	96.2
10M - 50M	10.7	8.0	92.0
50M - 100M	2.3	18.8	81.3
100M - 200M	1.9	23.1	76.9
200M - 300M	1.4	30.0	70.0
300M - 600M	2.7	36.8	63.2
600M - 1B	2.7	42.1	57.9
> 1B	63.9	82.5	17.5
Total	100.0	59.7	40.3

Table III

Number and Percent of All Corporations Not Electing ADR by Size of Total Assets and by Primary Reason for Non-election

Reasons for Non-Election	All Corporations Not Electing ADR		Corporations with Assets Under $250T		Corporations with Assets Over $250T	
	No.	%	No.	%	No.	%
All Reasons:	1,087,993	100	812,075	100	275,918	100
No significant asset acquisition	418,351	38.5	334,438	41.2	83,913	30.4
Present depreciation periods not materially longer than those available under ADR	369,202	33.9	265,176	32.7	104,026	37.7
Accounting and reporting under ADR burdensome	146,206	13.4	94,745	11.7	51,461	18.7
Does not understand ADR rules	92,052	8.5	76,602	9.4	15,449	5.6
Presently have net operating loss	20,978	1.9	13,633	1.7	7,346	2.7
Other reasons	21,541	2.0	14,978	1.8	6,564	2.4
No reasons given	19,663	1.8	12,504	1.5	7,159	2.6

62-209 O - 76 - 9

Mr. BIXLER. Mr. Chairman, my name is Roland Bixler. I am president and cofounder of J.B.T. Instruments, Inc., an independent, closely held manufacturer of electronics, located at New Haven, Conn. Our company provides employment for about 225 people and we have been in business 35 years. And by reinvesting our earnings, we have survived war and peace and good times.

As a small businessman in a manufacturing industry who has been involved in six or seven other businesses, I am pleased to represent the National Association of Manufacturers. As you indicated, I am the chairman of its task force on small business tax policy.

It is interesting to note that the NAM is a broad-based trade association, which has approximately 13,000 member companies. Most people do not seem to realize that 85 percent of all those members are small businesses, that is, they have 500 or fewer employees.

Now, I am here to testify on a particular matter of cost recovery, but I would just like to summarize on page 2 a few of the things which our task force on small business policy feels ought to be done to assist our economy to give small business a strong place.

The first thing is a permanent increase in the corporate surtax exemption to $100,000 or more. It has been raised this year, temporarily, to $50,000 in the Tax Reduction Act of 1975. That should be made permanent, because that hasn't been changed for many years.

The second thing is a reduction in the corporate tax rate—both normal tax and surtax—but without creating additional graduation. In fact, we feel the three-tier rate structure created by the 1975 act should be returned to two tiers, a system we have had heretofore.

Three, a permanent and stable investment tax credit of at least 10 percent. The reason for this is that when you have this yo-yo effect, we don't know where it is coming or not and we can't really make plans and decide whether to make the capital investment.

The fourth is the continuation of DISC, which provides significant cash flow to help U.S. firms to overcome the array of tariffs and subsidies and the other artificial devices used by foreign countries to protect local industry. An increasing number of small- and medium-sized firms are developing export only because of DISC. At the very time Congress is talking about eliminating DISC, we are just learning how to use it, and Congress is talking about its abolition.

Finally, a basic reform of our capital recovery policy, which I shall discuss shortly.

I did have the privilege of appearing before this committee on June 19, and at that time one of the things I talked about was the tax impact project report from the National Association of Manufacturers, known as TIPR, which has been given to each member of the committee. This was undertaken on a what-if basis, to say if certain legislation were adopted, either if things were added or if things were taken away that now exist, what would be the affect on a particular business. So there is a broad cross-section of businesses that responded. Their responses were put into an econometric model of data resources and the answers that they gave are here. The important thing is that it tells not just what would have happened in a given year, but it projects over a 5-year period and says that when tax changes are made, business reacts. Therefore, that is a different answer than if you simply take revenue estimates the first time. Now, that is already a part of the record.

The particular one that I would like to talk about is capital recovery allowances. An excellent approach to that would be H.R. 7543,

entitled "The Capital Recovery Act of 1975." For many, many years we have had the depreciation system in the tax code of this country and it has these problems, namely, it is related to the useful life of a new piece of equipment or a new plant that we acquire. It is a theoretical figure as to how many years that that would have life until it falls to zero.

But, one of the first problems with it is that it doesn't work in the real world of inflation and technological change. I happen to be the head of a technologically-based company, and some things get obsolete pretty fast, before we can really charge them off. In other cases, we are looking at a new piece of capital equipment and it is going to cost us 3½ times what that piece of equipment cost us only 8 or 9 years ago. This makes a whale of a lot of difference in our total cost. We should have recovered that cost much before now.

The second real problem—I mean it may be argued we have accelerated methods for calculating depreciation and we have the ADR that Dr. Ture mentioned, that is, the asset depreciation range, but many of these things have this real problem that they are so complex. Lots of small businesses and their accountants just throw up their hands and say that we can't use it. I am sure this happens also in larger businesses that have decentralized locations where you have to keep this kind of record for each one. So the result is that a good part of what was in the code isn't really given there.

The next thing is that IRS has the privilege, the responsibility perhaps, of issuing regulations and those regulations tend to take away some of these ADR benefits. For example, in 1974, they issued a new class for steam and electric generation and distribution property, and it meant that things that had been depreciated at one rate would suddenly have to be pulled out and be depreciated at a far slower rate. This was essentially done by administrative fiat. So I mention the complexity of the system. The asset depreciation range has 130 classes of assets. No one business, or very few, at least, small businesses, have 130 classes, but this is indicative of the problem that goes on.

Now what is really the answer to this thing? I believe that the legislation I mentioned is a simple and efficient capital recovery allowance system. This would take us away from the fascination of "useful life" and attempts to substitute the concept of recovering invested capital as rapidly and as efficiently as possible, so that we can reinvest it in our businesses, because the biggest single source of capital for small businesses is reinvestment of its earnings.

Now, I am proposing this system, this particular legislation. I call this the 5 and 10 system. This is the easiest way I can remember it. It would allow machinery and equipment to be written off in 5 years, and buildings and structures to be written off in 10 years. The investment credit would still apply. The full cost of the property would be recovered because salvage value does not enter into it. That is another one that causes a great deal of complication and paperwork and negotiation with IRS on the part of small businesses.

The taxpayer could take all or none of the maximum depreciation for any given year, and he could carry forward the unused maximum deductions in the succeeding taxable years, but the taxpayer would have the choice of when to recover that capital cost. This would be applicable to costs as they are incurred or paid, rather than when the eligible property is placed into service. Every once in a while, that is a real problem. You make a commitment and you spend the money,

but for some reason the equipment has a bug in it and you can't really put it into use right away. The rule is you can't start any of the present depreciation systems unless it is fully in use.

H.R. 7543 then sets up a new class of property known as section 189, with all those things in it.

Now, what would be the real impact of this? I am awfully glad to be sitting beside Dr. Ture. He was asked to make a detailed economic analysis of what that would be. The whole last part of my lengthy statement, a proposed capital recovery allowance system, is his calculation, his summation of his calculation. Frankly, I hope you are more up to date on modern mathematics than I am, because there is very heavy math in there, but let me just read the last lines here, because, as a general rule, the last lines are the ones that really, I find, are very important.

He estimates that if this new system had been in effect for the year of 1975, capital outlays in this country would have been $15½ billion beyond what otherwise would have been expected.

Senator NELSON. $15½ billion?

Mr. BIXLER. $15½ billion. Actually, they are going down in 1975 instead of any such trend as that. He estimates for the decade 1975 to 1985, capital outlays will increase $169 billion above what is expected under the present system. Now, with employment—and this is a matter that has concerned other witnesses this morning and is extremely important—employment in capital goods and construction industries alone would have increased an estimated 180,000 jobs the first year and after 3 years this might well have been 290,000 new jobs.

The Federal revenue impact, and this, of course, is a crunch, because by the conventional methods we are going to say this is a terribly expensive kind of proposition, but he goes on with some very worthwhile analysis that shows that we would have had a Federal revenue net gain for calendar 1975 of $6.4 billion more than could have been expected if we had not had that. Again, if you can't make all that capital investment, you can't have all those extra jobs and can't have that economic activity without producing more tax revenue.

He further points out that the Federal revenues would have increased more than $79 billion in constant 1974 dollars, and not some inflated figure, as the result of increased economic activity during the decade of 1975 to 1985. So, the important point is that this looks at the reaction in the system when a change is made, rather than simply saying—and the traditional approach would be to say "well, if you put in the 5 and 10 kind of system, there would be a loss in constant 1974 dollars of about $14.8 billion this year. It would have gone up as high as $34.5 billion in 1979. So, what I am really talking about is not an immediate kind of thing that is going to help us this afternoon, but certainly it is in the best interest of the country.

Now, I have just a very little summation yet, as to what happens in other countries. Canada is now allowing a 2-year writeoff.

Senator PACKWOOD. Two years?

Mr. BIXLER. Two years for machinery and equipment. The Liberal government there has decided to make this a permanent feature of the tax system, and the first feedback they are getting is that it is working. The United Kingdom allows 100 percent writeoff on the machinery in the first year.

Senator PACKWOOD. Just take it like any normal expenditure, in other words?

Mr. BIXLER. Exactly. The table at the top of page 11 of my testimony was prepared by Dr. Pierre Rinfret and presented before the Ways and Means Committee of the House in 1973. It assumes that a $10 million investment was made under exactly the same circumstances in six industrialized foreign nations and in the United States. This assumes all conditions are equal. So, if you look at the top of page 11 there, we will see that in the first year in the United Kingdom you have gotten back $9,408,000 out of the $10 million. In West Germany it would have been $8.8 million. In Japan, it would have been $5.5 million. In Canada, it would have been a little over $5 million. In France, it would have been a little over $5 million. In Italy, it would have been $2.2 million, and with all the methods we have in the United States now, like accelerated depreciation and the like, the most you would have had here would have been $2 million is all we would have charged off in that same period of time.

Senator PACKWOOD. How long has Britain had this 100 percent writeoff?

Mr. TURE. About 3 or 4 years.

Senator PACKWOOD. And still, they have an obsolete industry.

Mr. TURE. Well, they have an awful lot of other problems.

Senator PACKWOOD. I realize they have other problems, but has the law resulted in an immense modernization of British industry over the last several years?

Mr. TURE. It has in certain areas. My understanding is that the 100 percent writeoff is not eligible for all plant equipment. It is just for certain types of industrial equipment.

Mr. BIXLER. That is right.

Mr. TURE. And relative to what you would expect under the very troubled circumstances of that economy, there has been quite a substantial effect.

Senator PACKWOOD. Is the Canadian 2-year one applicable to all business investments or are there certain exceptions?

Mr. BIXLER. I guess there are a few exceptions in everything, but it is as to the bulk.

Mr. Chairman, just to conclude, this table also shows what would happen on the 5th year. And in the United States, at the end of 5 years, we could only have charged off $5.9 million of the $10 million, but under the proposed capital cost recover system, it would have come up to at least $8.9 million. So we think that the present depreciation concept is quite unsatisfactory. We think it really sanctions the erosion of the capital base. We think it is tremendously complex and liberalized modifications are not universally useful and they are subject to administrative changes. We think it is out of step with modern cost recovery policies elsewhere in the world. It inhibits more efficient use of existing supplies of capital.

Whereas, we are proposing a simple system that focuses on recovery of the real capital cost instead of "useful life."

So, I would like, in summary, to encourage the study of H.R. 7543, which is a codification and at least is a good starting point for this kind of a system.

Senator NELSON. Thank you very much for your statement. Our next witness is David Barnes, CPA, Coopers and Lybrand, chairman, Tax and Government Regulation Committee, Council of Smaller Enterprises, Cleveland, Ohio.

Mr. BARNES. Thank you, Mr. Chairman.

[The prepared statement of Mr. Barnes in full follows:]

COUNCIL OF SMALLER ENTERPRISES
690 Union Commerce Building • Cleveland, Ohio 44115 • 216/621-3300

STATEMENT OF

Council Of Smaller Enterprises
Government Taxation and Regulation Committee
David L. Barnes, C.P.A.
Coopers & Lybrand
1070 Union Commerce Building
Cleveland, Ohio 44115
and
Committee Chairman

A council of the GREATER CLEVELAND GROWTH ASSOCIATION

PRESENT TAX DEPRECIATION RULES ARE YESTERDAY'S ANSWER TO TODAY'S PROBLEM

INTRODUCTION:

Present tax depreciation rules and regulations need to be overhauled and replaced with progressive programs that meet the needs of today's changing business environment. The new programs should provide small business concerns the flexibility to internally generate capital by employing a liberal, non-cumbersome, rapid depreciation write-off method which will maximize depreciation charges in times when funds are needed for expansion.

The only chance of attaining effective reform of present rules and regulations is for Congress to make an objective analysis of present depreciation practices, reflect upon the analysis and answer these questions:

1. Do present depreciation regulations enable businessmen to recover their capital equipment investments quick enough to offset effects of inflation?

2. Do present regulations need to be as complicated as they are?

We believe the answer to both of these questions is "no".

To support our position, the opening section will discuss some of the broad economic problems faced by businessmen when trying to make capital investment decisions. The second section of this report will explain present tax depreciation accounting practices in order to point out some of the basic complexities. This will be followed by Section 3, a presentation of why liberalized depreciation rules are necessary to help business concerns generate needed replacement funds. This section will also discuss the severe inflation which has ravaged the machine tool industry. Sections 4 and 5 will discuss the concepts of timing differences and return on invested capital as to their affect on tax revenues.

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Introduction (continued....)

Section 6 will present a broad explanation of depreciation policies in other industrialized nations. Finally, Section 7 will present our alternative tax reform recommendations, 50% ADR and Capital Cost Recovery depreciation.

SECTION 1. Why Depreciation Rules Need To Be Reformed

A very strong argument supporting the need for a liberalized depreciation or capital cost recovery program is the positive effect such a program would have upon the never ending battle to hold inflation in check. We believe that a liberalized capital cost recovery program will provide the business community with the funds needed to reinvest in new plant and equipment. Capital equipment investment programs are an effective means of improving productivity. Unless productivity can out-pace wage demands, it is impossible to keep inflation in line. This was dramatically illustrated in 1973 and 1974 when the consumer price index was rising at an annual growth percentage of 6% and 11% respectively. A great deal of the price inflation that occurred during these two years was the result of inventory stockpiling brought on by speculation concerning future price increases and demand for goods and services. However, in the opinion of many economists, if speculative demand for goods and services were factored out to produce normal demand, there would still be substantial productivity shortages. Thus, with wage increases already out-pacing productivity gains, the only effective solution to demand fueled inflation is a massive investment in new plant and equipment.

The severity of the present shortage of productive capacity was highlighted in the March, 1975 International Economic Report of the President. The report notes that the average age of capital investment is older in the United States than in other industrialized nations, most of whom replaced their equipment after World War II. The report estimates that 30% to 40% of U. S. productive capital was in existence before 1960 compared to 15% to 25% in these other industrialized nations. This results in a greater portion of capital investment dollars being invested in replacement assets rather than assets which will expand productivity. This situation puts us at a serious disadvantage when competing in the international trade markets,

continued....

Section 1. (continued....)

the success of which depends upon the price and quality of manufactured products. Thus, our goods are less attractive in overseas markets.

It will not be easy to solve the problem of inadequate productive capacity. There are two shadows which darken the prospects for resolution. One being a shortage of investment capital and the second being the pessimism with which businessmen view the future.

Between Government deficit spending and the OPEC oil cartel, available investment capital has all but disappeared. The outlook for improvement is dim. This year, the Federal Government will be entering the money markets (in competition with private enterprise)to drain off $80 to $90 billion dollars to finance the forecasted deficit. The OPEC countries are holding billions of dollars which, because of international politics, may or may not be recycled back to the United States. Capital availability problems are compounded further when you consider the huge investment which will be required to obtain energy self-sufficiency and to comply with environmental and health and safety requirements.

The second problem is business confidence. The business sector has watched their inflation adjusted profits decline 58% since 1965 (Testimony from Treasury Secretary Simon). At the same time, there is more and more talk of increased Government regulation and even talk of industry nationalization. Businessmen are fearful of additional taxation which seems inevitable as 1) unemployment funds are depleted, 2) the cities and states face growing financial difficulties, and, 3) Social Security expenditures run well beyond present funding levels.

David Rowe in the University of Pennsylvania's Wharton Forecast states that business confidence has taken such a beating that businesses are wary about investing in new plant and equipment. This is supported by reports recently released by the Commerce Department. These reports state that business concerns are scaling

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Section 1. (continued....)

back their capital spending plans for 1975. Businessmen plan to spend $114.24 billion on plant and equipment in 1975, only 1.6% above the 112.4 billion spent in 1974. This is down from a 4.6% increase forecasted in January, 1975 which was cut back to 3.3% in March, 1975. The Conference Board research organization reported that the nation's 1,000 largest manufacturers decided in the first quarter of 1975 to reduce this year's capital expenditures by $1 billion.

Thus, we can see that the uncertain outlook of business conditions and the lack of investment funds are severely impeding the cure of one of our major economic ills; namely, a shortage of adequate productive capacity. It is not within the scope of this report to resolve all of the problems just discussed. However, we believe that a liberal capital cost recovery program will be one step in the right direction towards encouraging industry to modernize and expand productive facilities as a means of resolving some of the economic problems faced by our country.

SECTION 2. Today's Rules Are Complicated, Achieving A Degree of Bookkeeping Perfection Which Is Not Needed

The tax laws permit the deduction of a reasonable allowance for the exhaustion, wear and tear of property used in business or held for the production of income. This is a relatively simple concept with the purpose of allowing the taxpayer the realization of a return on his capital investment. Unfortunately, the present tax law, in attempting to clarify a "reasonable allowance", has created a preponderance of rules and regulations which serve more to increase the burden of record keeping than to assure fair and reasonable deductions.

Let us briefly review some of the requirements of current tax regulations:

Depreciation Methods

There are three generally used methods of computing depreciation. The most common method is Straight-Line which assumes that depreciation is sustained at a uniform rate throughout the useful life of the property. Depreciation under this method is computed by deducting in equal annual amounts the cost of the property less its estimated salvage value over its useful life.

The other two generally used methods, Double Declining Balance and Sum of the Years-Digits, are termed "accelerated" since they provide for the greatest depreciation in the first year and subsequently smaller deductions each succeeding year. Double Declining Balance is computed by applying a rate of up to 200% of the straight line rate to the decreasing book value of the asset. Under Sum of the Years-Digits, changing fractions are applied each year to the original cost less salvage value.

The above-mentioned methods, however, may not be used for all depreciable property. The tax regulations have placed certain restrictions on the depreciation of used property, realty, and property with less than a three year life.

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Section 2. (continued....)

The substance of these restrictions are as follows:

1. Accelerated methods are applicable only to new property with a useful life of three years or more.
2. The Declining Balance method may be used for used property at a rate of not more than 150% of the straight-line rate.
3. Accelerated methods are not allowed for new real estate except that real estate bought or constructed after July 24, 1969 may be depreciated using the 150% Declining Balance method or any other consistent method which does not give greater allowances in the first two-thirds of useful life than the 150% Declining Balance method. However, in the case of new residential rental property where at least 80% of the gross rentals come from dwelling units, the tax laws permit the use of 200% Declining Balance and Sum of the Years-Digits methods.
4. No accelerated methods are allowable in the case of used realty bought after July 24, 1969 except that used residential rental property with a useful life of at least 20 years may be depreciated at 125% Declining Balance.

Salvage Value

Usually a business asset has very little market value remaining at the end of its useful life. Whether due to physical deterioration or technological obsolescence, the ending value of the property is often minimal. The tax laws state that in no event may an asset be depreciated below a reasonable salvage value under any method of computing depreciation. However, the laws do permit the taxpayer to disregard all or a portion of the salvage value by allowing a reduction in salvage value of up to 10% of the basis of property with a life of at least three years. The effect of these regulations is to require the taxpayer

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Section 2.
Salvage Value (continued....)

to estimate the value his newly acquired property will have up to twenty or thirty years in the future and to maintain detailed records of yearly depreciation charges to assure that he does not depreciate the minimal salvage value. The value of this restriction appears somewhat minimal itself since upon disposal of the property, whether at the end of its useful life or earlier, any difference between the undepreciated cost and its disposal value will be recognized as a taxable gain or loss. Whether the property has been depreciated down to salvage value or to no value has no effect on the total expense taken over the life of the property. The only difference exists in the timing of the expense and that effect is usually very slight.

Bonus Depreciation

In addition to the annual depreciation allowed under the methods previously described, the tax regulations permit an additional first year deduction of 20% of the cost of property having a useful life of at least six years. This "bonus" depreciation is limited to $2,000 in any year and the taxpayer is required to maintain records specifically indentifying the property eligible for additional first year depreciation and how and from whom the property was acquired.

Proration of Depreciation Allowance

In the event that depreciable property is not acquired between December 16th or January 15th of any given year, the tax regulations require the taxpayer to calculate by half months the percentage of a year's depreciation which may be claimed for each asset. In effect, this proration requires the taxpayer to split one year's depreciation deduction in increments of half months between the first and last years of the assets life. The amount involved (a portion of one year's

continued....

depreciation) does not seem to justify the record keeping burden imposed by this regulation.

Capitalization Minimum

At the present time, the Internal Revenue Service generally allows the current deduction of purchases under $500 rather than requiring the capitalization of these minimal expenditures. Although this in itself does eliminate substantial record keeping costs, additional savings could be achieved by increasing this limit to $2,000. Since these purchases generally have a life of only two to three years and are replaced at the end of their usefulness, the actual annual tax deduction generated by expensing in the year of purchase would closely approximate the annual deduction presently allowed from spreading the cost over a two or three year period where various items are replaced each year.

ADR

The Class Life Asset Depreciation Range System (ADR) was established in an attempt to reduce controversy between the taxpayer and the Internal Revenue Service by setting forth acceptable quidelines for the taxpayer's use in formulating his depreciation policies. Unfortunately, since the System was accompanied by complex requirements and regulations, many taxpayers have hesitated to take advantage of the liberalized depreciation rates inherent in ADR due to the rigors of record keeping compliance required by its use. A few of the basic principles of ADR are briefly described in the following paragraphs.

The Regulations have established a series of broad industry classes of assets each with a class life. The taxpayer is allowed to select, from a range extending 20% above and below the class life, a useful life over which to depreciate his property. He may use any depreciation method he desires within the

continued....

Section 2.
ADR (continued....)

restrictions on used and realty property previously described. The depreciation method may be applied to assets individually or to a group of assets with the same class life placed in a "vintage account" by the year placed in service. Separate vintage accounts must be maintained for new and used assets, assets subject to the elective 10% salvage reductions, and assets on which additional first-year depreciation has been elected. A separate depreciation reserve must also be maintained for each vintage account.

Under ADR, retirements are separated into two categories ordinary and extraordinary. All retirements are considered ordinary except for the retirement of certain types of property described in the Regulations. The retirement proceeds of ordinary retirements are simply added to the depreciation reserve of the vintage account from which the asset is retired thereby reducing the depreciable basis of the remaining assets in that account. Extraordinary retirements, however, are removed from the asset and depreciation reserve accounts and the gain or loss on disposal is recognized in the year of retirement.

Another requirement of ADR is the mandatory use of one of two first-year conventions:

1. The half-year convention - Regardless of when the asset is placed in service, a half-year's depreciation is taken in the first year. Similarly a half-year's depreciation is claimed on extraordinary retirements in the year retired.
2. The modified half-year convention - A full year's depreciation is taken on all assets placed in service during the first half of the year. Second half additions get no depreciation deductions in the first year. Extraordinary retirements receive a full year's depreciation, a half-years depreciation, or none, depending on the half of the year in which the property was acquired and retired.

continued....

Section 2.
ADR (continued....)

In an effort to minimize controversy over the repair versus capital expenditure question, ADR established a "percentage repair allowance" rule. Basically the rule permits the mechanical computation of a dollar allowance which the taxpayer may use as the maximum deduction for questionable "repair" expenditures. The deductibility of expenditures under this limit which are clearly not capital items will not be contested by the IRS. Any repair expenditures which exceed the repair allowances must be capitalized as property improvements. The percentage repair allowance rule election must be made each year and can be elected for certain classes and not for others. In reality establishment of the percentage repair allowance rule accomplished very little. The IRS and the taxpayer must still come to agreement over whether an item "clearly" is or is not a capital asset.

The tax requirements that we have touched upon in this section are but a small part of the rules and regulations that businessmen must comply with under present depreciation accounting. The impact of these voluminous requirements are felt most heavily by small businesses in the area of record keeping. A typical small manufacturing company might maintain 400 individual asset cards. Each card will contain information as to the date of purchase, description of asset, depreciation method, useful life, salvage value and the amount of additional first year depreciation elected if any. In order to determine depreciation for the year, the businessmen must compute depreciation for each card taking into consideration the part year conventions, salvage value, additional first year depreciation already taken, method of depreciation involved, and total depreciation taken to date. Depreciation calculated in this manner of each asset is then summarized to arrive at the total depreciation expense for the year.

continued....

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Section 2.

ADR (continued....)

This procedure repeated in company after company each year imposes an unnecessary burden upon small business. In the following sections we will outline several proposals which will effectively reduce record keeping costs without adversely effecting tax revenues.

SECTION 3. Depreciation Can Be An Effective Vehicle For Generating Funds Needed To Replace Plant And Equipment If Proper Recognition Is Given To Inflation

Accounting theory states that capital assets employed by a business concern should be systematically depreciated by charging a percentage of cost (based on asset useful life) against annual operating income in order to set aside a portion of each year's profit for future asset replacement.

In 1954, the Joint Committee on Internal Revenue Taxation (for the House Ways and Means Committee) stated it would be appropriate to expand on this concept by permitting depreciation methods which would set aside funds at a more rapid pace to compensate for the inflationary trend in the cost of replacement assets. At that time inflation was running between 1% and 3% a year. Possibly because of this relatively low rate of inflation, initially proposed liberal depreciation rules never found their way into final legislation.

Today, the impact of inflation is much more severe. To illustrate the dramatic impact of inflation on the cost of replacement machinery and equipment, a comparison of wholesale prices for various categories of machinery and equipment may be informative. Application of the Bureau of Labor Statistics Wholesale Price Indices to selected categories of machinery and equipment, each of which was purchased for $10,000 in 1967, would result in the following replacement costs at the respective dates:

continued....

Section 3. (continued....)

Machinery and Equipment Representative Wholesale Replacement Prices

	All * Categories	Agricultural	Construction	Metal Working	General Purpose
1969 (average)	10,640	10,850	11,000	10,780	10,690
1971 (average)	11,550	11,720	12,140	11,730	11,910
1973 (average)	12,170	12,590	13,070	12,550	12,700
1974 (average)	13,940	14,380	15,230	14,690	15,120
November, 1974	15,270	15,970	16,970	16,190	16,890
April, 1975	15,970	16,670	18,380	16,960	17,610

(* Categories excluded from illustration are miscellaneous, electrical and vehicular equipment; the average 1974 replacement prices are $13,950, 12,500 and 12, 920, respectively).

The impact is even more dramatic if you compare replacement costs of individual items. The estimated Asset Depreciation Range (ADR) useful life of metalworking machinery and equipment is 12 years. Thus, it is possible that a machine purchased the first year of January, 1963 may require replacement by the end of December, 1974. If the machine cost $10,000 at the date of purchase, the replacement cost at the end of 1974 would be approximately $17,500. Under ADR rules, this asset could be depreciated in 9.5 years. If the company is successful in financing the growth of its business with retained earnings, it must rely on depreciation to provide funds for the replacement of old assets. Tables 1 and 2 calculate annual funds which are generated by employing the most advantageous ADR depreciation method and also calculates the compound growth of funds generated by depreciation if they were invested in certificates of deposit.

continued....

Section 3. (continued....)

TABLE 1

ANNUAL DEPRECIATION OF A METALWORKING MACHINE COSTING $10,000 WHEN PURCHASED JANUARY 1, 1963

Double Declining Balance Depreciation

Year (1)	Expense (2)	Reserve (3)	Net Book Value (4)
1963	2,105	2,105	7,895
1964	1,662	3,767	6,233
1965	1,312	5,079	4,921
1966	1,035	6,114	3,886
1967	813	6,932	3,068
1968 (5)	682	7,614	2,386
1969	682	8,296	1,704
1970	682	8,978	1,022
1971	682	9,660	340
1972 (June 30)	340	10,000	0

(1) ADR Asset Guideline Class 35.1 - Lower limit depreciable life, 9½ years.

(2) 21.05% times cost in year 1 and net book value thereafter.

(3) Prior year reserve balance plus current year expense.

(4) Original cost less annual reserve balance.

(5) Switch to Straight-Line depreciation method.

TABLE 2

CASH ACCUMULATED BY INVESTING FUNDS GENERATED FROM ANNUAL DEPRECIATION CHARGES IN CERTIFICATES OF DEPOSIT

continued....

CASH ACCUMULATED BY INVESTING FUNDS GENERATED FROM ANNUAL DEPRECIATION CHARGES IN CERTIFICATES OF DEPOSIT

Year (1)	Certificate of Deposit Interest Rate % (2)	Depreciation Funds (3)	Funds Subject to Interest (4)	Annual Interest Earned (5)	Cash Balance (6)
1963	4.00	2,105	1,053	42	2,147
1964	4.50	1,662	2,978	134	3,943
1965	5.50	1,312	4,599	253	5,508
1966	5.50	1,035	6,026	331	6,874
1967	5.00	818	7,283	364	8,056
1968	5.00	682	8,397	420	9,158
1969	5.00	682	9,499	475	10,315
1970	5.75	682	10,656	613	11,610
1971	5.75	682	11,951	687	12,979
1972	5.75	340	13,319	766	13,745
1973	5.88	-	13,745	808	14,553
1974	6.00	-	14,553	873	15,426

(1) ADR estimated useful life of assets defined in guideline class 35.1.

(2) Statistical Abstract of the United States 1974 - Federal Reserve Bulletin - Maximum Interest Rates Payable on Time and Savings Deposits: 1962 to 1974.

(3) Table - Column (2)

(4) One-half current year depreciation (average time on deposit) plus prior year cash balance.

(5) Column (4) multiplied by column (2)

(6) Column (3) plus column (5) plus prior year column (6)

Tables 1 and 2 illustrate that even with the most ideal financial planning (i.e., funding annual depreciation charges) the company in our illustration would be $2,074[1] short of the necessary funds needed to replace the metal-working machine purchased in 1963. In practice, very few companies are able to

continued....

Section 3. (continued....)

accumulate cash by funding depreciation. Fewer, if any, fund cash to meet asset replacement costs. This is true because, generally speaking, capital cost recovery (depreciation) and profit reinvestment do not provide enough funds to meet growing working capital and plant financing needs of companies experiencing even the most modest rates of growth.

[1] Replacement cost, $17,500 less 1974 cash balance, Table 2 column (6) of $15,426

continued....

Section 3. (continued....)

The following tables 3 and 4 present the magnitude of corporate financing problems:

TABLE 3

COMPARISON OF BUSINESS EXPENDITURES FOR NEW PLANT AND EQUIPMENT TO FUNDS PROVIDED FROM UNDISTRIBUTED PROFITS AND DEPRECIATION OF PLANT AND EQUIPMENT (1)

(in billions of dollars)

Year	Plant and Equipment Expenditures	Undistributed Profits and Depreciation	Required Funds Unavailable from Operations
1950	20.2	17.9	2.3
1955	29.5	29.2	.3
1960	36.8	34.4	2.4
1965	54.4	56.6	2.2
1969	75.6	60.7	14.9
1970	79.7	59.4	20.3
1971	81.2	69.9	11.3
1972	88.4	77.5	10.9
1973	99.7	81.8	17.9
1974	112.7	70.1	42.6

(1) U. S. Bureau of Economic Analysis, Survey of Current Business.

TABLE 4

INCREASED INVESTMENT IN WORKING CAPITAL (1)

(in billions of dollars)

continued....

INCREASED INVESTMENT IN WORKING CAPITAL (1)

(in billions of dollars)

Year	Net Working Capital	Increase from Prior Year
1969	185.7	
1970	187.4	1.7
1971	204.8	17.4
1972	224.3	19.5
1973	245.3	21.0

(1) U. S. Securities and Exchange Commission, Statistical Series, Net Working Capital of Nonfinancial U. S. Corporations.

Tables 3 and 4 clearly illustrate the impossibility of financing business growth with depreciation and profits. Of even more concern is the trend of excess investment needs over available funds.
Table 4 shows an increasingly negative trend.

At this point, we should review the manner in which period to period depreciation charges affect tax revenues.

SECTION 4. Timing Differences - How They Affect Tax Revenues

It is not unusual to view tax reform as being synonomous with tax avoidance. Quite often, this is not so. A specific case in point is the liberalization of time periods a company may employ to depreciate their plant and equipment. A new law that will accelerate present depreciation time periods merely defers to another period revenue that would be otherwise taxable. To understand this concept, the following illustration, presented on Table 5 , will isolate the operating results of three hypothetical companies (A, B and C) by computing tax revenues for a five-year period on a straight-line basis and then, on an accelerated basis which would allow the companies to write-off assets in 2 1/2 years. Each company has an undepreciated investment of $200,000 at the beginning of year 1 and makes no additional capital expenditures during the five-year period. The earnings of Company A are level. Company B's earnings are accelerating while Company C is in a declining earnings pattern.

Table 5 shows that under each set of operating conditions (level, growing, declining), total tax collections will be equal at the end of the useful lives of plant and equipment. Thus, liberal depreciation rules will not result in tax avoidance, but will only affect the timing of tax collections.

continued.....

TABLE 5
FIVE-YEAR COMPUTATION OF INCOME TAX USING
STRAIGHT-LINE AND ACCELERATED DEPRECIATION METHODS
(amounts in dollars)

	Company A					Company B					Company C				
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	Year 4	Year 5
Income before charges for depreciation	100,000	100,000	100,000	100,000	100,000	100,000	110,000	120,000	130,000	140,000	100,000	90,000	80,000	70,000	60,000
Depreciation expense:															
Straight-line basis	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Accelerated basis	80,000	80,000	40,000	-	-	80,000	80,000	40,000	-	-	80,000	80,000	40,000	-	-
Taxable income:															
Straight-line basis	60,000	60,000	60,000	60,000	60,000	60,000	70,000	80,000	90,000	100,000	60,000	50,000	40,000	30,000	20,000
Accelerated basis	20,000	20,000	60,000	100,000	100,000	20,000	30,000	80,000	130,000	140,000	20,000	10,000	40,000	70,000	60,000
Income tax (at a 50% tax rate):															
Straight-line basis	30,000	30,000	30,000	30,000	30,000	30,000	35,000	40,000	45,000	50,000	30,000	25,000	20,000	15,000	10,000
Accelerated basis	10,000	10,000	30,000	50,000	50,000	10,000	15,000	40,000	65,000	70,000	10,000	5,000	20,000	35,000	30,000
Accumulated tax revenue at the end of each year:															
Straight-line basis	30,000	60,000	90,000	120,000	150,000	30,000	65,000	105,000	150,000	200,000	30,000	55,000	75,000	90,000	100,000
Accelerated basis	10,000	20,000	50,000	100,000	150,000	10,000	25,000	65,000	130,000	200,000	10,000	15,000	35,000	70,000	100,000

Section 4. (continued.....)

Table 5, effectively demonstrates that over a period of years, the Treasury will realize the same total revenue regardless of the depreciation methods employed by taxpayers. However, on a short-term year-to-year basis, liberalized depreciation methods will have a negative impact on tax revenues in early years and a favorable impact in later years. Summarizing information presented in Table 5, Table 6 presents the tax revenue impact of accelerated depreciation over straight-line depreciation as follows:

TABLE 6

INCOME TAX REVENUES GENERATED BY ACCELERATED DEPRECIATION OVER (UNDER) REVENUE RESULTING FROM STRAIGHT-LINE DEPRECIATION COMPANIES A, B AND C COMBINED

Year	Amount
1	(60,000)
2	(60,000)
3	-
4	60,000
5	60,000

Thus, the Treasury will face some intitially lean years if depreciation rules are liberalized. Table 6, however, does not present a realistic picture of what will happen to tax revenues if depreciation rules are liberalized. The depreciation regulation changes we will be proposing in a later section tie resulting tax benefits to a program of reinvestment in plant and equipment or the purchase of government obligations. At this point, a review is necessary to determine what tax implications result from a program where tax benefits are reinvested in capital equipment. Before this can be successfully accomplished, a brief explanation of the "Return On Invested Capital (ROIC)" concept may be appropriate in explaining the total effect tax incentives have on tax revenues.

continued....

SECTION 5. How The "Return On Invested Captial"Concept Will Affect Future Tax Revenues

In some respects, capital investment decisions are akin to gambling. A businessman, pushed by a growing demand for goods and services or striving to improve productivity, is willing to gamble that a cash investment in capital equipment will be rewarded by the return of cash invested plus an attractive profit. If the businessman cannot invest in a capital equipment project that will return his capital and a relatively high profit return, theoretically, he will reject the project and invest his excess funds in safe institutional time deposits or other sound investment instruments. In practice, capital investment decisions produce results which range from highly successful to dismal failures. Table 7 presents a score card of the results of business capital investment decisions. The Table presents percentage profit returns which were computed by dividing net income reported on annual corporate income tax returns by the value of shareholders' equity:

TABLE 7

PROFIT TO SHAREHOLDERS' EQUITY

Year	% Return
1965	13.0
1966	13.4
1967	11.7
1968	12.1
1969	11.5
1970	9.3
1971	9.7
1972	10.6
1973	12.8
Average	11.5

continued....

Section 5. (continued.....)

Thus, Table _7_ shows that over the years in question, the averaging of investment successes and failures results in an average capital return of 11.5%

At this point, we can bring all the ROIC factors together in a hypothetical operating situation to determine what impact investment returns have on tax revenues. To accomplish this we will utilize the five-year operating results of Company B presented in Table _5_ and will add three additional operating years which report mature or flat earnings growth. First tabulation (Situation 1.) presents the five-year results of operations employing the straight-line depreciation method. The second tabulation (Situation 2.) will present the same set of operating facts except that accelerated depreciation (a program we call 50% ADR, which will be explained later) will be substituted for straight-line depreciation and the excess of accelerated over straight-line depreciation will be reinvested in capital equipment to generate an 11.5% investment return. The following Tables _8_ and _9_ provide computations of depreciation and reinvestment earnings under Situations 1 and 2.

continued....

TABLE 8

INCOME TAX IMPACT OF LIBERALIZING DEPRECIATION RULES
GIVING CONSIDERATION TO THE CONCEPT OF RETURN ON INVESTED CAPITAL

	Company B (Growth Period)						Company B (Maturity Period)			
	Year 1	Year 2	Year 3	Year 4	Year 5	Total	Year 6	Year 7	Year 8	Grand Total
Situation 1.										
Income before charges for depreciation	$100,000	$110,000	$120,000	$130,000	$140,000	$600,000	$140,000	$140,000	$140,000	$1,020,000
Depreciation expense (straight-line)	40,000	48,000	57,600	61,120	61,120	267,840	21,120	13,120	3,520	305,600
Taxable income	60,000	62,000	62,400	68,880	78,880	332,160	118,880	126,880	136,480	714,400
Income tax (at 50%)	$ 30,000	$ 31,000	$ 31,200	$ 34,440	$ 39,440	$166,080	$ 59,440	$ 63,440	$ 68,240	$ 357,200
Situation 2.										
Income before charges for depreciation	$100,000	$110,000	$120,000	$130,000	$140,000	$600,000	$140,000	$140,000	$140,000	$1,020,000
Income from reinvesting the excess of accelerated over straight-line depreciation in capital equipment (11.5% investment return) Table ___ annexed		4,600	10,120	12,144	12,144	39,008	12,144	12,144	12,144	75,440
	100,000	114,600	130,120	142,144	152,144	639,008	152,144	152,144	152,144	1,095,440
Accelerated depreciation expense:										
Original capital squipment	80,000	80,000	40,000			200,000				200,000
Reinvestment capital equipment		16,000	35,200	34,240	16,640	102,080	3,520			105,600
	80,000	96,000	75,200	34,240	16,640	302,080	3,520			305,600
Taxable income	20,000	18,600	54,920	107,904	135,504	336,928	148,624	152,144	152,144	789,840
Income tax (at 50%)	$ 10,000	$ 9,300	$ 27,460	$ 53,952	$ 67,752	$168,464	$ 74,312	$ 76,072	$ 76,072	$ 394,920
Situation 2. income tax over (under) Situation 1. income tax	$(20,000)	$(21,700)	$ (3,740)	$ 19,512	$ 28,312	$ 2,384	$ 14,872	$ 12,632	$ 7,832	$ 37,720

TABLE 9

COMPUTATION OF ACCELERATED AND STRAIGHT-LINE DEPRECIATION TO DETERMINE EXCESS FUNDS AVAILABLE FOR REINVESTMENT IN CAPITAL EQUIPMENT AND COMPUTATION OF EARNINGS PROVIDED FROM REINVESTMENT OF EXCESS DEPRECIATION FUNDS

	Year								
	1	2	3	4	5	6	7	8	Total
Accelerated depreciation:									
Initial asset investment	$80,000	$80,000	$40,000						$200,000
Reinvestment of excess depreciation:									
Year 1		16,000	16,000	$ 8,000					40,000
Year 2			19,200	19,200	$ 9,600				48,000
Year 3				7,040	7,040	$ 3,520			17,600
Total	80,000	96,000	75,200	34,240	16,640	3,520			305,600
Straight-line depreciation:									
Initial asset investment	(40,000)	(40,000)	(40,000)	(40,000)	(40,000)				(200,000)
Reinvestment of excess depreciation:									
Year 1		(8,000)	(8,000)	(8,000)	(8,000)	(8,000)			(40,000)
Year 2			(9,600)	(9,600)	(9,600)	(9,600)	$ (9,600)		(48,000)
Year 3				(3,520)	(3,520)	(3,520)	(3,520)	$ (3,520)	(17,600)
Total	(40,000)	(48,000)	(57,600)	(61,120)	(61,120)	(21,120)	(13,120)	(3,520)	(305,600)
Accelerated depreciation over (under) straight-line depreciation	$40,000	$48,000	$17,600	$(26,880)	$(44,480)	$(17,600)	$(13,120)	$ (3,520)	-
Cumulative value of investment arising from reinvestment of funds provided by excess depreciation		40,000	88,000	105,600	105,600	105,600	105,600	105,600	105,600
Additional pretax earnings at an 11.5% rate of return on invested funds		$ 4,600	$10,120	$ 12,144	$ 12,144	$ 12,144	$ 12,144	$ 12,144	$ 75,440

Section 5. (continued....)

Table 8 verifies the positive impact which will result from liberalization of depreciable asset lives. Over the depreciable lives of the assets in question (Situation 2.), accelerated depreciation and resulting reinvestment of excess funds produces $394,920 in total income tax revenue compared to Situation 1. which generates total income tax revenue of $357,200. This is a 10.5% improvement in tax revenues. Although the examples are simplified, the concepts are sound. Even during Company B's growth period where operations are absorbing the heaviest depreciation charges, cumulative tax revenues at the end of five years are higher in Situation 2. than in Situation 1. When Company B's growth levels off (Maturity Period years 6 through 8), income tax revenue gains improve dramatically.

A final question that needs to be answered is what financial impact results from comparing a steady flow of income tax revenue (Situation 1.) to a lower initial flow which improves as years go by (Situation 2.)? To answer this question, it is necessary to discount each year's income tax amount at a current interest rate to determine today's value of future revenues. The theory behind the discounting concept states that a dollar in hand today is worth more than a dollar in hand one year from today. Today's dollar could be deposited in a savings account at 8% and it would be worth $1.08 one year from now. Thus, comparing the value of a dollar today to a dollar to be received one or more years from now requires that the future dollars be discounted by a growing percentage as the year of receipt is extended.

Table 10 therefore, presents the present value of future income tax receipts. Again, Situation 2. produces the most favorable result. Discounted tax revenues are improved by $14,497, a 6% improvement over Situation 1. ($257,072 less $242,575).

continued....

TABLE 10

PRESENT VALUE OF INCOME TAX REVENUE
PRODUCED BY SITUATIONS 1. AND 2.

Year	Income Tax Revenue		Discount	Present Value of Future Income Tax Revenue	
Year	Situation 1.	Situation 2.	Rate (8%)	Situation 1.	Situation 2.
1	$ 30,000	$ 10,000	.926	$ 27,780	$ 9,260
2	31,000	9,300	.857	26,567	7,970
3.	31,200	27,460	.794	24,773	21,803
4	34,440	53,952	.735	25,313	39,654
5	39,440	67,752	.681	26,859	46,139
6	59,440	74,312	.630	37,447	46,817
7	63,440	76,072	.583	36,986	44,350
8	68,240	76,072	.540	36,850	41,079
	$357,200	$394,920		$242,575	$257,072

SECTION 6. Liberal Depreciation Policies of Other Industrialized Nations[1]

Other industrialized nations have generally adopted provisions relating to cost recovery allowances and capital investment incentives that are more favorable than those provided in the United States. This stems from the need to rebuild in order to overcome the ravages of war. There has also been a greater realization that rising productivity creates a rising level of per capita income and a better standard of living. In the United States, we appear to have relied more on rising demand to stimulate production while at the same time remaining complacent about the need to modernize and keep up with technology.

Not only have the European nations adopted tax policies fostering capital investment but they are relying ever more heavily on indirect taxes, such as the value-added tax, which do not impose a tax burden on investment to finance government expenditures. In the absence of such a neutral tax, U. S. investment bears a larger share of the cost of government than does investment of its trading partners.

The following table summarizes a comparison of cost recovery for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants, or deductions generally permitted. The deductions in the United States have been determined under the double declining balance method without regard to the limited first year allowances for small businesses.

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[1] Information in this section is reprinted from excerpts of an article appearing in the May 1975 edition of The International Tax Journal - The Treatment of Capital Recovery Allowances in the U. S. and Other Countries by B. Kenneth Sander and Charles T. Crawford.

continued....

Section 6. (continued....)

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of costs of assets)[1] [2]		
		First Taxable Year	First 3 Taxable Years	First 7 Taxable Years
United Kingdom	1	100.0	100.0	100.0
Canada	2	50.0	100.0	100.0
Netherlands	5	14.0	58.0	108.0
Sweden	5	60.0	95.7	130.0
Italy	6	19.6	67.9	100.0
Switzerland	6-2/3	15.0	58.4	90.0
France	8	31.3	67.5	94.9
W. Germany	9	16.7	49.6	88.8
Belgium	10	20.0	48.8	89.0
Luxembourg	10	28.0	60.4	94.4
Japan	11	37.1	63.9	88.1
United States (1975 Law)	10-1/2	29.5	60.7	94.5

The adoption of ADR and the restoration of the investment credit has done no more than raise the level of U. S. capital recovery to the point where we are tied for last among the industrialized countries... At this point, the following statements from the presentation made by Joel Barlow, at the NTA-TIA Symposium on Federal Tax Reform in Washington in July, 1973, seem an appropriate reminder:

"The United States has the lowest capital recovery tax allowances of any of the industrialized nations."

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[1] It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to a rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table above. The United States does not permit this approach.

[2] This reprint excludes table footnotes which explain computational methods and a comparison of pre-1975 methods.

continued....

Section 6. (continued....)

"The United States has the highest percentage of overage obsolete production facilities in relation to GNP of any of the industrial nations."

"The United States has the lowest rate of productivity increase of any of the industrial nations."

"The United States relies more heavily than any other industrialized nation on income taxation with its penalty on productivity and efficiency."

SECTION 7. THE 50% ADR OR CAPITAL COST RECOVERY TAX REFORM PROGRAM

Based on the information presented in prior sections, it seems appropriate that a conceptual change in present depreciation methods would incorporate features that would permit business concerns to:

- Recover capital investment costs more quickly to generate funds for reinvestment and offset the effects of price inflation.
- Eliminate many of the petty bookkeeping rules found in present depreciation rules and regulations.

We have reviewed the capital recovery allowance concept contained in H. R. 7543, "The Capital Recovery Act of 1975 sponsored by Representative Waggonner (D.-La.) and Representative Archer (R.-Tex.). In general, we are very pleased with the various sections of the Bill; particularly the depreciation rate percentages which permit cost recovery in five and ten years respectively for equipment and buildings acquired (paid for) after December 31, 1975.

We do believe certain revisions would improve the effectiveness of the Bill. Specifically, the bill should incorporate the mandatory reinvestment program described in our depreciation reform proposals. These programs will eliminate potentially abusive situations where cash flow generated by the liberal depreciation charges may, in some circumstances, sit in business bank accounts.

Another area of concern, results from the fact that H. R. 7543 restricts rapid cost recovery to assets acquired after December 31, 1974. In our opinion this feature limits the prospect of immediate economic stimulation that is needed to pull the Country out of the present recession. Our depreciation reform proposals liberalize depreciation write-offs on assets presently in service as well as future acquisitions. This not only improves upon the tax benefit features

continued....

Section 7. (continued....)

of H. R. 7543 but it also eliminates the accounting problem of maintaining two sets of tax depreciation records as would be required by the H. R. 7543 proposals.

Finally, H. R. 7543 excludes agricultural capital investments from the liberalized write-off provisions. In our opinion, agricultural assets should also qualify for the favorable provisions of H. R. 7543.

We are recommending that the traditional useful life concept of depreciation be abandoned in favor of a less complex capital cost recovery (CCR) program. CCR will provide small businesses the flexibility to internally generate capital by employing a liberal, noncumbersome, rapid depreciation write-off method which will maximize depreciation charges during periods when funds are needed for expansion.

We choose CCR because it achieves all the benefits of rapid depreciation without a maze of complex rules. Our recommendation is based on two alternative methods. Method 1 is called 50% ADR which employs double declining balance depreciation. Method 2 is called capital cost recovery which computes depreciation using a declining balance method employing a variable depreciation percentage depending on present asset guideline period lives. As stated in our discussion of H. R. 7543 we are in favor of the 5 and 10 year asset write-off provisions of the Bill However, because of certain Bill omissions and the fact that the bill may not attract concensus support, we are presenting reform methods 1 and 2, which in our opinion, are reasonable alternatives to H. R. 7543.

continued....

Section 7. (continued....)

METHOD 1. 50% ADR

Under 50% ADR, depreciable lives would be stated in a range of years for each pool. Present ADR asset guide line lives would be the starting point for computing 50% ADR depreciation. The ADR life periods would range 50% above or 50% below present asset guide line lives. Taxpayers would select, at their discretion, a rate which falls between the upper and lower limits. Thus, an asset with a 10-year useful life could be depreciated from between 5 to 15 years. It may be appropriate to restrict the depreciation rate to a straight-line basis for assets having an asset guide line period of 5 years or less. This would restrict cost recovery to a liberal 2½ year period, or less, depending on the ADR asset guide line life. Assets having a guide line period useful life of more than 5 years would be eligible to use accelerated depreciation methods. In the same vein, assets with a useful life of 25 or more years could be restricted to a 40% ADR factor. Again, the purpose would be to prevent too rapid a write-off period.

METHOD 2. CAPITAL COST RECOVERY

As mentioned above we favor the Capital Cost Recovery method. We choose this method because of the ease of computation routines. CCR depreciation is computed by applying a range of percentages to the undepreciated value of a category of assets (the categories will be explained later). This is commonly referred to as a declining balance depreciation method. The range of percentages are based, as with 50% ADR, on asset guideline period lives presently employed with conventional ADR. We believe consideration should be given to the following CCR rates:

continued....

Section 7.
Method 2. (continued....)

ASSET GUIDELINE PERIOD LIFE	CCR DEPRECIATION RATE %
2 to 15 years	50
16 to 30 years	20
31 or more years	10

In both the 50% ADR and the Capital Cost REcovery methods, we have suggested a range of years and rates at which groups of assets may be depreciated. If and when depreciation reform is considered by Congress, porposed legislation may increase or decrease these rates. The point we want to make however, is that either method (50% ADR or Capital Cost Recovery) can be tailored to achieve the same result. For example, CCR depreciation on a 25 year asset depreciated at a 20% declining balance rate will produce the same annual depreciation expense as the 50% ADR method (employing the 40% limitation for assets with a useful life of 25 or more years. See the description of the 50% ADR method). The only difference between the two methods being a slightly higher ADR depreciation in later years. This results from the fact that 50% ADR would permit a switch to straight-line depreciation generating more expense in later years than the CCR method which builds in salvage value by applying a fixed depreciation percent to an ever decreasing net book amount. On the other hand, CCR will produce higher or lower annual depreciation than 50% ADR epending on the asset guideline class life employed. Both methods, 50% ADR and Capital Cost Recovery, will produce higher annual depreciation charges than are achieved using present-day ADR methods.

To illustrate some of the concepts just discussed, Tables 11 to 14 present 3 hypothetical situations where a pool of like assets are being added to at the rate of $1,000 a year until the pool reaches $10,000. Each table records the annusl depreciation calculated for each $1,000 asset increment with respect to

continued....

TABLE 11

CONVENTIONAL ADR DEPRECIATION EMPLOYING
M'XIMUM ACCELERATED METHODS ON ASSETS
HAVING A 12 YEAR USEFUL LIFE (80%-10 YEAR WRITE OFF)

			Depreciation Expense By Year And Asset																		
Cost	Reserve	Annual Expense	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
$ 1,000	$ 200	$ 200	$200	$160	$128	$102	$ 82	$ 65	$ 66	$ 66	$ 66	$ 65									
2,000	560	360		200	160	128	102	82	65	66	66	66	$ 65								
3,000	1,048	488			200	160	128	102	82	65	66	66	66	$ 65							
4,000	1,638	590				200	160	128	102	82	65	66	66	66	$ 65						
5,000	2,310	672					200	160	128	102	82	65	66	66	66	$ 65					
6,000	3,047	737						200	160	128	102	82	65	66	66	66	$ 65				
7,000	3,850	803							200	160	128	102	82	65	66	66	66	$ 65			
8,000	4,719	869								200	160	128	102	82	65	66	66	66	$ 65		
9,000	5,654	935									200	160	128	102	82	65	66	66	66	$ 65	
10,000	6,654	1,000										200	160	128	102	82	65	66	66	66	$65
10,000	7,454	800																			
10,000	8,094	640																			
10,000	8,606	512																			
10,000	9,016	410																			
10,000	9,344	328																			
10,000	9,607	263																			
10,000	9,804	197																			
10,000	9,935	131																			
~~10,000~~	~~10,000~~	65																			
			$200	$360	$488	$590	$672	$737	$803	$869	$935	$1,000	$800	$640	$512	$410	$328	$263	$197	$131	$65

TABLE 12

50% ADR DEPRECIATION EMPLOYING MAXIMUM ACCELERATED METHODS ON ASSETS HAVING A 12 YEAR USEFUL LIFE (50%-6 YEAR WRITE OFF)

			Depreciation Expense By Year And Asset														
Cost	Reserve	Annual Expense	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
$ 1,000	$ 334	$ 334	$334	$222	$128	$ 99	$ 99	$ 98									
2,000	890	556		334	222	148	99	99	$ 98								
3,000	1,594	704			334	222	148	99	99	$ 98							
4,000	2,397	803				334	222	148	99	99	$ 98						
5,000	3,299	902					334	222	148	99	99	$ 98					
6,000	4,299	1,000						334	222	148	99	99	$ 98				
7,000	5,299	1,000							334	222	148	99	99	$ 98			
8,000	6,299	1,000								334	222	148	99	99	$ 98		
9,000	7,299	1,000									334	222	148	99	99	$ 98	
10,000	8,299	1,000										334	222	148	99	99	$98
10,000	8,965	666															
10,000	9,409	444															
10,000	9,705	296															
10,000	9,902	197															
10,000	10,000	98															
			$334	$556	$704	$803	$902	$1,000	$1,000	$1,000	$1,000	$1,000	$666	$444	$296	$197	$98

TABLE 13

CAPITAL COST RECOVERY DEPRECIATION
EMPLOYING A 50% DECLINING BALANCE RATE

Cost	Net Book Value (Prior Year Net Book Value Plus Current Year Additions)	Reserve	Annual Expense	Depreciation Expense By Years 1	2	3	4	5	6	7	8	9	10	11	12	13	14
$ 1,000	$1,000	$ 500	$500	$500													
2,000	1,500	1,250	750		$750												
3,000	1,750	2,125	875			$875											
4,000	1,875	3,062	937				$937										
5,000	1,937	4,031	969					$969									
6,000	1,969	5,015	984						$984								
7,000	1,985	6,007	992							$992							
8,000	1,992	7,003	996								$996						
9,000	1,996	8,001	998									$998					
10,000	-,999	9,000	999										$999				
10,000	1,000	9,500	500											$500			
10,000	500	9,750	250												$250		
10,000	250	9,875	125													$125	
10,000	0	10,000	125														$125(1)
				$500	$750	$875	$937	$969	$984	$992	$996	$998	$999	$500	$250	$125	$125

(1) Abbreviated for illustrative purposes.
In practice the balance would continue declining.

Section 7.
Method 2. (continued....)

conventional ADR in Table 11 and 50% ADR in Table 12. Table 13 presents the composite depreciation calculations made each year following the Capital Cost Recovery method. Finally, Table 14 summarizes annual depreciation expense computed using the 3 methods.

TABLE 14

ANNUAL DEPRECIATION EXPENSE SUMMARY

Year	Table 11 Present ADR (80% or 10 Years)	Table 12 50% ADR (50% or 6 Years)	Table 13 Capital Cost Recovery (50% of Net Book Value)
1	$ 200	$ 334	500
2	360	556	750
3	488	704	875
4	590	803	937
5	672	902	969
6	737	1,000	984
7	803	1,000	992
8	869	1,000	996
9	935	1,000	998
10	1,000	1,000	999
11	800	666	500
12	640	444	250
13	512	296	125
14	410	197	125
15	328	98	
16	263		
17	197		
18	131		
19	65		
Total	$10,000	$10,000	$10,000

Section 7.
Method 2. (continued....)

The above Tables point out several interesting situations. For example, in the early years of Capital Cost Recovery, higher annual depreciation charges are achieved than under 50% or conventional ADR. By year 6, 50% ADR depreciation begins to exceed CCR depreciation. By year 11, conventional ADR produces higher annual depreciation than either of the proposed methods. When you consider the realities of inflation and the potential of technological obsolescence, it appears that either one of the proposed methods would be preferable to the conventional ADR method. But when you compare all three methods for ease of computation, Capital Cost Recovery proves to be the most attractive. CCR requires fourteen separate calculations compared to sixty-50% ADR calculations and one-hundred conventional ADR calculations. The sheer simplicity of CCR makes the method an attractive alternative.

At this point, we would like to summarize procedures we are recommending for consideration when the various congressional committees begin drafting tax reform measures which will affect tax depreciation accounting.

CAPITAL COST RECOVERY/50% ADR TAX DEPRECIATION PROGRAM

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continued....

Section 7. (continued....)

1. Depreciable assets are pooled into basic functional categories. We believe the following groupings would be appropriate for most business concerns:
   a. Depreciable real estate
   b. Machinery equipment and fixtures
   c. Furniture and fixtures
   d. Transportation equipment
   e. Other (special tooling, dies, etc.)

   These groupings, for the most part, will conform with present Asset Depreciation Rand (ADR) class lives. Thus, it would not be necessary to redefine guideline class asset descriptions. However, all assets in pools (a) through (e) would be depreciated within the class life range which most closely matches the description of pooled assets. There would be no real need to segregate new and used assets because under 50% ADR or Capital Cost Recovery, useful life is no longer the basis behind spreading depreciation charges.

2. Each year, a dual depreciation computation would be made for assets recorded in each pool:

   Straight-Line - The cost of each year's additions would be divided by the the Asset Guideline Period life (mid-life) assigned to the respective pools and the result of these calculations would be added to the current year straight-line depreciation of prior year asset additions to determine the year's total expense.

   Accelerated - Depreciation would be determined using either 50% ADR or Capital Cost Recovery as explained above in Method 1. and 2. This second computation would produce depreciation used to determine taxable income.

continued....

Section 7. (continued....)

For maximum effectiveness, the program should be flexible. Thus, we recommend that annual tax depreciation charges should be determined on an optional basis from zero to the maximum amount permissable.

Reinvestment Program - To assure that liberalized depreciation rules produce the intended result (namely, to provide business concerns with funds for reinvestment in plant and equipment), we recommend that alternative reinvestment programs be made mandatory. Under these alternatives, the tax benefit of accelerated depreciation (50% ADR or CCR) over straight-line depreciation in any given year must be:

a. Less than or equal to fixed asset additions in the year depreciation is recorded.

b. Less than or equal to fixed asset additions in the year following the year depreciation is recorded.

c. Invested in government securities to the extent that (a.) and (b.) are not met.

Cash which is invested in government securities would become unrestricted in future years when straight-line depreciation begins to exceed accelerated depreciation or when funds are needed to purchase plant and equipment. There should also be carryover provisions where the excess of a year's fixed asset additions over amounts required in (a) above could be indefinitely carried forward to future years. These concepts are explained on Tables 15 and 16 .

From a theoretical point of view, the reinvestment program is sound. In accounting, depreciation charges are intended to generate funds for replacement of plant and equipment. To this extent, reinvestment of additional tax depreciation benefits in plant and equipment or in government securities (until such time as they decide to make equipment purchases) provides assurance that companies are doing what theory dictates.

continued....

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TABLE 15

ILLUSTRATION OF GOVERNMENT SECURITY REINVESTMENT PROGRAM

Year	Transaction	Depreciation Expense: Book	Depreciation Expense: Tax	Depreciation Expense: Book Over (Under) Tax	Fund Into And (Out) of Government Securities(1)
1.	Excess tax depreciation is not reinvested (nor will be next year) in plant and equipment.	$10,000	$20,000	$(10,000)	$5,000
2.	Depreciation is recorded and security investment funds are partially recouped.	10,000	4,000	6,000	(3,000)
3.	Depreciation is recorded and the balance of security investment funds are recouped.	10,000	6,000	4,000	(2,000)
	Summary	$30,000	$30,000	$ -	$ -

(1) Assuming the tax benefit is determined using a 50% income tax rate.

TABLE 16

ILLUSTRATION OF EXCESS ASSET ADDITION CARRYOVER PROVISIONS

Year	(A) Value of Asset Additions	(B) Tax Benefit Excess of Accelerated Depreciation Over Straight-Line	(C) Asset Addition Value Carryover (A)-(B)
1	$1,000	$ 600	$400
2	-	100	(100)
3	-	300	(300)
Summary	$1,000	$1,000	$ -

Section 7. (continued....)

3. Many of the present tax depreciation rules and regulations would be abandoned. As we pointed out in the Present Practices section, many of these rules seem to strive for a degree of accounting perfection that is unrealistic when you consider revenue impact and the concept of timing differences which smooth out year-to-year differences. Therefore, in the interest of promoting tax reform which achieves meaningful simplification of procedures, we recommend that the following procedural concepts be abandoned:

First (and Last) Year Conventions, which limit the amount of initial and final year depreciation to various percentages of a full year's depreciation, would be dropped. The concepts are inconsistent with our recommendations and they promote a degree of accuracy that is not needed.

Additional First Year 20% Depreciation Bonus gives companies a maximum $2,000 charge against taxable income which would become obsolete if depreciation write-off rates were sufficiently liberalized.

Salvage Value Accounting Requirements - would be abandoned because (1) most companies find legitimate ways of ignoring the concepts and (2) the concepts are structured for a contingency (eventual sale of equipment) which is inconsistent with the operating philosophy of most business concerns. For example, most companies are in the business of manufacturing and/or selling products. It is not their primary objective to sell plant and equipment used in the manufacturing process; the occurrence of such sales are incidental. Therefore, salvage value accounting routines incorrectly affect the depreciaiton taken on all operating assets, not just the occasional assets that are sold. Because of this inconsistency and because of the insignificant revenue impact or salvage value accounting, the concept should be abandoned.

The $500 Write-Off of Minor Capital Assets - would be abandoned in favor of a much higher limit, possibly $2,000. This would eliminate much of the nuisance

continued....

Section 7. (continued....)

accounting which is presently very costly to business concerns. Many such assets have a useful life of between one and three years. On an individual asset basis, you are dealing with a tax revenue impact of $1,000 in one year compared to $333 over three years. It hardly seems fair to burden overworked bookkeeping departments with such an insignificant concept. Detailed Fixed Asset Records - would be abandoned in favor of summary records which would record depreciation on a vintage basis in the case of 50% ADR or on a composite basis in the case of Capital Cost Recovery. In place of the individual asset depreciation records, listings of individual assets would be maintained by year of addition. The listings would provide adequate asset descriptions and their cost. When as asset is sold, it is located on the listing to determine its cost. Depreciation is calculated from the year of acquisition in order to determine gain or loss. Cost and accumulated depreciation are removed from the appropriate accounts and the resulting gain or loss is recorded in the appropriate accumulated depreciation pool. This routine conforms with present ADR accounting procedures which spread the effect of the gains or losses over the remaining life of assets in a pool. ADR Repair Allowance provisions would be abandoned for two reasons: (1) A liberal ADR or CCR program would eliminate the need for a repair allowance. (2) The ADR Repair Allowance provisions are a classic example of legislation which is intended to benefit but because the rules are so complicated, and the record keeping requirements are so excessive, few business concerns take advantage of the provisions. I know of no companies who are following ADR repair allowance accounting.

4. Finally, we recommend that our 50% ADR or Capital Cost Recovery accounting procedures be applicable to plant and equipment on hand at the date reform legislation becomes law, not just prospectively. This will impose a burden

continued....

Section 7. (continued....)

on businessmen to convert their fixed asset record keeping systems to the new format. However, the new formats are not complex. Thus, the resulting benefit will far outweigh conversion costs. Also, if the new law were elective, business concerns that do not want to make the changes would not have to do so.

In summary, let me point out the benefits of the reform measures we have recommended. The programs provide enough flexibility to permit businessmen to control cash flow. The programs will help ease the inflationary crunch which has hit the capital equipment market. The programs, particularly the Capital Cost Recovery method, are not complex; at the same time, they are fair. They should prove very useful in eliminating much of the needless red tape which complicates present-day depreciation accounting. The programs will ensure a surge in capital investment spending which will mean more jobs and a growing tax revenue base, both of which are vital if our economic ills are to be cured.

The programs we have presented should be looked at as an outline of what can be accomplished when writing reform legislation. We ask you to keep one fact in mind. Many honorable legislative objectives have been destroyed when original concepts were abandoned along the road to passage. In considering our detailed depreciation reform proposals, please keep the basic structure intact:

. Early Recovery of Capital Investments.

. Achieved in a Fair and Rational Manner.

. Which Abandons Inconsequential Bookkeeping Routines.

APPENDEX A

COUNCIL OF SMALLER ENTERPRISES

MEMBERSHIP SURVEY RESULTS

TOPIC: DEPRECIATION

We conducted a survey of our members asking four brief questions concerning their opinions about present depreciation rules and regulations. Surveys were mailed to each one of our 800 members. From this mailing, we received replies from 78 members. To the question:

> "Do you or your accounting personnel believe present depreciation record keeping requirements are too complicated?"

37 members answered "yes" and 41 answered "no".

The overwhelming majority of our members answered "no" to the question:

> "Are the present useful lives which are used to compute depreciation expense adequate to generate cash for reinvestment in replacement assets?"

The actual tally was 16 "yes" and 58 "no" with 4 not responding.

As you would expect, most of our membership would favor the quick write-off of plant and equipment. 58 members responded positively (20 negatively) to the question:

> "Would you be in favor of rapid write-off (quick depreciation) of capital assets if the benefit (cash tax savings) of such a program were required to be reinvested in new (or used) capital assets?"

A final survey question requested the following information from our membership:

> "Please provide the following information with respect to a piece of equipment you have recently replaced with a piece of new or used equipment of like specifications".

	Asset Replaced	New or Used Replacement Asset (Circle new or used)
Description of Asset	________________	________________________
Date acquired	________________	________________________
Asset cost basis	________________	________________________

The following table presents a selection of some of the replies.

APPENDIX A

MEMBERSHIP SURVEY RESULTS, Continued

Description (1)	Asset Replaced		Replacement Asset	
	Date Acquired	Cost Basis $	Date Acquired	Cost Basis $
Lift truck	1971	9,500	1975	13,000
Punch press (META)	1963	12,000	1975	30,000
GMC truck	1970	5,570	1975	9,267
Plating machine	1966	150,000	1973	250,000
Truck	1969	14,334	1975	21,192
Bridgeport verticle milling machine	1966	2,655	1975	3,450(u)
Lift truck	1969	4,567	1974	5,895(u)
Screw driving machine	1950	750	1975	3,100
Oldsmobile (replaced by Ford) wagons	1969	3,507	1973	4,210
Tractor	1970	9,088	1975	25,362
Caliper meter	1972	1,510	1975	2,125
Cash registers	1972	3,150	1975	5,300
Ironworker	1969	4,000(u)	1975	20,000

One of our members, an equipment distributor, reported the following purchase price listing on a line of engine generators (model 30KW) distributed by his Company:

Date	Purchase Price $	Comments
1963	3,850	
1971	4,150	
Oct. 1973	4,243	Based on a 2.25% price increase
Feb. 1974	4,464	Based on a 5.20% price increase
June 1974	4,732	Based on a 6.00% price increase
Aug. 1974	5,300	Based on a 12.00% price increase
Nov. 1974	6,678	Based on a 26.00% price increase
Feb. 1975	6,880	Based on a 1.50% price increase per month after Jan. 31, 1975
June 1975	7,123	Based on a .50% price increase
July 1975	7,123	Firm prices were establishedon this date

(1) Assets are new unless they are coded (u) for used

Mr. BARNES. My testimony concerns itself with the interrelationship of the capital formation question and the depreciation accounting methods. My comments will weigh equally on why rapid depreciation methods are an effective and equitable means of helping smaller enterprises internally generate capital, and why present depreciation practices impose needless hardships on small business organizations.

When I was first charged with this problem, I felt that the way to approach it would be to look into the question and first of all find out do we need to liberalize depreciation regulations and why should we. So, I gathered a great deal of data, which I will try to summarize, and I hope I won't skip anything in my abbreviations.

My research led me to gather a great deal of information that shows that fixed asset replacement costs have just soared in the last several years. Within 8 years, from 1967 in the construction industry, the average piece of equipment that would cost $10,000 in 1967 presently costs $18,000. So that with this information, and several other units of data, we determined that inflation, more than any other factor, has severely impaired the business community's ability to replace its machinery and equipment.

Depreciation can be an effective vehicle for generating funds to replace equipment if proper recognition is given to inflation. Therefore, we feel that the sooner business concerns can recover their investment in plant equipment, the sooner and the more funds they will have available for replacement.

Another problem, another area or research that we conducted showed that the downfall that businesses face when they try to invest funds in machinery and equipment is another area. Typically the small business concern relies on depreciation and retained earnings to finance these investments.

Senator NELSON. Depreciation?

Mr. BARNES. Depreciation of plant and equipment. Tables 3 and 4 on pages 18 and 19 of my detailed testimony show that there is a serious growing gap in the amount of depreciation and retained earnings as it relates to the expansion of plant and equipment. You might ask, why should we give businesses this tax break that the accelerated depreciation schedules will give them. The answer really is quite simple. It is a matter of timing differences. Depreciation accounting is not a tax-avoidance scheme; it is a tax-deferral scheme. If we depreciate our assets earlier in initial years, our income will be substantially greater in later years, thus you are effecting the timing of deductions and not the amount of deductions. There is no permanent avoidance of taxes through liberalized depreciation schemes.

Senator NELSON. The Treasury Department doesn't support that view. I suppose that is because there would be, in the beginning at least, a temporary loss of Treasury money, wouldn't there?

Mr. BARNES. On table 6 on page 21 of my detailed report, I worked out a hypothetical situation that shows that if an asset were allowed to be depreciated over 2½ years, as opposed to 5 years, given a fixed set of criteria that I used, tax revenues would be short by $60,000 in the first 2 years of that period comparing the two depreciation methods. In the third year of that 5-year period, the tax revenues would be equal. In the fourth and fifth year, the losses of the first 2 years would be recovered.

The next step of our program is we took a look at the effect that the investment in plant equipment has from a return on invested capital concept. Our research showed that over the recent 11-year period, corporations, averaging their good decisions and their bad decisions, got an average return of 11.5 percent. Again, we worked up a hypothetical situation which we developed and tailored to the program that we are going to recommend. That was that any benefit a business concern can get out of accelerated depreciation schedules will have to be reinvested in new plants and equipment. This reinvestment in new plants and equipment should earn this business an average return on that investment of an additional 11.5 percent.

Several tables, and I won't try and pick them out of my detailed testimony, have proved that if this mandatory reinvestment concept is built into part of the liberalized depreciation program, that Government tax revenues and income tax revenues from business concerns will actually increase over the long haul.

Now, our studies made computations on growing companies or companies that were mature in their growth and companies that actually had declining earnings. And in every case, we found that tax revenues actually increased if a mandatory reinvestment policy were made a part of our tax reform proposals in the depreciation area.

Now, you might say, well, this imposes a burden on the business concerns that cannot get delivery on fixed assets that they want to buy or maybe they have long-range plans, but they don't want to do it today. Well, we have an answer to that also. We recommend that the cash flow from this tax benefit, if it is not invested in new plants and equipment within the first or second year, that it must be invested in Government securities.

In effect, what we are recommending is that small business concerns would actually fund their depreciation to the extent of the tax benefits, I mean, they would fund this depreciation in Government securities so that the funds will be available when their eventual plans come to fruition.

I think the Treasury will find this feature of our proposals very appealing.

Senator BYRD. Could I ask a question at this point? Why do you need a mandatory provision? It seems to me that if you take Canada, for example, with the 2-year writeoff, the companies are then faced with either additional capital investments, which stimulate the economy and creates jobs, or pay that heavy tax, isn't that right?

So, why do you need to have a mandatory provision such as you are speaking of?

Mr. BARNES. Much of the testimony that the Treasury puts forth as arguments against good tax reform legislation bases its statement on the fact that there are abuses. There are companies that do not need accelerated depreciation schedules because they are not investing in new plant and equipment. They are mature companies and there are a number of mature companies who do not invest all of their depreciation under today's depreciation schedule in new plant and equipment.

Senator BYRD. But, if you took Mr. Bixler's proposal of a 5 and 10, at the end of a 5-year period, you take on equipment, and then the companies which have taken advantage of the faster writeoff, they would then begin to pay the total tax without any benefit of depreciation. So, it seems to me, just as you began your testimony, it seems that all you are doing from the Government's point of view is to defer the tax and not avoid the tax.

Mr. BARNES. Absolutely. But the only thing I am saying is that this extra tax benefit, if the Treasury finds this to be such a hardship on them, and they are worried about abuses, I am saying this is a way an abusive situation could be corrected. In my detailed testimony, I show that as the deferral turns around and the excess depreciation runs up, these companies will be able to recoup these funds. The basis for this feature is to eliminate abuse.

I think if you read the detailed testimony, I think it is apparent just how there could be an abusive situation. This answers that argument. Frankly, if we could pass depreciation legislation that would not consider this issue, I would be very happy. But, I would hate to see any reform measures that were going to come out be impeded or defeated because of some argument there may be abuses. So I thought that possibly this could overcome these arguments.

Senator JAVITS. Senator Byrd, would you yield for one question induced in my mind by this? We are talking about a situation where there are excess profits on oil, and we are talking about a plowback. Is there anything to the idea, which doesn't seem to have been suggested by any of you, that if we have an unusual depreciation allowance, that that be conditioned upon a plowback in new investments. Because, after all, to me, and I am speaking only for myself, I think in terms of the total society and I am interested in the modernization and productivity of American business. I am not as much interested in whether firm A or firm B makes money so that it is stimulated or has more savings or what have you in this field. So, does anyone have any opinion on the possibility of accelerated depreciation even Swedish style that gives full depreciation the first year, if there is a plowback into new machinery and equipment?

Mr. BARNES. Senator Javits, if you will read the detailed testimony, I have recommended that, that is, that any liberalization of

present depreciation measures be tied to a mandatory reinvestment program.

Senator JAVITS. A plowback?

Mr. TURE. Senator, may I take very strong exception to that approach? I think the question of abuse is grossly overdone. The Treasury will always raise the question of a possible abuse with respect to provisions it doesn't care for, but it will not raise that issue when it is in favor of a proposal. I think the abuse issue can be exaggerated way out of proportion.

Now, on the cost that you would incur by imposing the requirement of a plowback, they would be to enormously hamstring the managerial efficiency and therefore the productivity of company after company.

Mr. BARNES. I might answer that with the statement that it is possible, but I don't think you are going to have this abusive situation. I think that is going to be a small feature of any reform measure. Most companies that I am involved with—and I am a practicing CPA—every year their investment in new plant and equipment far exceeds any benefits that they would get out of the legislation that we are proposing.

Senator JAVITS. Under your plan, do they have at least this option, Mr. Barnes, that they don't have to take advantage of that special type of acceleration if they do have a plowback? Doesn't that partly answer Mr. Ture's point?

Mr. BARNES. That is right. That is one feature of our proposal, Senator, that companies may be able to take tax deductible depreciation on a sliding scale from zero to some limit.

Senator JAVITS. But, otherwise they can use the normal depreciation. That is their option, correct?

Mr. BIXLER. Senator, as a practitioner in the field, sometimes that money you save might be the most logical thing to put into the development of a new marketing approach or a new export approach. I don't think it has to be limited just to——

Senator JAVITS. Yes, that is the nature of a plowback. I am not dealing with that at all.

Well, this has been very illuminating. I mean I am glad we stimulated a little controversy here. We learned much more. Thank you, sir.

Senator NELSON. Let me call upon Mr. Rau next, and then if there are some additional comments that can be made, we may do so if we have time.

Our next witness is Charles W. Rau, director of taxation, Allis Chalmers Corp., and chairman, Taxation Committee, Wisconsin State Chamber of Commerce.

Mr. Rau, your statement in full will be printed in the record.

[The prepared statement of Mr. Rau in full follows:]

STATEMENT BY CHARLES W. RAU
ON BEHALF OF
METROPOLITAN MILWAUKEE ASSOCIATION OF COMMERCE
WISCONSIN MANUFACTURERS' ASSOCIATION
WISCONSIN STATE CHAMBER OF COMMERCE

BEFORE JOINT HEARINGS OF THE
SENATE SELECT COMMITTEE ON SMALL BUSINESS
AND
SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS
ON
SEPTEMBER 23, 1975

My name is Charles W. Rau and I appear here today as Chairman or a Member of the Taxation Committees of the Metropolitan Milwaukee Association of Commerce, the Wisconsin Manufacturers' Association, and the Wisconsin State Chamber of Commerce. Each of these organizations has asked that I testify on their behalf with respect to our current Federal income tax depreciation system and the proposed alternative of a Capital Cost Recovery system, such as encompassed within H.R. 7543.

In contrast to a $100,000 expenditure for media advertising or for professional services, which $100,000 becomes a tax deductible expense in the current year, a $100,000 expenditure to acquire a productive machine tool (needed to employ factory workers) gives rise to $100,000 in tax deductions which are spread over a period of approximately 10½ years. If the same $100,000 is invested in a new or expanded manufacturing building, such $100,000 in tax deductions is spread over a period of approximately 45 years. This disparity exists because under existing Federal income tax law, the <u>timing</u> of permitted tax deductions for expenditures already made to acquire tangible assets used in a business relates primarily to the physical life of those assets. Our existing tax laws do <u>not</u> recognize the full effects of obsolescence nor increased replacement costs. The adoption of the ADR depreciation system in 1972 was a step toward a Capital Cost

Recovery system as it did address itself to the obsolescence factor "within the limits of administrative discretion."

The ADR system is based on a permitted 20% deviation from a guideline life established for a class of assets. For instance, given a 10-year guideline life for a particular class of assets, a taxpayer may elect to use a depreciable life of no less than 8 years nor more than 12 years. The Treasury Department is responsible for reviewing actual average useful lives and establishing updated new guideline class lives, from which the 20% deviation in depreciable life is permitted. Unfortunately, such guideline lives may be extended due to the very inability of taxpayers to finance new plant and equipment additions--thus, statistically extending the "useful life" of the retained assets.

With the adoption of the ADR system came a highly complicated series of rules, classifications, and sub-classifications which creates a substantial record keeping burden for such taxpayers as desire to avail themselves of the shorter lives permitted under ADR. For many individual businessmen as well as for both smaller companies and larger decentralized companies, such complicated record keeping either precludes use of ADR or requires substantial expenditures to permit utilization of ADR. For a taxpayer not electing ADR, the old "facts and circumstances" rule is applied--which may mean an item by item determination of useful life between a Revenue Agent and an individual taxpayer.

Under the Capital Cost Recovery system set forth in H.R. 7543, two broad asset categories are substituted for the numerous ADR classes now in existence. (At our last count, there were some 138 ADR classes.) By simplifying the tax accounting requirements, small businesses in particular will be able to take advantage of tax deductions in the earlier years.

Also, by encompassing both the effects of obsolescence and increased replacement cost, the Capital Cost Recovery provisions of H.R. 7543 provide substantial cash flow relief--especially to those companies which are required to spend disproportionately large sums of money to acquire capital assets for the conduct of their businesses.

Perhaps one way to measure the effects of inflation on our existing useful life depreciation system is to restate, on a constant dollar basis, the depreciation deductions taken on both production machinery and a manufacturing building. To simplify the illustration, salvage value has not been taken into account and the full purchase price is deemed to qualify for depreciation deductions.

Exhibit A illustrates the effect of inflation on a $100,000 piece of machinery with a shortened ADR life of 10½ years. With an assumed 5% rate of inflation, only $79,000 of the $100,000 expended is recovered in depreciation tax deductions, on a constant dollar basis. Approximately $21,000 of the cost is lost to inflation. When these numbers are changed to reflect a 10% annual rate of inflation, the depreciation deduction becomes approximately $64,000, while the loss due to inflation is almost $36,000. Of course, the 10% investment tax credit does serve to reduce this loss.

Worse yet is the effect of inflation on an average 45-year life manufacturing building as demonstrated in Exhibit B. Here, assuming inflation at only a 5% rate, only $43,000 of the $100,000 cost is recovered in constant dollar depreciation tax deductions. Approximately $57,000 is lost to inflation. When an inflation rate of 10% per annum is assumed, the constant dollar depreciation deductions total only $26,000. Some $74,000 of the cost is never recovered as a tax deduction--on a constant dollar basis.

Thus, the cash flow attributable to tax deductions is substantially below that which might be anticipated as available under our current tax structure.

In Exhibit C, the effects of H.R. 7543 become evident. At an assumed inflation rate of 5%, only $10,056 of depreciation deductions on a machinery purchase are lost to inflation--and this amount would be almost entirely offset by a 10% investment tax credit. At an inflation rate of 10%, again assuming continuation of the 10% investment tax credit, approximately $8,000 of tax deductions remain lost to inflation--but at least two-thirds of the loss under current law is avoided.

With respect to buildings, as to which investment tax credit is not permitted under our tax laws, we again see a substantial reduction in the loss of tax deductions due to inflation as compared to the loss under current law. Assuming a 5% inflation rate, the tax deductions lost to inflation are reduced from approximately $57,000 down to approximately $17,000. At an assumed inflation rate of 10%, the loss of deductions due to inflation is reduced from $74,000 down to $29,000.

Perhaps on a larger scale Exhibits D, E, and F are useful referents. Exhibit D indicates the expenditures for equipment additions in the United States in terms of both constant dollars and current dollars. Exhibit E makes the same comparison for plant expenditures and Exhibit F is a comparison of combined plant and equipment expenditures.

Data developed by the National Association of Manufacturers indicates other industrialized nations of the free world generally rank substantially ahead of the United States in terms of the period of time during which funds expended for machinery and equipment are permitted to be deducted for tax purposes. Of possible special interest as to a Capital Co t Recovery proposal

is the statement which Canada's Minister of Finance made to that Country's Parliament on November 18, 1974, in commenting on the results of an experimental program permitting accelerated tax deductibility of expenditures made for machinery and equipment used in manufacturing and processing:

> "Finally, in the area of business investment, I wish to announce the extension of a measure which has made a major contribution to the strong investment performance, which is improving our productivity, enhancing supply, creating new jobs and helping to sustain the Canadian economy at a time when the economies of many other nations are faltering. This measure is the two-year write-off of expenditures on new machinery and equipment for manufacturing and processing in Canada, which is scheduled to expire at the end of this year. I am now proposing that it be extended without a terminal date." (My emphasis)

Whether we will soon return to only a 10% or a 5% annual rate of price increase as to buildings, farm equipment, or other production machinery remains to be seen. What does appear certain is that under our existing system of depreciation, businesses required to spend substantial sums of money on equipment or buildings cannot expect to receive a tax deduction equivalent to the dollars expended.

In addition to already high debt to equity ratios in the private sector and the need for added capital to meet pollution control and safety requirements, Secretary of the Treasury Simon estimated on January 22, 1975, that the governmental sector, including its sponsored agencies, will be raising $88.4 billion in the capital markets in fiscal year 1976--in contrast to a total of $55.6 billion which was raised by both the governmental and private sectors in 1974. With approximately $25,000 of capital equipment and plant

required to support each new manufacturing job, the unavailability of sufficient capital funds must limit employment opportunities. It is interesting to note that according to a February 24, 1975, issue of Business Week, some 1,400,000 of the 1,549,000 jobs lost in the United States since September, 1974, were in the manufacturing sector.

We believe H.R. 7543 will give needed tax relief where a demonstrated inequity exists. Tax relief which would benefit both unincorporated as well as incorporated businesses. Tax relief dependent upon the actual expenditure of funds--which expenditures must favorably impact upon our employment and inflation levels.

In proposing adoption of the investment tax credit, a Kennedy Administration spokesman stated the following to the House Committee on Ways and Means:

> "all of our citizens will benefit from modernization of our industry. A basic fact of economic life is that modernization and expansion are essential to higher productivity. Rising productivity will provide us with a rising level of per capita income, with resultant and widely shared benefits in the form of rising real wages and rising investment incomes. Rising productivity will also permit us to hold prices down."

Thank you for the opportunity to appear before you.

Exhibit A

LOSS IN DOLLAR VALUE DUE TO INFLATION
MACHINERY COST - $100,000; ACQUIRED JANUARY 1; 10½ YEAR LIFE - ADR - HALF YEAR CONVENTION; METHOD - DDB CONVERTED TO STRAIGHT LINE WHEN ADVANTAGEOUS

		Inflation @ 5%		Inflation @ 10%	
		a.	b.	a.	b.
Year	Annual Depreciation Deduction	Constant Dollar Value of Depreciation Deduction	Loss Due to Inflation	Constant Dollar Value of Depreciation Deduction	Loss Due to Inflation
1	$ 9,523.80	$ 9,066.66	$ 457.14	$ 8,657.13	$ 866.67
2	17,233.54	15,630.82	1,602.72	14,234.90	2,998.64
3	13,950.97	12,039.69	1,911.28	10,477.18	3,473.79
4	11,293.64	9,283.37	2,010.27	7,713.56	3,580.08
5	9,142.48	7,158.56	1,983.92	5,668.34	3,474.14
6	7,401.05	5,521.18	1,879.87	4,174.19	3,226.86
7	6,290.91	4,466.55	1,824.36	3,227.24	3,063.67
8	6,290.91	4,252.66	2,038.25	2,931.56	3,359.35
9	6,290.90	4,051.34	2,239.56	2,667.34	3,623.56
10	6,290.90	3,856.32	2,434.58	2,422.00	3,868.90
11	6,290.90	3,673.89	2,617.01	2,201.82	4,089.08
	$100,000.00	$79,001.04	$20,998.96	$64,375.26	$35,624.74

Exhibit B

LOSS IN DOLLAR VALUE DUE TO INFLATION
BUILDING COST - $100,000; BUILDING ACQUIRED JANUARY 1; 45 YEAR LIFE - NON ADR - METHOD - 150% DB
CONVERTED TO STRAIGHT LINE WHEN ADVANTAGEOUS

Year	Annual Depreciation Deduction	Inflation @ 5% a. Constant Dollar Value of Depreciation Deduction	Inflation @ 5% b. Loss Due to Inflation	Inflation @ 10% a. Constant Dollar Value of Depreciation Deduction	Inflation @ 10% b. Loss Due to Inflation
1	$ 3,333.00	$ 3,173.02	$ 159.98	$ 3,029.70	$ 303.30
2	3,221.91	2,922.27	299.64	2,661.30	560.61
3	3,114.52	2,687.83	426.69	2,339.00	775.52
4	3,010.72	2,474.81	535.91	2,056.32	954.40
5	2,910.37	2,278.82	631.55	1,804.43	1,105.94
6	2,813.37	2,098.77	714.60	1,586.74	1,226.63
7	2,719.60	1,930.92	788.68	1,395.15	1,324.45
8	2,628.95	1,777.17	851.78	1,225.09	1,403.86
9	2,541.33	1,636.62	904.71	1,077.52	1,463.81
10	2,456.63	1,505.91	950.72	945.80	1,510.83
11	2,374.75	1,386.85	987.90	831.16	1,543.59
12	2,295.60	1,276.35	1,019.25	730.00	1,565.60
13	2,219.09	1,176.12	1,042.97	641.32	1,577.77
14	2,145.12	1,083.29	1,061.83	564.17	1,580.95
15	2,073.63	997.42	1,076.21	495.60	1,578.03
16	2,004.72	918.16	1,086.56	435.02	1,569.70
17	2,004.72	874.06	1,130.66	394.93	1,609.79
18	2,004.72	831.96	1,172.76	358.84	1,645.88
19	2,004.72	791.86	1,212.86	326.77	1,677.95
20	2,004.72	753.77	1,250.95	296.70	1,708.02
21	2,004.72	717.69	1,287.03	270.64	1,734.08
22	2,004.72	683.61	1,321.11	244.58	1,760.14
23	2,004.72	651.53	1,353.19	222.52	1,782.20
24	2,004.72	621.46	1,383.26	202.48	1,802.24
25	2,004.72	591.39	1,413.33	184.43	1,820.29
26	2,004.72	563.33	1,441.39	166.39	1,838.33
27	2,004.71	535.26	1,469.45	152.36	1,852.35
28	2,004.71	511.20	1,493.51	138.32	1,866.39
29	2,004.71	485.14	1,519.57	126.30	1,878.41
30	2,004.71	463.09	1,541.62	114.27	1,890.44
31	2,004.71	441.04	1,563.67	104.24	1,900.47
32	2,004.71	418.98	1,585.73	94.22	1,910.49
33	2,004.71	398.94	1,605.77	86.20	1,918.51
34	2,004.71	380.89	1,623.82	78.18	1,926.53
35	2,004.71	362.85	1,641.86	70.16	1,934.55
36	2,004.71	344.81	1,659.90	64.15	1,940.56
37	2,004.71	328.77	1,675.94	58.14	1,946.57
38	2,004.71	312.73	1,691.98	52.12	1,952.59
39	2,004.71	298.70	1,706.01	48.11	1,956.60
40	2,004.71	284.67	1,720.04	44.10	1,960.61
41	2,004.71	270.64	1,734.07	40.09	1,964.62
42	2,004.71	256.60	1,748.11	36.08	1,968.63
43	2,004.71	244.57	1,760.14	32.08	1,972.63
44	2,004.71	232.55	1,772.16	30.07	1,974.64
45	2,004.71	222.52	1,782.19	26.06	1,978.65
	$100,000.00	$43,198.94	$56,801.06	$25,881.85	$74,118.15

Exhibit C

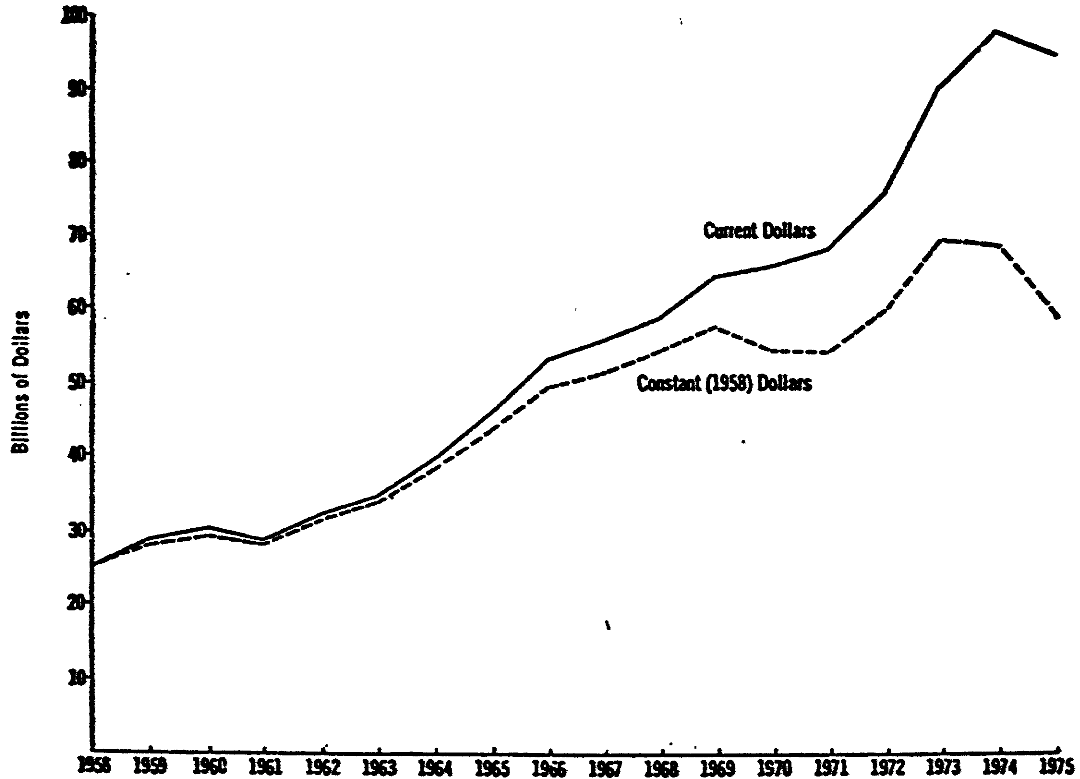
LOSS IN DOLLAR VALUE DUE TO INFLATION UNDER PROVISIONS OF H.R. 7543

MACHINERY COST - $100,000

		Inflation @ 5%		Inflation @ 10%	
		a.	b.	a.	b.
Year	Capital Cost Recovery	Constant Dollar Value of Capital Cost Recovery	Loss Due to Inflation	Constant Dollar Value of Capital Cost Recovery	Loss Due to Inflation
1	$ 40,000	$38,080	$ 1,920	$36,360	$ 3,640
2	24,000	21,768	2,232	19,824	4,176
3	18,000	15,534	2,466	13,518	4,482
4	12,000	9,864	2,136	8,196	3,804
5	6,000	4,698	1,302	3,720	2,280
	$100,000	$89,944	$10,056	$81,618	$18,382

BUILDING COST - $100,000

		Inflation @ 5%		Inflation @ 10%	
		a.	b.	a.	b.
Year	Capital Cost Recovery	Constant Dollar Value of Capital Cost Recovery	Loss Due to Inflation	Constant Dollar Value of Capital Cost Recovery	Loss Due to Inflation
1	$ 20,000	$19,040	$ 960	$18,180	$ 1,820
2	16,000	14,512	1,488	13,216	2,784
3	14,000	12,082	1,918	10,514	3,486
4	13,000	10,686	2,314	8,879	4,121
5	11,000	8,613	2,387	6,820	4,180
6	9,000	6,714	2,286	5,076	3,924
7	7,000	4,970	2,030	3,591	3,409
8	5,000	3,380	1,620	2,330	2,670
9	3,000	1,932	1,068	1,272	1,728
10	2,000	1,226	774	770	1,230
	$100,000	$83,155	$16,845	$70,648	$29,352

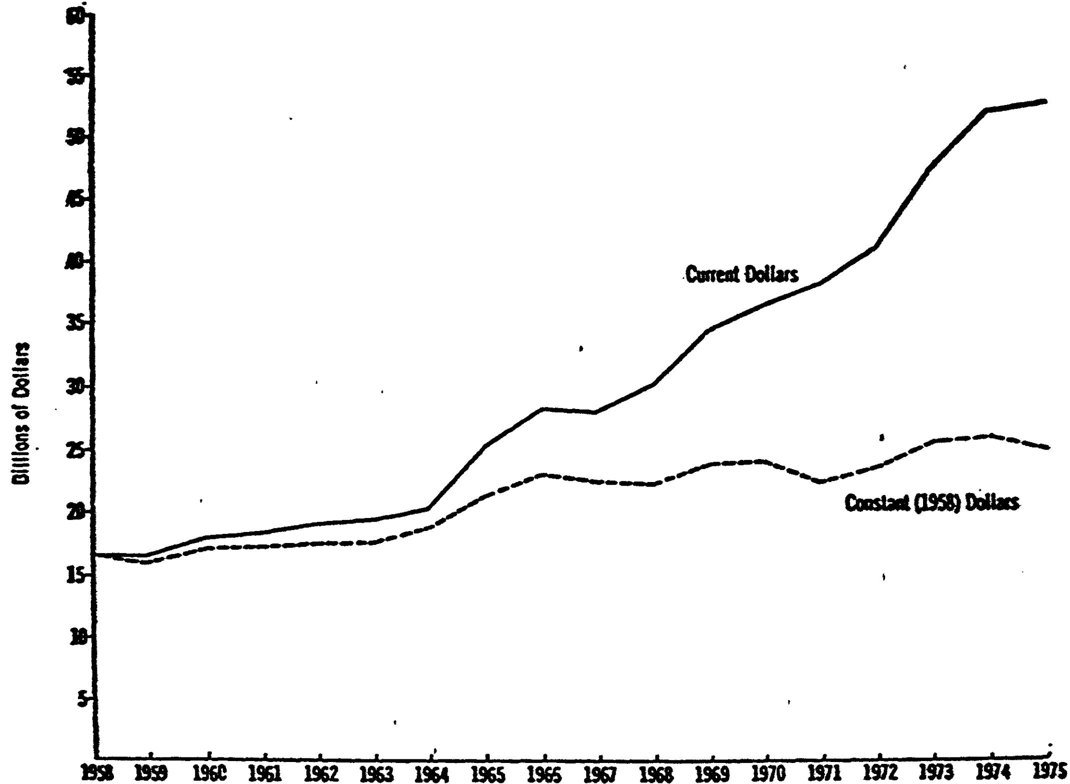


Source: Survey of Current Business, June, 1975, Vol. 55, No. 6, National Income and Product Tables, p.9

Note: Data for 1975 includes statistics for first quarter only

Exhibit D

PLANT

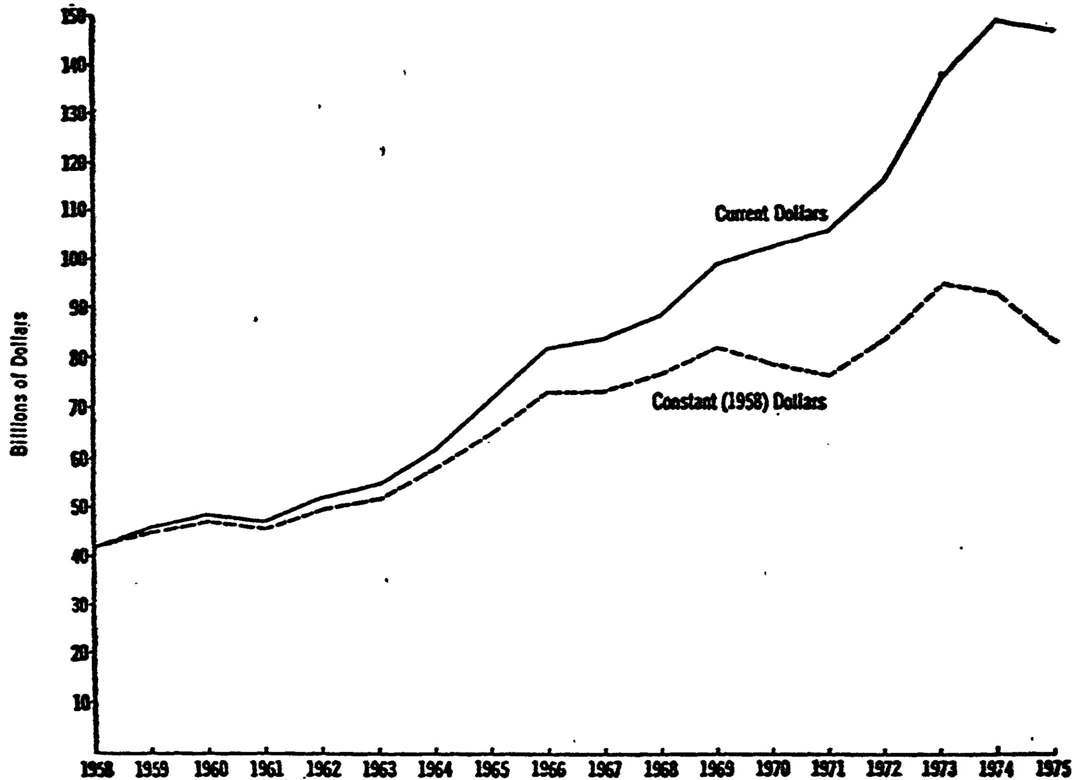


Source: Survey of Current Business, June 1975, Vol. 55, No. 6, National Income and Product Tables, p.9

Note: Data for 1975 includes statistics for first quarter only

Exhibit II

PLANT and EQUIPMENT



Source: Survey of Current Business, June 1975, Vol. 55, No. 6, National Income and Product Tables, p.9

Note: Data for 1975 includes statistics for first quarter only

Exhibit 4

Mr. RAU. Thank you, Mr. Chairman.

I appear here today on behalf of the Metropolitan Milwaukee Association of Commerce, the Wisconsin Manufacturers' Association, and the Wisconsin State Chamber of Commerce. Each of these organizations has asked that I testify on its behalf with respect to our Federal income tax depreciation system and the proposed alternative of a capital cost recovery system, such as encompassed within H.R. 7543.

In contrast to a $100,000 expenditure for media advertising or for professional services, which immediately becomes a tax deductible expense in the current year, a $100,000 expenditure to acquire a productive machine tool (needed to employ factory workers or to enable a farmer to earn a living) gives rise to $100,000 in tax deductions which are spread over a period of approximately 10½-years. If the same $100,000 is invested in a new or expanded manufacturing building, such $100,000 in tax deductions, attributable to money already spent, is spread over a period of approximately 45 years.

Our existing tax laws do not recognize the full effects of obsolescence nor increased replacement costs in the timing of tax deductions for expenditures already made to acquire productive assets.

The ADR system is based on a permitted 20-percent deviation from a guideline life established for a class of assets. The Treasury Department is responsible for reviewing actual average useful lives and establishing updated new guidelines class lives, from which the 20-percent deviation in depreciable life is permitted. Unfortunately, such guideline lives may be extended by the Treasury, due to the very inability of taxpayers to finance new plant and equipment additions—thus, statistically extending the useful life of the retained assets.

Messrs. Barnes and Bixler have already alluded to the complexity of the ADR system, and certainly small businesses in particular would gain the advantage of simplicity from the proposed legislation encompassed within H.R. 7543.

Also, by encompassing both the effects of obsolescence and increased replacement cost, the capital cost recovery provisions of H.R. 7543 provide substantial cash flow relief—especially to those companies which are required to spend disproportionately large sums of money to acquire capital assets for the conduct of their business.

Perhaps one way to measure the effects of inflation on our existing useful life depreciation system is to restate on a constant dollar basis, the actual depreciation deductions taken under current law on both production machinery and a manufacturing building. To simplify the illustration, salvage value has not been taken into account and the full purchase price is deemed to qualify for depreciation deductions.

Exhibit A of the testimony submitted illustrates the effect of inflation on a $100,000 piece of machinery with a shorten ADR life of 10½ years. Assuming double-declining balance depreciation and a 5-percent rate of inflation—and again, we are assuming the full $100,000 cost to be subject to depreciation deductions—only $79,000 of the cost is really recovered in deductions, in terms of the same kinds of dollars as were expended in the first year. Some $21,000 of those deductions are lost due to the impact of inflation at a 5-percent rate. If inflation goes to a 10-percent rate, we only recover $64,000 in tax deductions and approximately $36,000 of those deductions are lost due to inflation.

The situation with a building, represented by exhibit B, shows on a constant dollar basis over a 45-year life, which is the average manufacturing building life and using again the most accelerated method permitted under current tax law, only $43,000 of constant dollar tax deductions are permitted on the $100,000 of expenditure. Some $57,000 is lost, due to inflation. While we get the full $100,000 in tax deductions, by getting them over this lengthy period of time—inflation is eating away at each year's deduction. With inflation at a 10-percent per annum rate, we would only be permitted approximately $26,000 in constant dollar deductions and we would lose $74,000 due to inflation.

Exhibit C attempts to set out the affects of H.R. 7543. I guess Mr. Bixler referred to it as the 5 and 10 approach. By accelerating the deductions for machinery and equipment, including farm tractors, over a 5-year period; the loss due to inflation is diminished to a little over $10,000. With a 10-percent investment tax credit, the expender of the funds recovers almost an equivalent amount. Inflation at the 10 percent rate, however, gives rise to an $18,000 loss due to inflation, but again is offset by the 10 percent investment credit.

And as to buildings, again a dramatic decrease in the amount lost to inflation is indicated in exhibit C.

Exhibits D, E, and F are referents to the national scene in terms of the amounts being spent on plant and equipment in current dollars, as contrasted with expenditures when the effect of inflation is deleted. They tell us something, I believe, about our modernization and our capacity in this country.

Data developed by the National Association of Manufacturers and others indicates other industrialized nations of the free world generally rank substantially ahead of the United States in terms of the period of time during which funds expended for machinery and equipment are permitted to be deducted for tax purposes. Of possible special interest as to a capital cost recovery proposal is the statement which Canada's Minister of Finance made to that country's Parliment on November 18, 1974, in commenting on the results of their experimental program permitting accelerated tax deductibility of expenditures made for machinery and equipment used in manufacturing and processing:

> Finally, in the area of business investment, I wish to announce the extension of a measure which has made a major contribution to the strong investment performance, which is improving our productivity, enhancing supply, creating new jobs and helping to sustain the Canadian economy at a time when the economies of many other nations are faltering. This measure is the 2-year writeoff of expenditures on new machinery and equipment for manufacturing and processing in Canada, which is scheduled to expire at the end of this year. I am now proposing that it be extended without a terminal date.

Whether we will soon return to only a 10-percent or a 5-percent annual rate of price increase as to buildings, farm equipment, or other production machinery remains to be seen. What does appear certain is that under our existing system of depreciation, businesses required to spend substantial sums of money on equipment or buildings cannot expect to receive a tax deduction equivalent to the dollars expended.

In addition to the already high debt to equity ratios in the private sector and the need for added capital to meet pollution control and safety requirements, Secretary of the Treasury Simon estimated on January 22, 1975, that the Government sector, including its sponsoring

agencies, will be raising $88.4 billion in the capital markets in fiscal year 1976—in contract to a total of $55.6 billion which was raised by both governmental and private sectors in 1974. With approximately $25,000 of capital equipment and plant required to support each new manufacturing job—and I understand for farmers it is $86,000, according to the June 2, 1975, issue of Business Week—the unavailability of sufficient capital funds must limit employment opportunities. It is interesting to note that according to a February 24, 1975, issue of Business Week, some 1,400,000 of the 1,549,000 jobs lost in the United States since September 1974, were in the manufacturing sector.

We believe H.R. 7543 will give needed tax relief where a demonstrated inequity exists. Tax relief which would benefit both unincorporated as well as incorporated businesses. Tax relief dependent upon the actual expenditure of funds—which expenditures must favorably impact upon our employment and inflation levels.

In proposing adoption of the investment tax credit, a Kennedy administration spokesman stated the following to the House Committee on Ways and Means:

> All of our citizens will benefit from modernization of our industry. A basic fact of economic life is that modernization and expansion are essential to higher productivity. Rising productivity will provide us with a rising level of per capita income, with resultant and widely shared benefits in the form of rising real wages and rising investment incomes. Rising productivity will also permit us to hold prices down.

Thank you for the opportunity to appear before you.

Senator NELSON. Thank you very much for your fine presentation. The text will be printed in full in the record.

First, let me say that the committee appreciates very much all of you appearing here today. The research committee of CPA's and lawyers which the Council of Smaller Enterprise set up is an example of the kind of serious research effort our committees are trying to encourage that group, and all of you I think have made a very valuable contribution to a reconciliation of the issues which we consider most important in effecting small business.

This is a joint hearing of the Small Business Committee and the Finance Committee. I think there are six members of the Small Business Committee, fortunately, who are on the Finance Committee, which has jurisdiction over tax matters. So, we were able to have some successful impact upon the tax reduction legislation that came before the Finance Committee early this year. We had a bipartisan representation there that was interested in small business and how the tax reduction proposals would affect them.

We appreciate very much the work of which all of your organizations and all of you personally have devoted to this testimony. I expect the Small Business Committee and the Finance Committee may want to call upon you in the future, in particular when the Ways and Means Committee in the House has acted, since they have to act first on tax measures.

And then we will have the issue before the Finance Committee and we will have a chance to evaluate what has been done there and its impact on small business. I am sure the chairman of the Finance Committee, Senator Long, would be happy to have the viewpoint of the small business community and in particular of this morning's

witnesses, who have put in so much time and effort in preparing your valuable statements for these hearings.

Senator JAVITS. Mr. Chairman, may I make one comment? I have to go and I would like to join the Chair in behalf of the minority, because I am the ranking member, in thanking the group. You have been very helpful.

Mr. Chairman, might we not save a lot of time if we took the discussion that went on here before Senator Byrd, and took Mr. Bixler's 5 and 10, as modified by Mr. Barnes' idea and submitted them now to the Treasury for comment? We would submit it to get their views on what they think about this effort.

I think here we have some well structured and pragmatic propositions. It would save us a lot of time, I think.

Senator NELSON. I think it would be useful, and I would direct the staff to prepare a letter for our signature to go to the Treasury and also we have met with the Canadians a year ago, with representatives of the Canadian Government just about a year ago, to discuss with them their 2-year depreciation schedule and its impact on investments and taxes. We do not have an answer to that latter question on the impact on the Treasury, although we have written to them to seek to get the answer to that. We may wish to send up some of our technical staff, as well as a committee member or two, to explore their experience in some depth, so that at the time the Finance Committee has its hearings we will not only have the opinion of the Treasury Department as to what might happen here, but we will also have the statistics on what did happen as the consequence of this act in Canada where they will be basing the information they supply us on their own actual experience, which I think could be very valuable to the Finance Committee and to the Congress in making the judgment about what kind of, if any, of accelerated depreciation program we ought to adopt.

Mr. BARNES. Mr. Chairman, I would like to make one closing comment as part of this panel, and that is that we have talked today on tax reform proposals that will accelerate the rate of depreciation, but we have not touched on tax simplification, which is very dearly needed by small business and particularly in the depreciation area where there are many, many rules and regulations that are just not needed within the context of what we are trying to accomplish.

Senator BYRD. I would like to say amen to that, but the trouble is every time Congress gets into that field, it gets more complicated.

Mr. BARNES. I have a simple solution and I say in my written testimony, or I have recommended in my written testimony, that we just abolish several procedures that are presently employed today. There will be no loss of anything other than a lot of aggrevation on the part of small business and certainly the accountants that serve them if we do that.

Senator BYRD. I think you raise a very fine point.

Mr. SUMICHRAST. Mr. Chairman, since I didn't have a chance to touch upon depreciation, may I just make a brief comment? Under present conditions there is no way you can build apartments in the United States. As a result, the housing recovery—whatever it is, and there is very little of it for most of it is in the single-family units—is just not going to occur. At the present time, there are very few apartments being built in the United States.

Now, the proposal which is being discussed on depreciation by the Ways and Means Committee, will further add to the problem and really, literally will kill whatever incentive there may be in the future to build apartments. I am warning you this is going to be a very heavy political issue next year and the year after, because I cannot see, from the numbers we have, I cannot see the feasibility of building rental projects.

Senator NELSON. When the legislation gets here, the Finance Committee would be happy to hear your viewpoints on all aspects of whatever the pending legislation is before the committee.

Senator BYRD. I would like to ask Mr. Bixler a question. Mr. Bixler, if you could have only one, which would be preferable: The investment tax credit, or the 5-and-10 depreciation rate?

Mr. BIXLER. I think, Senator Byrd, this is the same question as Senator Nelson asked me on the 19th of June. I said that the National Association of Manufacturers has no position. So I must speak only as an individual.

Senator BYRD. Yes, I was speaking in that context.

Mr. BIXLER. And in the context of our particular business, I guess the investment tax credit would be the single most important thing, because it would give us very immediate kind of approach. But the capital costs recovery in the longer term certainly has great advantage, because it would be flexible. Some years we could take it all, and other years we would not. We would certainly get our costs back a whole lot sooner. But I guess it is a very political kind of choice and what we really need is both of these things.

I was just going to take one other second to say I know we all have a lifetime habit of talking about depreciation and accelerated depreciation, but I hope the concept we can get into our vocabularies is capital cost recovery. The concept we are talking about is how to get back the costs of that, whereas depreciation always gets tied into useful life and length of service.

Senator BYRD. At one point at the beginning, I did not favor the investment tax credit, but I have changed my views a good bit on that, and I think it has been very helpful.

Mr. BIXLER. Provided it is permanent, Senator.

Senator BYRD. I think that Congress and the Chief Executive, because President Johnson was on again and off again with it, and President Nixon was on again and off with it, and Congress has been on again and off again with it, and I think we've got to decide to either take it off or leave it on. I think it leaves business up in the air otherwise.

But, the investment tax credit does cost the Treasury. Now, the accelerated depreciation, however, as I visualize it, does not cost the Treasury. It might cost the Treasury 1 or 2 years, or several years, but in the long run, the business will pay into the Government the same amount of money under accelerated depreciation as you would under nonaccelerated depreciation.

Mr. TURE. Senator Byrd, I would like to respectfully submit one qualification to your assertion about the revenue costs. I don't believe that the investment tax credit costs the Treasury money. I think the surest way for the Treasury to lose money would be to repeal the investment tax credit.

Senator BYRD. Well, I don't dispute that, but what I really meant was that there is an out-of-pocket cost to the Government, you might

say. Now, you are assuming you are going to get it back directly. I am saying the other is not an out-of-pocket cost. It might be an out-of-pocket cost for one particular year or for one particular company, but in the long run the Government is going to get the same thing back from that company.

Mr. TURE. If I might, I would like to add one further observation to what Mr. Bixler was suggesting to you. There is an obvious and understandable inclination on the part of you gentlemen who have to make the decision about this sort of thing, an inclination to try to rank the relative desirability of one tax measure versus another. I would like to affirm a statement that I offered before. The problem that we face is not one that will be solved by any one or a very small list of tax changes. I think that, in fact, the focus ought to be shifted from which are the smallest number of tax changes that we can make to deal with our problem, to exactly the opposite; to a very careful exploration of the particular financial, saving, and investment problems in one group in the economy after another.

For example, the sort of tax proposal which Mr. Bixler spoke of, which I heartily endorse, because I think it is an enormously constructive proposal, is going to be of relatively small significance to companies whose capital requirements do not take the form of fixed assets, but take the form of working capital primarily. They need a different kind of tax reduction. To them, perhaps the very best thing you could do would be to increase the surtax exemption and to reduce the corporate tax rate very substantially.

For the ordinary householder who ought to be brought into the act, contributing to the aggregate flow of saving and capital formation in the United States, for some of them the most attractive thing would be to do something by way of integrating the corporate and individual income tax, something on dividends. For others, entirely different kinds of tax relief measures are required, because for one reason or another they may not be in the equity market.

I think a point to be made is additional saving, no matter who does it and no matter how he does it, will find its way into the capital market eventually and all businesses will be claimants on it. But, you surely do not want to pick out a few particular tax changes that will disproportionately advantage one kind of business or one sector in the economy in going into that market to claim those additional resources. You want to allow everybody to get into the act.

Senator BYRD. I think you are quite right on that. What concerns me is the Congress is going to come out by disadvantaging everybody.

Senator NELSON. Thank you very much, gentlemen, for your contribution. We will resume hearings tomorrow at this same hour and in the same room, hearing from the Smaller Business Association of New England, Oliver O. Ward, president; and from the Smaller Manufacturers Council of Pittsburgh, Frank B. Fairbanks, Jr. We will also hear from the Council of Smaller Enterprises of Cleveland and the Independent Business Association of Wisconsin. These representations of regional small business organizations will be followed by a panel on the relationship of taxes to employment.

The hearing is recessed.

[Whereupon, at 12:30 p.m., the committees recessed, to reconvene at 9:30 a.m., Wednesday, September 24, 1975.]

SMALL BUSINESS TAX REFORM

WEDNESDAY, SEPTEMBER 24, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:45 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business), and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance) presiding.

Present: Senators Nelson, Bentsen, Hathaway, Haskell, Brock, Laxalt, Byrd of Virginia, and Packwood.

Also present: William B. Cherkasky, staff director, Senate Small Business Committee; Herbert L. Spira, tax counsel, Senate Small Business Committee; Judah C. Sommer, minority counsel, Senate Small Business Committee; David Allen, office of Senator Bentsen; Phillip Kawior, office of Senator Brock; Sam Ball, office of Senator Laxalt; George Pritts, minority staff, Senate Finance Committee; and Samantha Singer, office of Senator Haskell.

Senator NELSON. The hearing will come to order.

The hearing this morning will consist of two panel presentations. I understand each panel has been informed of the time limitation constraints. The first panel is made up of the representatives of: The Smaller Business Association of New England represented by Mr. Oliver O. Ward, president. The Smaller Manufacturers Council, Frank B. Fairbanks, Jr., Government Relations Committee, accompanied by Mr. William D. Barth, director of Small Business for the Worldwide Organization of Arthur Andersen & Co., and the Council of Smaller Enterprises of Cleveland with Charles McDonald, chairman, Federal Legislative Committee, accompanied by Michael A. Shemo, CPA, and William A. Tomko, CPA, Tax and Government Regulation Committee. Finally, we have the Independent Business Association of Wisconsin with Bruno Mauer, president. If each of you who speak would identify yourselves so that the reporter will have the record correct, we would appreciate it. You can divide the time however you desire in your presentation. Please go ahead.

[The prepared statements of Senators Nelson and Bentsen in full follow:]

HEARINGS BEFORE

SENATE SELECT COMMITTEE ON SMALL BUSINESS

AND

SUBCOMMITTEE ON FINANCIAL MARKETS, SENATE FINANCE COMMITTEE

September 24, 1975
9:30 a.m., Room 2221, DSOB

OPENING STATEMENT BY SENATOR GAYLORD NELSON

This morning constitutes the second day of this series of hearings on Small Business Tax Reform by the Select Committee on Small Business and the Financial Markets Subcommittee of the Senate Finance Committee.

We have found that to get at the real problems small and medium-sized independent firms have with the tax system, we must deal with the fundamental questions of business taxes and the economy as a whole. Yesterday we addressed the area of raising capital.

Today, we are examining the effect of taxes on the labor component of business output. These questions are of vital importance in the operation of small and medium-size firms and of the economy as a whole. Unemployment is currently running about 8½ percent and the prediction is that it will not go below 7 percent for a year.

It seems to me that this level of unemployment is unacceptable in terms of the human suffering involved. Small business accounts for more than one half of private employment, and has great potentials for helping the economy in this regard.

We have been fortunate with the witnesses who are willing to testify for the Regional small business organizations and those who are appearing on the panel of employment and taxes.

We appreciate the time and efforts which have gone into your appearance before the Committee and your recommendations for helping small business and the Nation with its essential tax and economic problems.

OPENING STATEMENT OF SENATOR LLOYD BENTSEN
JOINT HEARINGS OF THE
SENATE FINANCIAL MARKETS SUBCOMMITTEE
AND THE
SENATE SMALL BUSINESS COMMITTEE

Wednesday, September 24, 1975

This morning we resume the second day of hearings on the financial problems facing small businesses.

Our Nation's small businessmen have been facing a particularly difficult time during these periods of recession, inflation and energy shortages. Their costs have gone up. Demand for their products and services has generally declined. As a consequence, many smaller firms are faced with a serious profit squeeze.

In turn, those small enterprises that want to modernize and expand have been finding it very difficult to raise capital. The interest rates smaller firms must pay are often excessive. Yet the success of the small businessman is very important to the entire economy. They employ about half of the private work force in our Nation.

What we have to do is to try to find ways to cut Government redtape and paperwork which is burdening the small businessman. We must provide tax equity for small enterprises.

In this regard I recently introduced legislation along with Senator Nelson to extend the provisions of the 1975 Tax Reduction Act which apply to small business and also introduced legislation to provide simplified reporting requirements for small businessmen under the new pension act.

Today I am introducing legislation to require all Congressional Committees to include in their legislative reports an estimate of the forms and record-keeping requirements anticipated by the enactment of new legislative proposals.

What we are looking for is a return to the climate of economic opportunity that has promoted broad-based growth in America since our beginning. Economic growth that is stable and vibrant. Economic growth that is not inflationary.

Economic growth that will keep prices down as it works to put unemployed Americans back to work.

The small business hearings that Senator Nelson and I are chairing will help us develop sound proposals to achieve these goals.

63-209 O - 76 - 14

PANEL PRESENTATION OF THE REGIONAL SMALL BUSINESS ORGANIZATIONS: SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, OLIVER O. WARD, PRESIDENT, ACCOMPANIED BY EDWARD PENDERGAST, PAST PRESIDENT; SMALLER MANUFACTURERS COUNCIL, FRANK B. FAIRBANKS, JR., VICE CHAIRMAN OF THE GOVERNMENT RELATIONS COMMITTEE, ACCOMPANIED BY WILLIAM D. BARTH, DIRECTOR OF SMALL BUSINESS WORLDWIDE ORGANIZATION OF ARTHUR ANDERSEN & CO.; COUNCIL OF SMALLER ENTERPRISES OF CLEVELAND, CHARLES McDONALD, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, ACCOMPANIED BY MICHAEL A. SHEMO, CPA, SCHULTZ, KRAHE, MARTIN & LONG, WILLIAM A. TOMKO, CPA, TAX AND GOVERNMENT REGULATION COMMITTEE, AND DAVID BARNES, CPA, COOPERS & LYBRAND, CHAIRMAN, TAX AND GOVERNMENT REGULATION COMMITTEE; INDEPENDENT BUSINESS ASSOCIATION OF WISCONSIN, BRUNO MAUER, PRESIDENT

Mr. WARD. Good morning, Mr. Chairman and members of the committee. Lest you look upon us in horror at the conglomeration of bodies here——

Senator NELSON. Would you identify yourself please?

Mr. WARD. I am Oliver Ward, president of the Smaller Business Association of New England. I have with me Edward Pendergast, who is past president of the association, who will also testify. In order to leave time for answers, each group will limit itself to 15 minutes.

We thank you for this opportunity to testify once again before this committee, this joint session. We are here today with our fellow regional small business associations in order to bring your attention, especially, to the needs of small business.

We would like at the outset to make several points. We think the point too often is lost in Washington that with few exceptions, like universities and not-for-profit organizations and the like, there are only two major employers in the United States who are sustainers of people: One is business and the other is Government, either in the form of Government payroll or Government assistance in one form or another. Of course there is ultimately one who bears the expensive burden of the Government route and that is the productive earner who pays taxes. Unless we can create a favorable economic climate in which business may grow and prosper, we will continue to have a totally unacceptable number of people on unemployment or welfare.

I noted in your opening statement, Mr. Chairman, you made reference to the unemployment problem which we have seen. With the exception of those who are genuinely unable to work, it seems to us that the number of people on unemployment or welfare is a terrible indictment on all of us to the effect that we have not been able to design a system that really works.

Senator NELSON. Are you reading from your statement or talking extemporaneously?

Mr. WARD. No, I am not. I'm really sort of summarizing it.

Senator NELSON. Fine. All prepared statements will be printed in full in the record. We appreciate your summarizing it because I think we wouldn't get through within the time limitations if everybody read theirs. Thank you.

Mr. WARD. Thank you. We are not here asking for handouts or subsidies. We are asking for a climate conducive for corporate growth. Corporate growth translates directly to more people working. That in every respect is to be desired. We are trying to work with you toward that end.

We continue to see, particularly in the administration and to some extent in the House Ways and Means Committee, considerable bias in favor of large business. In a meeting we had in the White House a few weeks ago with Deputy Secretary of the Treasury, Stephen Gardner, the administration set forth and defends its only proposed solution to the capital shortage; namely, the integration of the tax system.

Senator NELSON. The what?

Mr. WARD. The integration of the tax system; in other words, the taxes on corporate earnings and the taxes on the individual receiver of dividends. While we are not opposed to that proposal as such, we find it standing alone is outrageously discriminatory against small business. We see it fundamentally as a retroactive tax break for the current shareholder. What we suggest is an incentive system of benefits which will be given for a positive beneficial action by the taxpayer; namely, investment. Small business will in the aggregate desperately need capital in the decade ahead. It is hardly in a position to benefit from proposals which would reduce the tax on dividends since small business is seldom in a position to pay dividends.

Isn't a tax throwoff or a dividend, as it is usually called, fundamentally an admission that the growth potential of a country is over or at least severely limited? Doesn't this sort of proposal fundamentally benefit the least productive corporations?

When we pointed out to the administration or rather to the Secretary the discriminatory aspects of these proposals, we were told: "Don't let that bother you. The benefits will filter down to smaller businesses." It seems to us that is something like saying "Fear not those of you who travail and are heavily ladened, for you shall be sustained by the crumbs that are cast from the table." We suggest our proposals for restructuring the long-term capital gains tax would be far more efficient and effective to the system. What we are proposing is that the holding period be changed from 6 months to 1 year; the rate from 1 year to 5 years holding be 35 percent and from 5 to 10 years it be 25 percent; and for holding in excess of 10 years it be 12.5 percent.

Senator NELSON. Just to check my memory for me, is that basically the Bentsen bill? Are you familiar with that?

Mr. WARD. Mr. Chairman, I'm not familiar with that.

Senator NELSON. Senator Bentsen has introduced a bill along that line.

Mr. WARD. What we are also suggesting is that this proposal be limited to direct investments. In other words, for a company that goes directly into a company, we are suggesting that trading or speculation in the existing securities be excluded from it and that it only apply where the money goes into the company. It seems to us this is more efficient insofar as the Treasury loss would occur at a future date in many instances 10 years and would apply only where a desired action has occurred, namely, in investment. By limiting it to direct investments, the reduction in the Treasury would also apply only where there were more jobs and equipment as such.

Senator LAXALT. Can you explain again what you mean by "direct investments?"

Mr. WARD. What we are talking about is there are two kinds of stocks: Primary stock and secondary stock. Primary stock has been issued directly by the corporation and is purchased by a shareholder. Secondary stock is where it comes from one shareholder to another shareholder. In other words, we are excluding what is traded on the exchanges. What we are talking about is these lower rates would only apply when an individual makes an investment directly into a company.

Senator BROCK. The rate is not paid unless you sell the stock, is it?

Mr. WARD. Pardon me?

Senator BROCK. The rate is not paid unless you sell the stock.

Mr. PENDERGAST. The tax is not paid unless you sell the stock.

Mr. WARD. Yes; it is not until you have a long-term capital gains tax we are talking about.

Senator BROCK. Would you elaborate on that?

Mr. WARD. Well you have the gain and you would then sell the stock and it would become the same stock as any other stock once it is sold. But the person who made the direct initial investment into the company, when he sells it, he gets the tax gain.

Senator LAXALT. You are talking about a closely held company?

Mr. WARD. No; I am not. This would apply to any direct——

Senator BROCK. When the second purchaser holds it for 10 years, what you would tax him at?

Mr. WARD. I would hold him under the present system. What I am suggesting here is a system designed to produce a desired effect, namely, direct investments which produce jobs. In other words, when somebody buys General Motors stock on the New York Stock Exchange and they hold it for 180 days, they haven't done anything for the economy. If somebody buys a new issue of stock, even if it is General Motors, something very positive happens; you have new money coming into the company which then gets translated into jobs.

Senator LAXALT. The sale of the assets rather than securities?

Mr. WARD. Well I don't think you would get involved in the sales of assets.

Senator LAXALT. Well, isn't that a method by which you can dispose of a small business just as well dealing in securities?

Mr. WARD. Oh, I see what you are saying. You are saying from the point of view of the individual, if an owner of a small business has it? Well, there isn't any reason why you couldn't make these provisions apply in that instance. I'm thinking more in terms of the case of stock and the long-term capital gains tax applies to that and that is probably the most common form, but there isn't any reason why it couldn't apply to the sale of assets in a small business. What I am trying to suggest is a system that would apply to any business, big business or small business, and the tax break would only be received when something positive and beneficial was done.

Senator HATHAWAY. But you say the second buy doesn't do anything for the economy, but he actually does because he maintains the market for the securities, which is extremely important because if there isn't any market, the first issue isn't going to go for very much.

Mr. WARD. Well, this is true. He is supporting the market now with the present system. In other words, we are not suggesting that any changes be made that are adverse to his interests.

Senator BROCK. You are saying a tax break occurs only to the first purchaser of a new issue?

Mr. WARD. Correct, because he is the one who is doing something where the money goes straight into jobs.

Senator HATHAWAY. We are saying the second purchaser is also very important and he ought to get the same tax break.

Senator BROCK. I don't know how you can discriminate.

Mr. WARD. Don't forget that he is getting a present tax break right now through the system now. In other words, right now there is a tax break for that person.

Senator BROCK. No, but if you motivate people to go into the first issue market, then you destroy the second issue market; therefore there is no motivation for that market. You are killing the goose who laid the golden egg. You are killing the motivation for the guy to make the investment at all.

Mr. WARD. I don't think you would destroy the second market.

Senator BROCK. But you are certainly discriminating against him.

Mr. WARD. Well I prefer to look at it in terms of you are——

Senator BROCK. I mean it is patently ridiculous to say that the existence of a market is not serving the interests of the economy. That is what you are saying.

Mr. WARD. Ultimately it is serving the interest of the economy.

Senator BROCK. Ultimately and very directly.

Mr. WARD. There is no question but that is true. But if you can do something to encourage people to make investments, you are doing something very positive.

Senator BROCK. That is what they do on the New York Stock Exchange. They are making an investment.

Mr. WARD. But they are not making the same kind of an investment.

Senator BROCK. Yes, they are. For that purpose it is exactly the same kind of investment. He is purchasing a share of a corporation and thereby contributing.

Mr. WARD. But the money doesn't go to the corporation. The money doesn't go into new jobs. It goes into somebody else's pocket.

Senator BROCK. That is for the person who got the stock in the first place to decide. If he couldn't sell that stock, he wouldn't get it in the first place.

Mr. WARD. I understand and I agree with you, but we are not suggesting the destruction of the marketplace. All we are suggesting is a further gain to the person who makes a direct investment and holds it for a long period of time.

Over on the House side in the Ways and Means Committee we know that last week Chairman Ullman said that he would support a continuation of the investment tax credit and that is all of the emergency tax act of earlier this year. This seems to us to be highly disproportionate. There seems to be to us highly disproportionate benefits to the investment tax credit insofar as some 300 corporations received over half the benefits. It seems to us that this again is discriminatory against small business. We find it incredible that Ways and Means will entertain that proposal, but at the same time will not extend either in time or amount the surtax exemption.

With reference to the surtax exemption, Congress has recognized since the thirties in over 10 revenue acts that a unitary corporate tax structure is not desirable. Even at that time, $25,000 was legislated as the dividing line. It is again self-evident that inflation alone requires an increase to at least $100,000. The temporary increase in the exemption earlier this year was largely due in large measure to the actions of your committee.

On the matter of the estimated tax payments, which we go into in some detail in the written testimony, a growing company's most significant need is cash flow. During this period of growth, increase and inventory and accounts receivable leave a corporation with little or no available cash, working capital. The present estimated tax payments schedule presents a disastrous doubleup of cash flow requirements for taxes. This occurs at the very period the growth company most needs cash to purchase equipment and hire people. We suggest as one possible solution, that the total Federal tax payments not exceed 125 percent of the prior year's tax liability.

We advocate a liberalization of the permissible life of corporate assets, coupled with a greater flexibility as to when the depreciation may be taken and in what amounts.

We finally ask that the DISC program, which has been assailed from all sides because of the Treasury report showing benefits to the largest corporations, be considered to be retained at least for small business. The fallacy is that the reaction time of new legislation for small business is significantly slower than for large business. Based

on our own surveys we submit that small businesses are now for the first time exporting that significant numbers. As far as small- and medium-size businesses are concerned, the DISC legislation is doing exactly what Congress has intended and we ask that it be retained at least to the extent of $2 million or $3 million or $4 million in earnings.

Mr. Pendergast?

Senator NELSON. Go ahead. We will get the main presentations first and then probably it would be better to go to questions, although if the members of the committee have any, you can go ahead and ask them.

Mr. PENDERGAST. My name is Edward Pendergast. I am chairman of the Smaller Business Association of New England's Tax Committee. I am not going to go into any great detail and testimony. I'm here primarily to help answer questions.

I would like to reiterate one or two points Mr. Ward has made and put some strong emphasis on what I think personally is the single most important thing that Congress can do to help small businesses under the present tax structure we are talking about. That is to increase the surtax exemption from $25,000, which initially was started as the differentiation in the late thirties, to $100,000, which the cost of living makes the equivalent to 1930 dollars. This would bring into the pocket of the small businessman with taxable income of $100,000 over $6,500 which he could use for investment in jobs and equipment.

Senator NELSON. $6,500 over the amount produced with the surtax exemption at $50,000?

Mr. PENDERGAST. Yes; that is what I said, the taxable of $100,000. I mean the way the present legislation is set up, the benefit for the first $25,000 is relatively small, that is, it is $500.

If the growth of small business is considered to be a desirable element in the economy, I think that this in itself would be the most significant thing that could be done. I'm not going to go into extensive detail because our testimony has some of the supporting documentation, and I don't want to take additional time.

Senator NELSON. Well, thank you. As I said, your prepared statements will be printed in full in the record.

[The prepared statement of Mr. Ward in full follows:]

STATEMENT OF

OLIVER O. WARD, PRESIDENT
GERMANIUM POWER DEVICES CORPORATION
ANDOVER, MASSACHUSETTS

AND PRESIDENT OF THE

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.
69 HICKORY DRIVE
WALTHAM, MASSACHUSETTS

AND

EDWARD H. PENDERGAST, JR., CPA
PENDERGAST, CREELMAN & HILL
BOSTON, MASSACHUSETTS

PAST PRESIDENT OF THE
SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

HEARING

SELECT COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

WEDNESDAY, SEPTEMBER 24, 1975

Messrs. Chairmen and Members of the Committee:

Thank you for this opportunity to testify before this august Committee.

We would like to express our appreciation for your efforts on our behalf with reference to the Tax Reduction Act of 1975. Whereas the Administration's proposal would have given the corporate tax relief to the 5,000 largest corporations, namely, those with incomes over $1 million, the Act actually spread the relief over all corporations which pay federal taxes this year. We are convinced that without your help, we would not have seen this Act in the form we did. You can see from Exhibit A the extent of the Administration's original proposal's benefit to large business. Some other alternatives are also outlined.

Our program for major elements that small business needs for survival are:

1. $100,000 surtax exemption

2. Change in estimated tax for corporations

3. Depreciation changes

4. Retain Domestic International Sales Corporations

5. Restructure capital gains tax

We represent small and medium-sized business. We wish to stress the concept of medium sized with reference to the small business community, those corporations which range from 20 or so employees to 500 employees, which may be translated to sales of $500,000 to $15 million, the economic backbone of our economy. We note that most European countries, notably France, Germany and Belgium, use the term

small and medium-sized business. We feel that all too often only the largest and smallest businesses get attention from our government. It is from this medium-sized category of business that flows the intense competition, lower prices, higher quality, and new technology all essential to an efficient economy.

We are concerned by the declining share of business done by those other than the largest corporations. Whereas one employee in four in 1960 worked for either big business or the government, by 1975 that had reached one out of three. We do not view this as healthy for the country. We who are already in small and medium business are not threatened as such. From the point of view of the country and the economy, we are concerned with the lack of new business formations. If the growth of these businesses, through a variety of machinations is not encouraged, the natural attrition of established small and medium businesses, coupled with the proclivity of government and large business to grow, will cause small and medium-sized business to constitute a continuing declining share of employment and innovation.

The economies of scale are over-rated.

The opportunities for abuse are manifest.

Small and medium-sized, independent business due to its nature of being small, fragmented, and diverse does not accumulate tremendous power in the marketplace and government itself. These very characteristics are both advantageous for the country and disadvantageous to small business in the political process where it comes to making small business' views known.

We are addressing ourselves today in particular to the capital formation issue. Capital formation basically comes from three sources:

1. Equity financing.
2. Borrowing.
3. Retention of Profits.

It is self evident that equity financing is virtually unavailable at this time.

The data compiled by the MIT Development Foundation vividly illustrates capital starvation that the small business faces today. Exhibit B shows that gross proceeds for financing small companies dropped from $568.5 million to $16.1 million in 1974 with no public offerings in the first quarter of 1975. The Foundation also points out, "We are now in a period of where there is essentially no venture capital available for so-called start-up enterprises, the national environment for such activities has been adversely affected and as a result, we may very well have a decade of hiatus where no Polaroids or Xeroxes will be initiated."

Borrowing for small business is seriously limited by the squeeze caused by the demands of big business and the various governmental bodies on the limited supply. The competition for funds will be tremendous. It has been estimated that over $300 billion a year will be required between the years of 1977-1980 to finance the growth of America.

Small business is not able to tap some of the principal sources of borrowed money that is available to the large business. Commercial paper, debenture offerings, and long-term loans are not available to small business. The small businessman must rely on friends and on the local bank. In this economy, friends are not interested in speculative investments. The local bank is able to invest its money in attractive, lower-risk investment opportunities. Many banks use this type of economy to "clean-up" their portfolios, thereby limiting, and in some cases, drying up small business' access to the debt market. At the same time, inflation has increased costs and amounts needed for financing. More complex revenues and more selective screening of loan applicants means more delay and increased legal and accounting costs.

What is left is the retention of earnings as the principal source of funds. Assistant Secretary Frederic Hickman recently put it well when he said that we must affect the decision made by anyone who is able to save as to whether he invests in the future growth of America or goes to Jamaica on holiday.

What affects that decision? Ultimately, that decision will be made on how attractive it is to invest in a business, large or small. As the government begins to draw huge amounts of money out of the marketplace to finance its deficit, interest rates will surely rise again. We note the prime rate has already started to rise. This makes for tough competition for what money is left. Large business, generally able to pass on its costs, including high interest, to the consumer, tends to be concerned more with availability than cost. Small business which frequently has its prices determined by market conditions rather than costs must absorb such increases. Last year interest rates for small business (usually at prime and 3 or so points) was paying effective rates of 15-16%. That is, if it could get money at all.

As a result of its inability to go to the traditional capital markets, if a growing business is to be able to retain a reasonable portion of its earnings to finance that growth, it needs a better tax climate. If the tax law is allowed to revert to the pre-1975 status, a corporation with taxable income of $200,000 will have a liability of $89,500 or 45% of these pre-tax earnings. This payment to the federal government deprives him of almost half of the money he could otherwise reinvest in business expansion and additional JOBS.

We propose:

1. Raising the surtax exemption to $100,000.
2. Moderation of the corporate estimated tax payment schedule.

3. Depreciation liberalization and increased flexibility.

4. Retention of the Domestic International Sales Corporation (DISC), particularly as it applies to small and medium-sized business.

5. Capital gains structure should be revised to encourage long-term direct investments.

With reference to the surtax exemption, Congress has recognized since the 30's in over 10 revenue acts (Exhibit C) that a unitary corporate tax structure is not desirable. Even at that time, $25,000 was legislated as the dividing line. It is again self evident that inflation alone requires an increase to at least $100,000. This increase will die unless permanent action is taken. We feel this is a long-term issue whose time is not now. For the moment, bring us out of the 30's and into the 70's by raising the surtax exemption to $100,000.

On the matter of the estimated tax payments schedule, a growing company's most significant need is cash flow. During this period of growth, increase in inventory and accounts receivable leave a corporation with little or no available cash. The present estimated tax payment schedule presents disastrous double-up of cash flow requirements for taxes. Exhibit D demonstrates how a corporation earning $300,000 might have to pay in excess of $265,000 or 88% of its pre-tax earnings in one year! This occurs at the very period the growth company most needs cash to purchase equipment and hire new employees. We suggest as one possible solution, that the total federal tax payments not exceed 125% of the prior year's tax liability. The same corporation paying over 88% of its pre-tax earnings would have its cash requirements for payments of federal income taxes

reduced from $265,000 to $164,000. The corporation's tax liability would not be reduced but payments would be extended over a longer period of time. When earnings stabilize and cash needs moderate, the corporation would catch up.

We advocate a liberalization of the permissable life of corporate assets coupled with a greater flexibility as to when the depreciation may be taken and in what amounts. At present depreciation life and method cause some of the major disputes between the IRS and the taxpayer. Essentially, the argument is not in amount of tax due but year of liability. England allows expensing of plant property and equipment in years of purchase. Canada allows some selection as to how much depreciation and in which year the depreciation can be taken. The proliferation of legislation now leads the poor small businessman through code section after code section (1238, 1245, 1250, and 38 to name a few). He must choose first year bonus or not. He must decide, straight-line, double declining, 150% declining or sum of the years digits. Depreciation life selection is ruled by general rules, possibly old Bulletin F, Rev Proc 72-10, and now "The Class Life Assets Depreciation Range". God help the poor taxpayer. End this nonsense and provide simple rules with flexibility like Canada's.

The DISC program has been assailed from all sides because of the initial Treasury report showing a huge preponderance of benefits to the largest corporations. The fallacy is that the reaction time to new legislation for small business is significantly slower than for large business. Based on our own member surveys, we submit that small businesses are now for the first time exporting in significant numbers. As far as small and medium-sized businesses are concerned, the DISC legislation is doing exactly what Congress has intended and should be preserved.

As to long term capital gains, we advocate indexing on the basis of an investment. This would have the effect of protecting the purchasing power of the investment prior to the taxation of any real gain.

We might consider a reduced capital gains tax rate for direct investment in small enterprises. This would be an effective incentive to move venture capital in to seed money situations and start-ups. An immediate income tax deduction for investors for direct investment in small enterprises would also be an effective incentive for start-up financing. The investor would have a zero tax base, the capital gains tax to be levied on disposition.

As an alternative, we advocate changing the long term capital gains rate. We suggest extending the minimum holding period to one year. For one to five years we suggest a tax rate of 35%; 5-10 years, 25%; and over 10 years, 12½%. This would have the effect of somewhat inexactly adjusting the inflation. It would also encourage long term productive investments. Also, with an eye to prospective eventual Treasury loss, we feel that it would be reasonable to limit such lower long term capital gains rates.

In a meeting in the White House on August 27, 1975, with Deputy Secretary of the Treasury, Stephen S. Gardner, the Administration set forth and defended what is to date its only proposed solution to the problem of capital formation; namely, the integration of the tax system.

While we are not opposed as such to these proposals, we find them outrageously discriminatory against small business. Furthermore, we feel that the proposals will serve more as a retroactive tax break than as an incentive for future beneficial action.

Small business will in the aggregate desperately need capital. It is hardly in a position to benefit from proposals which will reduce the tax on dividends since small business seldom is able to pay dividends. For the Administration to take the position that a positive effect will "filter down", obscures the fact that the proposal is pro big business and, by virtue of being, in effect, inapplicable, anti-small business.

We do not see the proposals so much for the incentives they purport to give as being a tax break for shareholders.

With reference to our proposals for lower long-term capital gains taxes, we are suggesting that they be restricted to direct investments. We are also suggesting long qualifying holding periods for the lowest rates. These proposals require that an investment be made directly with the obvious desired effect of providing capital for new jobs and equipment. We do not ask that they apply to trading or speculation in already existing securities.

Our proposals would benefit both large and small business.

We think the point is too often lost here in Washington that with few exceptions (universities, not-for-profit organizations and the like), people are employed or sustained by only two significant sources. One is business and the other is government. The latter may be in the form of government payroll or on one form of welfare or another. We think that unless the government helps to create a favorable economic climate in which business may grow and prosper, that we will continue to have a totally unacceptable number of people on unemployment or welfare. We are not asking for handouts or subsidies. We are asking for a climate conducive to corporate growth.

We submit some additional suggestions:

1. Sub-Chapter S -- increase maximum number of shareholders from 10 to 15 and allow some trusts to hold shares.

2. Section 303 -- Redemption -- reduce the limit from 35% of the gross estate or 50% of the taxable estate to 20% and 40% respectively.

3. Interstate Taxation -- twice passed the House. This Act would establish uniform jurisdictional standards for Interstate Taxation.

In conclusion, we reiterate our five major points:

1. Raising the surtax exemption to $100,000.

2. Moderation of the corporate estimated tax payment schedule.

3. Depreciation liberalization and increased flexibility.

4. Retention of DISC, particularly as it applies to small and medium-sized business.

5. Capital gains structure should be revised to encourage long term direct investments.

Thank you for the opportunity to present our recommendations on the critical issues of tax reform.

62-209 O - 76 - 15

SEPTEMBER 24, 1975

EXHIBIT A

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

EFFECTS OF VARIOUS APPROACHES TO REDUCTION IN CORPORATE TAX RATES

Size of Corporations (000's omitted)	0-25	25-50	50-100	100-250	250-1,000	Over 1,000	Total
# of Corporations (1970)	584,057	64,339	40,835	26,681	13,725	4,806	734,443
	79.5%	8.8%	5.6%	3.6%	1.9%	.6%	100.0%
Average Benefit							
Plan I 22% to $50,000, 48% on excess	None	$ 2,700	$ 6,500	$ 6,500	$ 6,500	$ 6,500	
Plan II 22% to $100,000, 48% on excess	None	2,700	11,450	19,500	19,500	19,500	
Plan III 20% to $50,000, 45% on excess	$ 153	3,400	8,070	10,580	32,060	315,500	
Plan IV 20% to $100,000, 45% on excess	153	3,400	12,800	23,080	32,410	328,000	
Plan V 22% to $25,000, 48% on excess	None	670	2,850	8,270	30,000	667,500	
Cost to Treasury (Millions)							
Plan I 22% to $50,000, 48% on excess	None	194 (23.4%)	296 (35.7%)	204 (24.6%)	100 (12.0%)	36 (4.3%)	830 (100.0%)
Plan II 22% to $100,000, 48% on excess	None	194 (11.4%)	522 (30.7%)	581 (34.2%)	299 (17.6%)	104 (6.1%)	1,700 (100.0%)
Plan III 20% to $50,000, 45% on excess	98 (3.1%)	241 (7.6%)	365 (11.5%)	310 (9.8%)	485 (15.3%)	1,671 (52.7%)	3,170 (100.0%)
Plan IV 20% to $100,000, 45% on excess	99 (2.6%)	241 (6.3%)	577 (15.1%)	680 (17.8%)	489 (12.8%)	1,734 (45.4%)	3,820 (100.0%)
Plan V 22% to $25,000, 48% on excess	None	43 (1.1%)	116 (3.0%)	221 (5.5%)	417 (10.3%)	3,203 (80.3%)	4,000 (100.0%)

SEPTEMBER 24, 1975 EXHIBIT B

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

FINANCING DATA FOR SMALL COMPANIES

		Est. Gross Proceeds from New Offerings (1)	Small, New Co. Offerings (2)	Small Co. as Percent of Gross Proceeds
		(All Dollar Figures in Millions)		
1968		$ 4,583	$ 568.5	12.4%
1969		8,396	1,102.8	13.1%
1970		8,630	385.5	4.5%
1971		13,237	527.8	4.0%
1972		14,062	921.0	6.5%
1973		11,023	157.5	1.4%
1974		6,304	16.1	0.3%
1975	1 Qtr.	N.A.	none	N.A.

(1) Estimated gross proceeds from new equity securities offered for cash in the United States. (Excluding offerings by issurers not required to file new securities offerings under the Securities Act of 1933.) Source: Securities and Exchange Commission

(2) New offerings of small companies. Includes all "firm" underwritings of equity securities of less then $5 million for companies with net worth prior to offering, of less that $5 million. Excludes Regulation A offerings, "best efforts" sales, government securities and foreign issues. Source: SBIC/Venture Capital, published by S. M. Rubel & Company, Chicago

N.A. Not Available

Data Supplied by MIT Development Foundation

SEPTEMBER 24, 1975 Exhibit C

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

HISTORY OF INCOME TAX ON CORPORATIONS 1936 - 1974

Revenue Act	Income for	Net Income	Rate (Per Cent)
1936	1936, 1937	First $2,000	8
		Next $13,000	11
		Next $25,000	13
		Remainder	15
1938	1938, 1939	First $5,000	12½
		Next $15,000	14
		Next $5,000	16
		Over $25,000	19
1940	1940	First $5,000	13½
		Next $15,000	15
		Next $5,000	17
		Over $25,000	24
1941	1941	First $5,000	15
		Next $15,000	17
		Next $5,000	19
		Over $25,000	to 31
1942	1942-1945	First $25,000	15-19
		Over $25,000	to 40
1946	1946-1949	First $25,000	15-19
		Over $25,000	to 38
1950	1950	First $25,000	23
		Over $25,000	42
1951	1951	First $25,000	28 3/4
		Over $25,000	50 3/4
	1952-1963	First $25,000	30
		Over $25,000	52
1964	1964	First $25,000	22
		Over $25,000	50
1965	1965-1974	First $25,000	22
		Over $25,000	48

SEPTEMBER 24, 1975

EXHIBIT D

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

CALENDAR YEAR CORPORATION

Year	Taxable Income	Federal Taxes Due (Cash Flow Basis)
1972	$200,000 loss	None
1973	break-even	None
1974	$200,000 taxable income	None
1975	$300,000 taxable income	None
1976	$300,000 income	$265,800

Due Dates	1975 Tax Payments	1976 Estimated Tax Payments	Total Tax Payments
March 15	$65,250		$ 65,250
April 15		$33,825	33,825
June 15	65,250	33,825	99,075
September 15		33,825	33,825
December 15		33,825	33,825
			$265,800

Senator NELSON. Who is next?

Mr. FAIRBANKS. Mr. Chairman, I am Frank B. Fairbanks, Jr., president of Horix Manufacturing Company, a manufacturer of packaging machinery located in Pittsburgh, Pa. I am the vice chairman of the Government Relations Committee of the Smaller Manufacturers Council (SMC). SMC is a trade association headquartered in Pittsburgh, with approximately 600 member companies in Pennsylvania, Ohio, and West Virginia, with a combined employment of over 55,000 people.

Mr. William Barth, director—small business, of Arthur Andersen & Co., is with me today to give testimony, also.

Arthur Andersen has been most helpful in the preparation and review of our SMC material. Furthermore, Mr. Sheldon Ausman, currently managing partner of the Pittsburgh office of Arthur Andersen, and formerly partner in charge of the Small Business Division of the Milwaukee office, is also here today in the audience to help answer any questions you may have.

SMC appreciates the opportunity you have given us to go into some of the problems which are causing difficulty for our members.

I would like to say that our concern here is the perpetuation of the smaller and independent enterprises and the jobs that such firms provide. We do not ask for preferential tax treatment, but rather changes that will provide us an opportunity to compete on a more equal basis with large corporations.

Many studies by national business trade organizations, with which I am sure you are familiar, have documented the relationship between capital investment and job growth. Further data, presented as appendix A, reveals that the growth of small business would be even more productive in the expansion of jobs because small business is more labor intensive.

Senator LAXALT. What was that last statement?

Mr. FAIRBANKS. In our opinion, small business, and I am speaking here of manufacturers, is more labor intensive. I'm speaking specifically of manufacturers in that regard.

As the SBANE representatives previously have stated and in the opinion of most SMC members, the most significant action which the Congress could take to aid small business growth would be to make permanent the present 1 year temporary corporate surcharge exemption of $50,000, and thereafter to increase it to a level of $100,000. Further, to compensate for inflation, the $100,000 level should have provision for automatic adjustment with the cost of living.

In the matter of the investment tax credit for small business, we feel that special consideration should be given to small business. Surveys by such associations as the National Association of Manufacturers have documented the fact that the investment tax credit, in its present form, provides significantly greater benefit to large companies than to smaller companies. To correct this inequity, we strongly support a permanent graduated investment tax credit as follows: 25 percent of the first $3,000, if 3 or more years of useful life; 20 percent of the amount between $5,000 and $25,000, if 3 or more years of useful life; and 15 percent of the amount between $25,000 and $50,000, if

3 or more years of useful life. Above $50,000 the present investment tax credit provisions would apply with the usual requirements of 7 years or more of useful life for 10 percent, and graduated down for shorter lives.

Senator LAXALT. How did you arrive at those percentages?

Mr. FAIRBANKS. Arbitrarily.

Senator LAXALT. Just arbitrarily?

Mr. FAIRBANKS. Rather arbitrarily, Senator.

Senator LAXALT. That is necessarily the way it is done I think.

Mr. FAIRBANKS. Yes. I guess any of these are rather arbitrary. It was our feeling that there are many very small companies that don't even buy very many long-lived assets. Maybe the biggest purchase they have is an automobile where it probably has a useful life of 3 years. For this reason we are proposing a fairly high tax credit at the low end to help the really small business and not putting much of a restriction on the life of the assets.

Further as an aid to small business, we feel the temporary limit of $100,000 for used equipment should be made permanent. That is presently temporary.

Next I would like to tell you a little bit about the natural gas shortages as they affect SMC members. One of our members was forced by a local gas company to take a 40 percent cutback. Due to the nature of his process, which was the firing of ceramics, he could not convert to oil or to coal. So what he had to do was install facilities to handle propane at a capital cost of about $200,000. Propane on an equivalent heating basis is approximately three times as expensive as natural gas. It is also my understanding that most propane is made from natural gas. So it is a question of whether we are really saving energy with the present pricing restrictions on natural gas.

I should also mention he tried from several sources to buy so-called deregulated gas, but his size was such that the gas well owners were not interested in getting involved in such a small contract in their opinion. Also, many of our SMC members have been threatened with curtailment of operations because of the natural gas shortage and forced to in some cases to install oil heating facilities.

We feel that legislation is urgently needed which will increase the availability of natural gas through regular distribution channels. We don't particularly advocate one approach or the other, but we think this is a serious problem for small business.

As I mentioned earlier, the survival and growth of small business is directly related to the growth and survival of a very considerable number of jobs. Two of the most significant elements in the continuity and survival of small enterprises are, (1) capital gains taxes on the sale of closely held businesses, and (2) estate taxes. Our consultant, Bill Barth, will explain later in detail the ways in which present tax laws work against the long-term survival of the independent business and a proposal to correct that in equity.

But let me, for the moment, try to explain the estate tax problem. If there are unreasonable limitations on the ability of my company to survive at the death of the owners, I may lose the incentive to operate the business in such a manner as to anticipate the continuation of the

organization as a separate entity. Rather, I may pursue policies aimed at maximizing short-term return on investment, with a view toward sale to a large public company. Fortunately, in my company we are in what we believe to be excellent financial condition. We do not conduct our business in the manner I have suggested. Personally, I look forward to our company remaining independent and continuing to serve the needs of our customers. Further, it is my opinion, based on personal contact with other SMC member companies, that most SMC members are desirous of maintaining further continuity of their business. In many cases that may include the continued interest and involvement of future generations of the family owner.

Unfortunately, the present estate tax laws make the continuity of small, independent enterprises very difficult at the time of the death of an owner. It is the opinion of SMC that the Congress should act to encourage the survival of independent businesses at that time.

Specifically, we advocate the following: The $60,000 estate tax exemption has not kept up with inflation. It should be increased to at least $180,000. The estate tax rates up to $1 million of taxable estate should be reduced, as I have detailed in my written presentation.

We feel that greater liberalization of section 303 redemption rules is desirable. We feel to provide more equitable treatment for unmarried stockholders, including widows, and to offset the effect of the recent sharp decline in the value of small companies, the requirements for eligibility for a section 303 redemption should be reduced to 40 percent of taxable estate or 20 percent of gross estate. Again, I have given considerable supporting arguments in my written presentation.

The recent law which raised the interest rates charged on tax delinquencies has had an unfortunate effect in that it raised the interest rate on section 6166, which permits, under certain conditions, a 10-year payment of estate taxes on small business interests. We feel that the old 4 percent rate should be reinstated, or at least a 6 percent rate is more equitable.

Senator NELSON. Senator Mondale is both a member of the Small Business Committee and the Finance Committee—and, of course, this is a joint hearing—and he has introduced a bill along these lines. It has been cosponsored, I think, by many members of both committees. Have you looked at that bill or would you have your tax people look at it?

Mr. FAIRBANKS. We would be happy to do so.

Senator NELSON. I think it was just introduced this week or last week. Could you give us a little memorandum of your evaluation? Of course, that proposal should have a hearing before the Finance Committee, at the appropriate time, and you would have an opportunity to testify on it. But, I think it might be helpful if you could give us a little memorandum on it. I cosponsored the bill and we will list the cosponsors in the record.[1] We would appreciate a brief memorandum evaluating that bill that Senator Mondale put in. Could you do that?

Mr. FAIRBANKS. I would be very happy to.

[Mr. Fairbanks subsequently submitted the following:]

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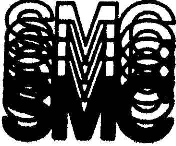
[1] S. 2894, 94th Cong., 1st sess., Sept. 23 (legislative day, Sept. 11), 1975, proposed by Mr. Mondale (for himself, Mr. Humphrey, Mr. Nelson, Mr. Abourezk, Mr. Curtis, Mr. Philip A. Hart, Mr. Hartke, Mr. Hollings, Mr. Huddleston, Mr. Laxalt, and Mr. McGee).

Smaller Manufacturers Council
[illegible] Blvd. of the Allies
Pittsburgh, Pennsylvania [illegible]
Telephone [illegible]

October 16, 1975

Honorable Gaylord Nelson
Senate Office Building
Washington, D. C. 20510



Subject: S.2394, Estate Tax Relief for Farmers and Small Businessmen

My dear Senator Nelson:

During recent testimony before your Senate Small Business Committee, you asked us to comment on the subject bill. S.2394, which was introduced by Senator Mondale and included your support, provides for the following:

First. Increase the present $60,000 estate tax exemption to $150,000;

Second. Allow family farms to be valued for estate tax purposes at their value as farm land rather than their value for other commercial purposes, as long as the land is kept in the family and continues to be used for farming;

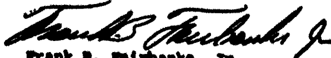
Third. Return the interest rate on 10-year installment payments of estate taxes--recently raised to 9 percent--to its previous level of 4 percent; and

Fourth. Allow 10-year installment payments whenever immediate payment would result in hardship--instead of undue hardship, as present law requires.

We have reviewed in detail the provisions of this bill, and the Smaller Manufacturers Council fully endorses and supports all of the changes therein.

We urge the immediate adoption of the bill, as an essential element in small and independent enterprises, whether they be engaged in farming, manufacturing, or other activities. We very much appreciate your recognition of the problems, and your effort to correct it through such activities as your support of S.2394 and your recent hearings on small business tax reform.

Yours very truly,



Frank B. Fairbanks, Jr.
Vice Chairman - Government Relations

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Senator BROCK. Are you talking about the estate tax exemption?
Senator NELSON. Yes, along similar lines.

Senator BROCK. I had a bill that would raise it to $200,000. I think that is exactly what you are suggesting?

Mr. PENDERGAST. I might say that what he is talking about is the provision that allows a small business payout to be made over a 10-year period on an estate.

Senator BROCK. I understand. I'm talking about the exemption.

Mr. FAIRBANKS. Senator, you are saying you have introduced a bill to raise the exemption to $200,000? We would support that very much.

Senator LAXALT. Don't we presently have a 10-year payout on estate taxes?

Mr. PENDERGAST. The interest rate is 9 percent.

Mr. FAIRBANKS. Yes; I was speaking to the interest rate, which was 9 percent, which had been raised from 4 percent. That was a real jolt.

Senator LAXALT. This family continuity argument is strong in my opinion and one that we don't hear often enough around here. Has anyone in the small business area broken out the number of businesses which are family-held?

Senator BROCK. When they add farms, there is a heck of a majority.

Mr. FAIRBANKS. I would guess that the great majority of small business is family-owned.

Senator LAXALT. What is that?

Mr. FAIRBANKS. I said I would guess that the majority of small business is quite closely held. As far as detailed statistics, they would be pretty hard to come by.

Senator BROCK. Yes; almost by definition they are closely held.

Mr. FAIRBANKS. Mr. Chairman and Senators, in conclusion I believe very strongly in the importance of the smaller and independent enterprises as a vital part of the American economy. Your concern is certainly much appreciated.

[The prepared statement of Mr. Fairbanks in full follows:]

STATEMENT BY
FRANK B. FAIRBANKS, JR., PRESIDENT, HORIX MANUFACTURING COMPANY,
AND VICE-CHAIRMAN OF GOVERNMENT RELATIONS COMMITTEE
OF THE SMALLER MANUFACTURERS COUNCIL
BEFORE SENATE SMALL BUSINESS COMMITTEE AND SENATE FINANCE COMMITTEE
SEPTEMBER 24, 1975

I am Frank B. Fairbanks, Jr., President of Horix Manufacturing Company, a manufacturer of packaging machinery located in Pittsburgh, Pa. I am the Vice-Chairman of the Government Relations Committee of the Smaller Manufacturers Council (SMC). SMC is a trade association headquartered in Pittsburgh, with approximately 600 member companies in Pennsylvania, Ohio and West Virginia, with a combined employment of over 55,000 people.

Mr. William Barth, Worldwide Director - Small Business, of Arthur Andersen and Company, is with me today to give testimony, also. Arthur Andersen has been most helpful in the preparation and review of our proposals. Further, Mr. Sheldon Ausman, Managing Partner of the Pittsburgh office of Arthur Andersen, and formerly Partner-in-charge of the Small Business Division of the Milwaukee, Wisconsin office, is with us today.

SMC appreciates the opportunity you have afforded us, together with SBANE, IBAW, and COSE, to meet with you today to tell you some of the conditions which are causing difficulty for our members.

Our concern here is the perpetuation of the smaller and independent enterprises and the jobs that such firms provide. We do not ask for preferential tax treatment, but rather changes that will provide us an opportunity to compete on a more equal basis with large corporations.

The need for the creation of new jobs and the prevention of loss of existing jobs is a matter that is very high, not only in your minds, but in the minds of small business owners and managers. Because of economic conditions, our company was recently forced to reduce its production personnel by 15%. Such action also significantly put back to some extent the progress we had made in our Affirmative Action Program for the hiring of minorities and females.

Many studies by national business trade organizations, such as the NAM Tax Impact Project, reprinted beginning on page 488 of the June 17-19 hearing, have documented the relationship between capital investment and job growth. Further data, presented as Appendix A, reveals that the growth of small business would be even more productive in the expansion of jobs.

Surtax Exemption

In the opinion of most SMC members, the most significant action which the Congress could take to aid small business growth would be to make permanent the present one year temporary corporate surcharge exemption of $50,000, and thereafter to increase it to a level of $100,000. Further, to compensate for inflation, the $100,000 level should have provision for automatic adjustment with the cost of living.

Equalization of Investment Tax Credit for Small Business

Surveys by such associations as the National Association of Manufacturers have documented the fact that the investment tax credit, in its present form, provides significantly greater benefit to large companies than to smaller companies. To correct this inequity, we strongly support a permanent graduated investment tax credit, as follows:

25% of the first $5,000, if 3 or more years of useful life

20% of the amount between $5,000 and $25,000, if 3 or more years of useful life

15% of the amount between $25,000 and $50,000, if 3 or more years of useful life

10% of the amount in excess of $50,000, if 7 or more years of useful life

7% of the amount in excess of $50,000, if 5 to 7 years of useful life

4% of the amount in excess of $50,000, if 3 to 5 years of useful life

Further, as an aid to small business, the temporary limit of $100,000 for used equipment should be made permanent.

Natural Gas Shortages

One of our SMC members, because of a 40% cutback in allocation of natural gas, was forced to take costly action. Due to the nature of his process requirements, namely the firing of ceramics, conversion to oil or coal was not feasible. At the time last year when the cutback occurred, it became necessary for him to install facilities to burn propane, at a capital cost of approximately $200,000. Further, propane, on an equivalent heat basis, is approximately three times as expensive as natural gas. More recently, he tried, from several sources, to contract to buy natural gas at prevailing rates. In many cases, it appeared that the gas suppliers were not interested in getting involved with special contracting to meet his relatively small requirements, so he has been forced to continue the use of high cost propane.

Many of our SMC members are threatened with serious curtailment of their operations because of the natural gas shortage anticipated for this winter. Legislation is urgently needed which will increase the availability of natural gas through regular distribution channels. Many of our member companies are not large enough to be able to enter into special contracts for gas at unregulated prices, but we are being cut back in order to give preference to residential heating needs.

Continuity of the Business

As mentioned earlier, the survival and growth of small business is directly related to the growth and survival of a very considerable number of jobs. Two of the most significant elements in the continuity and survival of smaller enterprises are (1) capital gains taxes on the sale of closely-held business and

(2) estate taxes. Our consultant, Bill Barth, will explain later in detail the ways in which present tax law works against the long-term survival of the independent business.

But let me, for the moment, try to explain the estate tax problem. IF THERE ARE UNREASONABLE LIMITATIONS ON THE ABILITY OF MY COMPANY TO SURVIVE AT THE DEATH OF THE OWNERS, I MAY LOSE THE INCENTIVE TO OPERATE THE BUSINESS IN SUCH A MANNER AS TO ANTICIPATE THE CONTINUATION OF THE ORGANIZATION AS A SEPARATE ENTITY. Rather, I may pursue policies aimed at maximizing short-term return on investment, with a view towards sale to a large public company and/or liquidation. Typical of such policies which might be pursued in order to maximize short-term advantage are the following:

1. Fund our pension plan at the minimum legal level, or possibly, if we did not have a pension plan, not create such a plan at all.
2. Keep plant and equipment maintenance at a minimum, with the consequent probability of a higher rate of accidents.
3. Fail to conduct long-term research and development.
4. Inadequately plan for continuing management.

It is our opinion that all of the above are undesirable conditions for good employee relations. Fortunately, in my company, Horix Manufacturing Company, we are in excellent financial condition, we do not conduct our business in the manner described above, and personally I look forward to our company remaining independent and continuing to serve the needs of our customers. Further, it is my opinion, based on personal contact with other SMC member companies, that most SMC members are desirous of maintaining the future continuity of their business.

In many cases this may include the continuing interest and involvement of future generations of the family of the owner.

Unfortunately, the present estate tax laws make the continuity of small, independent enterprises very difficult at the time of the death of an owner, and we regretfully suggest that many owners have little hope for long-term survival of their enterprise. It is the opinion of SMC that the Congress should act to encourage the survival of independent small business, as a more desirable, preferable alternative than conglomeration.

Specifically, in order to further the above objectives, we urge the Congress to make certain changes in the Estate Tax law, which has not been significantly revised since 1941.

A. Reduction of Estate Tax Rates

1. The $60,000 estate tax exemption has not kept up with inflation. It should be increased to at least $180,000.
2. Estate tax rates, up to 1,000,000 of taxable estate, should be reduced, as detailed in Appendix B.

B. Liberalization of Rules for Section 303 Redemptions

To provide more equitable treatment for unmarried stockholders (including widows), and to offset the effect of the recent sharp decline in the value of small companies, the requirements for eligibility for a Section 303 redemption should be reduced to 40% of taxable estate or 20% of gross estate. Further detail on this proposal is shown in the attached Appendix C.

C. Deferred Payment of Estate Taxes on Small Business Interests

Section 6166 permits, under certain conditions, a 10-year payment of estate taxes on small business interests. However, the interest rate, currently at 9%, is so excessive as to make Section 6166 of limited use. We feel the previous 4% rate, or at least a 6% rate, is more equitable.

....

Mr. Chairman and Senators, in conclusion, I believe very strongly in the importance of the smaller and independent enterprises as a vital part of the American economy. Your concern is very greatly appreciated.

(7)

Appendix A

Corporate Employment Trends

	1963	Employment (millions) 1967	Change
Large business *	17.3	15.8	- 1.6
Small business **	9.8	15.9	+ 6.1
		Sales & Receipts ($ millions)	
Large business	$312.1	$500.3	+ $188.2
Small business	423.8	500.6	+ 76.8

* Large business assumed to be all corporations with $50 million or more sales & receipts.

** Small business assumed to be all corporations between $100,000 and $49,999,999 sales & receipts.

Source: Analysis by Smaller Business Association of New England of census data shown in the 1974 Report of the Senate Small Business Committee.

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(8)

Appendix B

Present Estate Tax Structure

1. An exemption of $60,000 is deductible from the gross estate in determining the taxable estate.

2. Estate tax rates are as follows:

Taxable Estate		Tax Rate
$0-	5,000	3%
5,000-	10,000	7
10,000-	20,000	11
20,000-	30,000	14
30,000-	40,000	18
40,000-	50,000	22
50,000-	60,000	25
60,000-	100,000	28
100,000-	250,000	30
250,000-	500,000	32
500,000-	750,000	35
750,000-	1,000,000	37

Proposed Estate Tax Structure

1. The $60,000 estate tax exemption should be increased to $180,000.

2. Estate tax rates should be as follows:

Taxable Estate		Tax Rate
$0-	50,000	5%
50,000-	100,000	10
100,000-	150,000	15
150,000-	200,000	20
200,000-	400,000	25
400,000-	600,000	30
600,000-	1,000,000	35

Appendix C

Details of Proposed Changes in Section 303, Estate Tax Law

At the present time, in order for an estate to undertake a 303 redemption, the closely-held stock must be at least 35% of the gross estate or 50% of the taxable estate. We would propose that these restrictions be changed to 20% and 40% respectively.

Section 303 provides an incentive for small business to be continued rather than being sold out to big business. In order that Section 303 accomplish its purpose in these days of depressed stock prices, we feel that certain technical changes are required in this aspect of the Estate Tax Law.

We propose that Section 303 be amended as follows:

1. Change the 50% limitation in paragraph (b) (2) (A) (ii) to a 40% limitation.
2. Change the 35% limitation in paragraph (b) (2) (A) (i) to a 20% limitation.

The principal justifications for these changes are as follows:

1. As a general guideline, the value of stock in closely-held companies for estate tax purposes is usually determined by comparison with market value of traded securities, in accordance with Revenue Ruling 59-60. For manufacturing and retail companies, the primary consideration is usually comparative price/earnings ratios. The comparison is usually made with the smaller publicly-traded companies. As we are all aware, the price/earnings multiples for small public companies have dropped sharply in the last few years. Thus, a block of closely-held stock

that in 1972 might have been 35% of the gross estate could very readily not come anywhere being near that percentage now. We suggest that, in all fairness, a prompt reduction of the percentage requirements is fully justified.

2. For estates which make full use of the marital deduction, the "50% of taxable estate" requirement is more easily met, as this is 25% or less of the gross estate. However, estates of single people, such as widows who have inherited considerable stock from their husbands, obviously can never use the marital deduction, so they would almost always be involved with the "35% of gross estate" rule. We think changing the "gross estate" requirement to be half of the "taxable estate" requirement would provide more equitable treatment of individual business owners. Even if the "50% of taxable estate" limitation is not reduced to 40%, the "35% of gross estate" rule should be changed to 25%.

Mr. FAIRBANKS. Now I would like to introduce our consultant, Mr. Barth.

Mr. BARTH. In the interest of conserving your time and to further emphasize the point made by Mr. Fairbanks relative to the continuity of small businesses and family businesses, I would like to relate to you a story. This is an actual story, but the names have been changed. I will use the name of John Heath. John Heath is a successful small businessman. He created jobs in his community. He bought equipment and it formed a good tax basis for the local school system and all other purposes. After about 30 years—Senator, you are smiling. I trust maybe you have run across this. We see this so frequently. After about 30 to 35 years, the gentleman complied with his wife's suggestion that it would be time to take life easy and enjoy the fruits of his labor. So when it was decided he would dispose of his company, he found that he had three prospective purchasers. The first purchaser was an individual who would like very much to have this closely held company. He offered a good cash price for it. It was his intent to continue the company with the same character that it had been maintained. He wished to avoid changes in personnel at all levels of the organization.

The second purchaser was a small closely held company whose intent was very similar to that of the individual. The small closely held company, however, saw the additional product line and the additional facility as complementing its own. The third prospective purchaser was XYZ Co. This is a publicly held company. The representative of XYZ spoke to John Heath, my client, and said: "You will learn that there is a distinct tax advantage in dealing with me." And so John Heath sought counseling. He learned that the sale of his company to the individual who had cash to pay for it would trigger an immediate capital gains tax and therefore such a sale would be costly. The same consequences would result should John Heath sell his company to the other closely held business because certainly the stock of the other closely held business had no public market value. For all practical purposes, the only medium of exchange which the closely held company could use to expand its operations was cash. Therefore the same tax consequences would occur. John then learned that by transferring his stock to the XYZ Co., the publicly held company, in exchange for shares of that company, he would not have a taxable transaction in that the stock he received would take the basis of the stock that he surrendered and clearly the representative of XYZ Co. was correct when he indicated that he held a significant competitive advantage over the individual or the small company.

Now this information was particularly distressing to John Heath because for years he planned to pass on his business and keep it as it had been. His concern for his long-time employees in the plant, for members of his management team—and this concern is certainly something that runs through small companies; the paternalistic attitude—and it caused him to fear that XYZ might decide to combine the operations of his small company with one of XYZ's divisions was uprooting the company from the community and from its labor base. John had seen this happen.

Now if the story that I have related to you represents only an isolated incident, then this certainly wouldn't have a very great effect on our total business community. But John Heath's predicament is being experienced each day of the year. My associates and I routinely counsel the owners of small companies who are faced with the same problem that John Heath faced in such a transaction. I think also abandoned plants and local pockets of unemployment bear witness to ill-fated transfers of company ownership.

Simply stated, our tax rules relating to the disposition of corporate interests mitigate against small companies perpetuating themselves. On the contrary, they contribute significantly to the concentration of power in fewer companies, which only become larger with the passage of time. If you believe, as I do, that small business is the cornerstone of our free enterprise system, then it is blatantly incongruous to continue to make it disadvantageous for the owner of a small business to convey the ownership of his business to another small businessman simply because all he has to pay is cash. Also at this particular time, when it is in vogue to talk about employee ownership and we hear a lot of ESOPS, the same results are obtained. It is disadvantageous for the employees to buy the company from their employer.

As a means of correcting this inequity, may I suggest that the selling shareholders of a closely held company be permitted to carryover the tax bases of their respective interests to such assets as are acquired within a limited time frame by application of the proceeds received from the sale. Now you will recognize this as——

Senator NELSON. Would you repeat that?

Mr. BARTH. May I suggest that the selling shareholders of a closely held company be permitted to carryover the tax bases of their respective interests in such assets as are acquired within a limited time frame by the application of the proceeds. In other words, if they use the proceeds from the sale, if they reinvest those within a limited time frame, which would have to be defined, that the new assets would take the bases of the assets that were sold; the assets being the assets of the business. And Senator you ask a question, and I think this was to the first witness, you asked about the difference between assets or stock. It would make no difference. If stock were sold, it would be his basis in the stock. If assets were sold, it still would go through that basis.

Senator BROCK. Mr. Barth, may I give you a hypothetical? Let's say that I have $10,000 worth of base value according to my investment and I sell out for $100,000 and within 6 months I buy $100,000 worth of Procter & Gamble stock. Procter & Gamble stock would be valued at $10,000 for the purposes of capital gains taxation should I subsequently sell it. There would be no capital gains on the initial sale.

Mr. BARTH. That is what I said.

Senator LAXALT. How does your example relate to John Heath in his situation?

Mr. BARTH. In his situation, his basis in the company he sold, and let's say he had $10,000 to use the same example, now if he had $10,000 invested and he sold his company for $100,000 and within the time frame he reinvested——

Senator NELSON. What was the time frame?

Mr. BARTH. I haven't defined that. I think the Senator said 6 months, but I'm not really worried about that. But if within a limited time frame the assets were reinvested, his capital was reinvested, the new assets would take the basis that he had in his old company, which was $10,000.

Senator LAXALT. So there would be no recognized gain?

Mr. BARTH. At that time.

Senator BROCK. Until he sold the new assets?

Mr. BARTH. Right.

Senator BROCK. And that would be taxed at the same rate he would have if he had sold the old?

Mr. BARTH. That is correct.

Senator BROCK. So you are deferring the taxes?

Mr. BARTH. Correct.

Senator BROCK. Which is what you do on a tax-free merger.

Mr. MAUER. Also in home mortgage or home equity the same principle applies.

Senator LAXALT. What type of investment would John have to deal in?

Mr. BARTH. I presume that would have to be defined, but it would seem to me there should be great latitude there in order that he could protect himself with some diversification in investment. You see, at the present time if he is receiving stock only, he has no diversification. This has brought catastrophic results to many previously successful small businesses.

You can recognize that this is a very similar provision to what we already have relating to the sale of personal residence. This is the same thing we do in housing.

Senator BROCK. That is right.

Mr. BARTH. We are deferring taxes. We are not forgiving the taxes. We are simply deferring it.

Senator BROCK. Mr. Barth, can I interrupt you just for a second and suggest that if you are going to do that—and I think it does make a lot of sense, or at least that is my initial impression—that you also crank in, and I assume you would, some support for changes in State taxes, State exemptions because, as we are now taxing people, you'd better not die if you own a small business because you are going to lose it and you are going to be wiped out. And there is no relief unless you have public stock.

Mr. BARTH. That is true.

Senator BROCK. So the same situation is even worse in the case of the death of a major owner.

Mr. BARTH. Well, we speak of the need for capital in small business. I would like to pursue this one step further and say if those proceeds from the sale of John's company, if they were reinvested in another small business, the tax deferral business should again be present upon the distribution of the succeeding business. In other words, this may have a chain reaction as long as the man is investing and is in the defined, controlled position of a small business.

Now while the term "closely held" requires definition and other circumstances requisite to the transaction requires formalization, and this I recognize, the objective of this proposal should be self-evident.

My belief that a successful small business means jobs and industry within a community, that often voids the larger employer. And my belief that a small business should not be the victim of discrimination in this respect and that further we must maintain our position as an industrialized nation leads me to conclude we cannot afford to suppress the entrepreneurial talents of any of our people. And these are some of the more obvious reasons for asking for what I consider to be equal opportunity for the small entrepreneur. Thank you.

Senator LAXALT. We don't hear any discussion at these hearings at all about the insurance factor in insulating against the estate tax situation. Is this no longer in vogue in small businesses?

Mr. BARTH. No, I think it is in vogue.

Senator LAXALT. Should there be some different treatment of the insurance factors as assistance from us taxwise?

Mr. PENDERGAST. You are suggesting insurance proceeds be taxable?

Mr. MAUER. They are taxable I believe.

Senator BENTSEN. No, your insurance premiums——

Mr. MAUER. Excuse me, I meant the payment of the tax premium.

Senator BENTSEN. Your insurance premiums are not a taxable expense. That is your point. So they are paying a very substantial premium with no credit on their taxes to try to maintain that kind of liquidity.

One of the other problems you run into in a small corporation is you have a fellow who has a $10,000 tax base and he decides he wants to retire and he doesn't want to merge into a company but really wants diversification, so he decides to sell. What is he faced with? He is faced with a 35-percent capital gain and another 2½ percent on preference tax and in New York and California he is faced with another 5 percent, so you are talking about 42 percent. So he says, "I won't sell." And so you have people making tax decisions and not investment decisions. So then you don't have the liquidity of capital. And that I think is a very serious problem we have in this country.

How many of you can float a new issue today? I floated a new issue back in 1958 and today I couldn't at all go public if I was back in business trying to get started. I don't think the day has passed when you are going to have a new Polaroid or a new Xerox, yet I don't know how you are going to fund them in this kind of a capital market.

Mr. BARTH. You could pursue the point you are making, Senator, and say today some companies do go public merely to get diversifications to give them liquidity for their estate and they have no business going public. They are then saddled with tremendous redtape and in their minds they are still philosophically operating their business as a small business, although it must conform to all of the regulations.

Senator BENTSEN. Well the small company trying to go public has almost an impossible task. The multiples really don't work out but for a very, very few. And you don't have the kind of support on the stock market for these new firms that you used to have.

I'm sorry, Mr. Chairman, for interrupting, but I feel kind of strongly on that.

[The prepared statement of Mr. Barth in full follows:]

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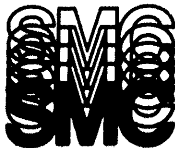

Statement of

WILLIAM D. BARTH

Worldwide Director of Small Business
Arthur Andersen & Co.

Consultant to
Mr. Frank B. Fairbanks, Jr.
Smaller Manufacturers Council
Pittsburgh, Pennsylvania

Before: Joint meeting of Senate Select Committee on Small Business and Senate Finance Committee

Subject: Small Business Tax Reform

Date: September 24, 1975

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Utilizing his entrepreneurial talents supported by an intimate knowledge of each facet of his business, John Heath developed a thriving small company. Plant facilities were expanded, new jobs were created, and the economic well-being of the community was enhanced by the presence of this successful closely-held company.

John's desire to enjoy the rewards of nearly thirty years of hard work and to improve the liquidity of his estate led him to the decision to sell his company. Once this decision became known, three prospective buyers indicated a desire to enter into negotiations for its purchase.

The first purchaser, an individual, found John's company much to his liking, and offered a good cash price for it. It was his intent to continue the operation in its present location, wishing to avoid changes in personnel at all levels of the organization.

The second prospective purchaser was a small, closely-held company which wished to acquire John's product line and productive capacity to complement its own. Much the same as the individual purchaser, the small acquiring company offered a cash price, and looked forward to continuing the operations which John developed with as little change as possible.

A third prospective purchaser was XYZ Incorporated, a publicly held company whose representative emphasized that there was a significant tax advantage which John could realize should he dispose of his company for stock of XYZ.

Seeking counsel, John learned that the sale of his company to the individual purchaser for cash would trigger a substantial capital gains tax; thus, such a sale would be costly. The same consequences would result should John receive cash as consideration from any other purchaser, and since there was no market available for the disposition of the stock of a closely-held company, cash was the only practical medium of exchange should John sell to a small company, the second prospective purchaser. John then learned that by transferring his stock to XYZ in exchange for shares of that company, he would not effect a taxable transaction as the stock he received

would take the cost basis of the stock he surrendered. Clearly, the representative of XYZ was correct when he indicated that he held a significant competitive advantage over the individual or the small company.

The foregoing information was particularly distressing to John as for years he had planned to pass-on his business to a purchaser who would continue the character of the business as John had molded it. His concern for his long-time employees in the plant and for the members of his management team, which is common among the proprietors of closely-held companies, caused him to fear that XYZ might decide to combine the operations of his small company with one of XYZ's divisions, thus uprooting the company from the community and from its labor base.

If the story of John Heath represented merely an isolated incident, the consequences would not be very important to our total business community. But John Heath's predicament is being experienced each day of the year in every state of our nation. My associates and I routinely counsel the owners of small companies faced with the same painful decision that John encountered. Abandoned plants and local pockets of unemployed bear witness to the possible consequences of an ill-advised transfer of company ownership.

Simply stated, our tax rules relating to the disposition of corporate interests mitigate against small companies perpetuating themselves; on the contrary, they contribute significantly to the concentration of power in fewer companies which thus

become even larger with the passage of time. If you believe, as I do, that small business is the cornerstone of our free enterprise system, then it is blatantly incongruous to continue to make it disadvantageous for the owner of a small business to convey the ownership of his business to another small businessman simply because he must pay for his purchase in cash, rather than stock. Isn't it ironic that the advocacy of employee ownership is in vogue, yet the employees, whether in a small group or represented collectively by an ESOP must bargain at the same disadvantage as any other purchaser who has only cash to offer.

As a means of correcting this inequity, may I suggest that the selling shareholders of a closely-held company be permitted to carry over the tax basis of their respective interests to such assets as are acquired within a limited time frame by application of the proceeds received from the sale. (You may recognize the similarity between such a plan and the opportunity now available to defer the payment of taxes on the sale of a personal residence.) It is further suggested that proceeds of sale of a closely-held company not reinvested within the allowable time period would be subject to tax at reduced capital gains rates, the lesser rates giving recognition to the impact of inflation. In the event cash proceeds of sales are invested in another closely-held business, the tax-deferral privilege should again be present upon the disposition of the succeeding business.

While the term "closely held" requires definition and other circumstances requisite to the transaction require formalization, the objective of this proposal should be self-evident. My belief that a successful small business means jobs and industry within a community often without a larger employer, my belief that small business should not be the victim of tax discrimination, my belief that to maintain our position as a leading industrialized nation we cannot afford to suppress the entrepreneurial talents of our people--these are but some of the more obvious reasons for asking for equal opportunity for the small entrepreneur.

Mr. McDONALD. Good morning, gentlemen. I am Charles McDonald and I am chairman of the Federal Legislative Committee of the Council of Smaller Enterprises of Cleveland. I would like to thank you for this opportunity to testify before your committee. Also, on behalf of the 800 small business companies who are members of the Council of Smaller Enterprises, I would like to thank you and the members of your committee for the thoughtful consideration you have given small business during the course of your legislative efforts.

Congressman Vanik, in testimony during recent Ways and Means Committee hearing, stated: "You fellows come with hat in hand requesting tax relief. Tell us how to do it without destroying the tax system." We propose to attempt to do so today. As we announced during our June 1975 testimony, we have formed a committee of professional accountants to identify research areas of needed tax reform for small business. The Government Taxation and Regulation Committee has met this challenge by writing a comprehensive report on several significant tax reform proposals. The report places heavy emphasis on reform which will provide small business concerns with needed capital formation tools that will eliminate needless complexities of present tax regulation.

We have three committee members who will summarize the salient points of our testimony: Mr. Barnes, he will start our panel discussion.

Mr. BARNES. My name is David Barnes and I am a CPA in Cleveland, Ohio. I also chair this committee.

The Government Taxation and Regulation Committee has researched 11 tax reform proposals covering many broad topics. Because of time limitations, my colleagues, Mike Shemo and Bill Tomko will make capsuled presentations of the key points covered in the detailed research findings which have been presented in our written testimony.

Our report on depreciation accounting methods was presented at yesterday's hearing. Therefore, Mike Shemo will open today's program by presenting a report of the need to increase the amount of allowable accumulated earnings credit.

Mr. SHEMO. Thank you. I am Mike Shemo, a partner in Schultz, Krahe, Martin & Long, a local CPA firm in Cleveland, Ohio. Section 531 of the Internal Revenue Code imposes a penalty tax on corporations which accumulate earnings with the purpose of avoiding taxes on shareholders. With one exception insofar as decided cases are concerned, the accumulated earnings penalty tax has been applied only to closely held domestic corporations. This type of corporation generally falls within the definition of a small business.

We do not wish to quarrel with the need for a law or means to penalize abuses or tax avoidance schemes. Our purpose is to impress you with the need for a meaningful adjustment to the accumulated earnings credit. We would like to see the small businessman freed from the fear of being penalized for conservative business policies.

Present IRS regulations state that a "retention of earnings and profits to provide against unrealistic hazards" suggests that earnings have been unreasonably accumulated. However, it is clear that certain real business contingencies are not unrealistic hazards even though the ultimate monetary impact may be uncertain. Thus, the courts have recognized the right to accumulate funds in the face of unsettled

conditions in the particular industry as a whole, threat of strike and risks peculiar to the industry.

It would seem to be desirable to permit a corporation to accumulate and retain in liquid form an amount sufficient to insure that a recession or change in the market conditions will not cause the corporation great hardship. The analysis of some courts, which, in effect, insist upon an accounting for every dollar of surplus, seems to require that the corporation forever operate two steps ahead of the sheriff. The mere fact that the amount of such contingency fund might be difficult to fix should not seriously mitigate against the merits of the idea.

We are recommending that new legislation be written to correct present-day deficiencies inherent in the application of code section 531. The legislation should strictly require the imposition of the penalty tax only in cases where tax avoidance is the sole motive behind the retention of earnings. Legislation should increase the accumulated earnings credit to at least $500,000 and even more importantly permit the small businessman to accumulate a reasonable amount of liquid assets as a reserve for unidentified contingencies such as a recession or economic slowdown. This would provide small businesses with the opportunity to better compete with the larger publicly held companies by putting them on a more equal footing particularly in times of critical economic downfall.

Senator HASKELL. Didn't we just increase the accumulated earnings?

Mr. SHEMO. To $150,000.

Senator HASKELL. To what?

Mr. SHEMO. To $150,000.

Senator HASKELL. You are advocating $500,000?

Mr. SHEMO. Five hundred thousand dollars, but even more importantly than that, Senator, I think there is a misconception in a lot of people's minds that the accumulated earnings credit of $150,000 or $500,000 allows the businessman to set aside that amount of money for the so-called unidentified contingencies. All that credit means is that a company, who is small enough if they haven't accumulated that much in earnings, is basically exempt from the penalty tax. Once a company has accumulated under present-day law $150,000 of surplus, and has invested it in strictly business assets like equipment and receivables and inventory and so on, he is not permitted under present law to accumulate $1 of excess cash just as what we call a reserve fund. He must account for every dollar of surplus. He must account for it based on a working capital formula. They do allow you to maintain sufficient funds for your present working capital requirements and it would also allow you to accumulate dollars for specific future acquisitions of assets or what have you. But they have to meet very specific requirements. The courts have been very tough on this.

Senator LAXALT. Under present conditions, why should there be any limitation at all?

Mr. SHEMO. Frankly, Senator there is some possibility of abuse.

Senator LAXALT. In what areas do you think there would be abuse?

Mr. SHEMO. In situations where companies have accumulated earnings and really have no need for them and simply do not pay them out to the shareholders because the shareholders wish to avoid the tax. As a tax specialist, I can't say I wouldn't mind seeing that

provision go. But realistically speaking, there are situations where abuse can take place and I think the Treasury Department will rightfully point that out.

Senator LAXALT. Of course, the taxes will be paid on the front end. All you are doing is allowing the imposition of the double tax.

Mr. SHEMO. We are strictly talking about the double tax.

Senator LAXALT. Which is unfair in my judgment too. You can talk about "double-dipper" out here, but that is the real "double-dipper."

Mr. SHEMO. The second area I wish to discuss is the net operating loss carryover. New corporations, and particularly smaller enterprises, often undergo a substantial period of operating losses at the beginning of their existence. Because of the inability to carry back such losses and the 5-year limit on carryovers, these corporations may experience the situation where they may not have a sufficient period of time to permit taxable income to reach a level where initial losses can be fully absorbed. Because of this problem we advocated in testimony earlier this year before the Senate Select Committee on Small Business that the net operating loss carryover period for new corporations be extended for a period of 8 to 10 years.

In support of our position, we have conducted a survey of the members of the Council of Smaller Enterprises concerning their experience with current net operating loss carryover. Of those who responded, over 50 percent had experienced initial net operating losses and of those, 28 percent were not able to absorb them in full. The total amount of unabsorbed initial losses was $2,870,000, and we are talking about small businesses.

While existing corporations can take advantage of an 8-year period by carrying back 3 years and forward 5 years, to absorb losses, a new business is limited to a 5-year carryover provision at a time in its corporate existence when it needs a longer period. Since smaller enterprises are dependent on internally generated capital for growth, the current limit on the net operating loss carryover period can have an adverse affect on such growth. If the period were extended, however, the resulting tax benefit could be used to finance the second stage of a small enterprise's growth and frankly just allow it to exist. In the long run, it would allow it to continue to expand with resulting long-term favorable impact on both employment and taxes.

I would like to now introduce Bill Tomko who will discuss the need for uniform State tax requirements.

Mr. TOMKO. My name is Bill Tomko and I am with Arthur Young & Co. and am a member of the Cleveland Council of Smaller Enterprises' Government Taxation and Regulation Committee. I would like to discuss the problems that small businesses encounter in dealing with interstate taxation.

This is a very sensitive area as you pointed out, Senator Haskell, in the June testimony. I want to emphasize in the front end that we are not talking about regulating a State or municipality's ability to levy a tax or collect a tax, but rather we are talking about the need to simplify the forms and the procedures which businesses have to comply with in a variety of States. As the situation now stands, a business is faced with 50 different tax forms if they are in 50 different

States with 50 different sets of requirements and reporting on the forms. For instance, the popular three-factor formula for allocating income sounds simple and sounds uniform on its face, but in practice the forms require a multiplicity of information. Certain States require that you break down the individual assets within the State, for instance, furniture and fixtures in that State, depreciation on furniture and fixtures in that State and depreciation out of that State. This requires a terrific amount of separate bookkeeping and is time consuming at the end of the year and is totally unproductive and in my opinion unreasonable.

Senator NELSON. We are aware that there is a great deal of variety in the tax systems of the several States. Some States have personal property tax and some don't; and some States tax income at various levels; and some assign a percentage of income made in one State and you pay on that. What is your remedy?

Mr. TOMKO. I suppose as a practical matter you would need the wisdom of Solomon to propose an exact answer.

Senator NELSON. Then we'd better move on to another subject.

Mr. TOMKO. What I think is a reasonable alternative is a prodding of the existing States—well, I mean the States have formed the multitax commission to deal with this problem. Perhaps there should be some prodding in the direction of adopting a uniform form. The rates, enforcement, and collection would be left up to the States.

Senator BROCK. If I may suggest this, in Canada the provinces are allowed to impose a surtax on the corporate tax. They are not allowed to set their own tax or change the premise of the tax, but they are allowed to set the rate of the surtax to 2 percent, 2½ percent, 4 percent. It is a much more efficient system. You just have one code. Everybody operates under the same system. It is a progressive tax.

Senator NELSON. This is the tax on income?

Mr. TOMKO. That is the primary one we are talking about.

Senator BROCK. And frankly if you could ever get something like that in this country, that might be helpful. You do tie the responsibility of revenue to the people who raise that tax and the legislation has to contain that action, but I am referring to an absolutely uniform method of transaction across the country. I think it makes a whole lot of sense.

Senator NELSON. I don't understand. What you are saying is that States tax income at various percentage levels and some States don't even have an income tax, so how do you handle that? How would you handle that in Wisconsin, Oregon, New York, Minnesota?

Senator BROCK. Well in Tennessee we have no income tax in my State.

Senator NELSON. But how do you handle that because you couldn't have a corporation with an interstate operation paying a lower level of income tax than the competing resident businesses.

Senator BROCK. What I am suggesting is that the tax would be absolutely uniform within the State, but the State could use the Federal taxes rather than creating its own collection mechanisms and different forms. And so you would use the Federal system as the central tax system both in terms of premise and operation. You

would simply tell the Federal Government and Tennessee that we want to add 2 percent to the Federal tax. That tax then is collected for the State.

What this does is enormously simplify the tax system. And frankly I don't like property and sales tax, but this to me is a much simpler system. This to me will be a better way to do it.

Senator NELSON. You mean if they do have a personal property tax?

Senator BROCK. There is nothing we can do about it there.

Mr. PENDERGAST. Mr. Chairman, the problem here is more a question of taking the taxable income and allocating among the States. If you have a company that just operates within one State, there is no problem about that. The Canadian approach would not solve that problem. If the corporation has $100,000 worth of pretax income, then what Senator Brock says is yes, we can tax it on that basis. The problem is how do we determine what percentage of that was earned in Tennessee and what percentage of that was earned in Mississippi. There should be one formula allowed and not just one tax rate. It almost doesn't make too much difference what the formula is, just that there is a formula. As it is now, you can end up being taxed on more than 100 percent of your income. For instance, the method of taxation of one of the mineral producing trusts in Minnesota ended up in a duplicate tax because Minnesota taxed it as royalty income and other States taxed it as dividend income.

The problem as I understand it is complex. The National Association of State Tax Administrators has been working together for the last 4 or 5 years and has managed to come up with about 17 different proposals. They claim in the next year they are going to be able to come up with one proposal. If they don't, I think it is necessary for Congress to insist on even an arbitrary proposal so that you won't have this type of multiplicity of reporting and multiplicity of methods of determining allocation of income from State to State.

Senator BROCK. And all these costs are passed on to the consumer.

Mr. PENDERGAST. That is correct.

Mr. TOMKO. The schedule in our written testimony following page 67 lays out some of the more common adjustments a corporation would have to go through in just determining what the State taxable income would be before the apportionment factor even came into it. I'm talking about the adjustments to the Federal tax.

Senator NELSON. Have you completed your testimony?

Mr. TOMKO. I would like to talk about now some of the problems a small business would have in implementing and using LIFO. LIFO is an inventory costing system which significantly lessens the effects of inflation on a company's income statement. LIFO essentially works by relating the cost of an item sold to the cost the selling company will incur when it purchases or replaces a manufactured item. This is on page 69 of our testimony.

While it is true that any enterprise's inventory may determine the cost of that inventory by use of the LIFO method, the regulations governing its use are so complex and ambiguous that smaller businesses are frequently unable to comply and, therefore, unable to use LIFO. Under the primary methods of computing LIFO, illustrated in table 3

of the LIFO testimony, the regulations fail to clearly spell out what is, and is not, an acceptable method of implementing and applying these methods. Of particular concern are the following: Failure to clearly define when and under what conditions the use of a method of even the double extension method is acceptable; failure to reasonably define what is an adequate sample size; failure to define currently what constitutes a new item of inventory and the conflict between Treasury regulations 1.471(2)(C) and 1.472(2)(C). In addition to resolving and clarifying the aforementioned conflicts and ambiguities, we request that consideration be given to revising the LIFO regulations in two more fundamental ways. Consideration should be given to providing a relief provision which would prevent a company from losing a substantial portion of the LIFO benefit when its year-end inventory has decreased significantly due to extraordinary reasons. Small businesses with their relatively smaller inventory amounts are particularly vulnerable to significant variations in ending inventory and they are, therefore, hard hit by this lack of a relief provision.

Currently most retail merchants and some wholesale establishments are spared the necessity of computing an index or percentage relationship of the end-of-the-year prices to the beginning-of-the-year prices on an item-by-item basis that other companies must use. These retailers and wholesalers are permitted to use Bureau of Labor standard indices which determine the rate of price increases in their inventory. We submit that consideration should be given to allowing other businesses to elect to use the Bureau of Labor standards wholesale price indices to evaluate at least the material content of their inventory.

While we concede that the use of Bureau of Labor standard indices would only currently be based on national averages and not applicable to any one business, it would provide a reasonable approximation of price level movements in inventory.

Senator NELSON. Thank you. Let's see, there is one more witness. Mr. Mauer of the Independent Business Association of Wisconsin.

Mr. BARNES. We have not completed our program, Mr. Chairman. Is there some timing problem?

Senator NELSON. Yes, each panel was notified that the total time was an hour for each panel. We have one more panel to hear from this morning. It is now 10 minutes to 11. Do you have something in addition?

Mr. BARNES. Yes, we have several more reform proposals.

Senator NELSON. Well, let's hear Mr. Mauer and then come back to you. Are they in addition to those listed in Mr. Ward's statement, the five items on page 2?

Mr. BARNES. Yes, the remaining sections deal with accounting for goodwill on corporate balance sheets; irregularities in subchapter S regulations; the Domestic International Sales Corp., a new look on that; estimated tax refunds for corporations on overpaid estimated taxes; and then a little section on business search expenses.

Senator NELSON. Well let's hear from Mr. Mauer and see what we have left as to our time. Your prepared statement will, of course, be printed in full in the record.

[The prepared statement by the Council of Smaller Enterprises of Cleveland in full follows:]

COUNCIL OF SMALLER ENTERPRISES

690 Union Commerce Building • Cleveland, Ohio 44115 • 216/621-3300

STATEMENT OF

Council Of Smaller Enterprises

Government Taxation and Regulation Committee

David L. Barnes, C.P.A.

Coopers & Lybrand

1070 Union Commerce Building

Cleveland, Ohio 44115

and

Committee Chairman

Michael A. Shemo, C.P.A.

Schultz, Krahe, Martin & Long

800 Investment Plaza

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and

Committee Member

William A. Tomko, C.P.A.

Arthur Young & Co.

1100 Superior Avenue

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INTRODUCTORY STATEMENT OF

Charles R. McDonald, President
McDonald Equipment Company
37200 Vine Street
Willoughby, Ohio 44094

Chairman Of The Federal Legislation Committee
Of The Council Of Smaller Enterprises
690 Union Commerce Building
Cleveland, Ohio 44115

Mr. Chairman and Members of the Committee:

I would like to thank you for this opportunity to testify before your Committee. Also, on behalf of the 800 small business companies who are members of the Council Of Smaller Enterprises I would like to thank you and the members of your Committee for the thoughtful consideration you have given small business during the course of your legislative efforts.

As we announced during our June, 1975 testimony, we have formed a commitee of professional accountants to identify and research areas of needed tax reform. The Government Taxation and Regulation Committee has met this challenge, by writing a comprehensive report on several significant tax reform proposals. The report places heavy emphasis on reform which will provide small business concerns with needed capital formation tools that will eliminate needless complexities of present day tax regulations.

CONTENTS

Topic	Page
Introduction To Testimony by William A. Tomko, C.P.A.	
Present Tax Depreciation Rules Are Yesterday's Answer To Today's Problems by David L. Barnes, C.P.A. and Jon R. Tallman	1-40
Increase The Accumulated Retained Earnings Credit by Gerhard H. Boecker, C.P.A.	41-58
Net Operating Loss Carryover Periods Need To Be Extended by William R. Carnie, C.P.A. and Douglas C. Carlson	* 59-64
Uniform State Tax Requirements Are Needed by Nicholas D. Pellecchia, C.P.A.	65-67
Recommendations For Revising The LIFO Inventory Regulations by William A. Tomko, C.P.A. and David L. Barnes, C.P.A.	68-76
Amortization Of Purchased Goodwill Should Be Deductible For Tax Purposes By David L. Barnes, C.P.A. and William K. Evans	* (Included in pages 59-64)
Subchapter S Rules Need Revision By Michael A. Shemo, C.P.A.	77-84
Support For Increasing Surtax Exemption to $100,000 By William A. Tomko, C.P.A.	85-86
Internal Revenue Code DISC Provisions Should Be Retained By William R. Carnie, C.P.A. and Douglas C. Carlson	87-96
Amendment Of Estimated Tax Overpayment Regulations By Douglas C. Carlson	97-100
Liberalization Of Deductibility Of Business Search Expenses By Douglas C. Carlson	101-102

INTRODUCTION TO TESTIMONY

As we stated in June, the crucial problem confronting business today is the securing of funds with which to finance its future growth. This problem is particularly troublesome for the smaller enterprises. Small businesses are at the end of the line when they seek funds from third parties. These small enterprises are de facto prevented from entering the equity markets in any meaningful way.

The aggregate amount of new stock issues sold by corporations with net worth of $5 million or less has fallen from a yearly average of $759.5 million for the four year period 1968 - 1971 to a yearly average of $372.5 million for the January 1, 1972 - June 1, 1975 period; indeed, during the current expansionary period of stock prices there had been no new issues during the first five months of 1975.

Accordingly, small businesses have been forced to secure ever increasing amounts of debt, frequently at extremely high costs, to finance their operations. According to statistics developed by the Treasury Department in 1973, small manufacturing corporations, those with assets of $1 million or less, had a debt equity ratio of 93.6%, whereas, the debt equity ratio of all corporations was 62.1%. Perhaps a more important statistic is the fact that 55.8% of the smaller business's debt was short-term debt, whereas only 29.3% of total corporate debt was short term. During 1974, the effective average rate of interest on business loans of $10,000 to $1 million exceed 10% for the entire year. The rates charged on the smallest loans were on the average 6% higher than the rate charges on loans in excess of $1 million. In addition to the obvious long range problems of debt financing, another adverse effect has been the expanding power of creditors to make or break a small business by approving or rejecting loan requests.

continued....

As a result of decreasing available outside financing, today's small enterprises are forced to increasingly look to internally generated funds, or, after tax profit retained in the enterprise, as the primary source with which to finance their future growth. According to testimony by the Department of Treasury for all corporations taken as a whole, retained earnings in real terms have declined from 3% of GNP in 1965 to a minus percentage in 1974. In otherwords, the rate of earnings retention has actually decreased when adjusted for inflation. This problem is further illustrated by the fact that in 1965 retained earnings provided in excess of 20% of the new funds for capital formation. By 1974, this source shrunk; providing only 5% of capital expenditures. Small firms have been particularly hard pressed to retain earnings.

If the small business enterprises, which provide 52-53% of the total employment in this country, are to continue to thrive and grow, and to absorb their share of our expanding labor force, capital funds must be available when needed. The following proposals that we shall submit are designed to equalize this disparity and increase the availability of funds for America's smaller enterprises.

PRESENT TAX DEPRECIATION RULES ARE
YESTERDAY'S ANSWER TO TODAY'S PROBLEM

INTRODUCTION:

Present tax depreciation rules and regulations need to be overhauled and replaced with progressive programs that meet the needs of today's changing business environment. The new programs should provide small business concerns the flexibility to internally generate capital by employing a liberal, non-cumbersome, rapid depreciation write-off method which will maximize depreciation charges in times when funds are needed for expansion.

The only chance of attaining effective reform of present rules and regulations is for Congress to make an objective analysis of present depreciation practices, reflect upon the analysis and answer these questions:

1. Do present depreciation regulations enable businessmen to recover their capital equipment investments quick enough to offset effects of inflation?

2. Do present regulations need to be as complicated as they are?

We believe the answer to both of these questions is "no".

To support our position, the opening section will discuss some of the broad economic problems faced by businessmen when trying to make capital investment decisions. The second section of this report will explain present tax depreciation accounting practices in order to point out some of the basic complexities. This will be followed by Section 3, a presentation of why liberalized depreciation rules are necessary to help business concerns generate needed replacement funds. This section will also discuss the severe inflation which has ravaged the machine tool industry. Sections 4 and 5 will discuss the concepts of timing differences and return on invested capital as to their affect on tax revenues.

continued....

Introduction (continued....)

Section 6 will present a broad explanation of depreciation policies in other industrialized nations. Finally, Section 7 will present our alternative tax reform recommendations, 50% ADR and Capital Cost Recovery depreciation.

SECTION 1. Why Depreciation Rules Need To Be Reformed

A very strong argument supporting the need for a liberalized depreciation or capital cost recovery program is the positive effect such a program would have upon the never ending battle to hold inflation in check. We believe that a liberalized capital cost recovery program will provide the business community with the funds needed to reinvest in new plant and equipment. Capital equipment investment programs are an effective means of improving productivity. Unless productivity can out-pace wage demands, it is impossible to keep inflation in line. This was dramatically illustrated in 1973 and 1974 when the consumer price index was rising at an annual growth percentage of 6% and 11% respectively. A great deal of the price inflation that occurred during these two years was the result of inventory stockpiling brought on by speculation concerning future price increases and demand for goods and services. However, in the opinion of many economists, if speculative demand for goods and services were factored out to produce normal demand, there would still be substantial productivity shortages. Thus, with wage increases already out-pacing productivity gains, the only effective solution to demand fueled inflation is a massive investment in new plant and equipment.

The severity of the present shortage of productive capacity was highlighted in the March, 1975 International Economic Report of the President. The report notes that the average age of capital investment is older in the United States than in other industrialized nations, most of whom replaced their equipment after World War II. The report estimates that 30% to 40% of U. S. productive capital was in existence before 1960 compared to 15% to 25% in these other industrialized nations. This results in a greater portion of capital investment dollars being invested in replacement assets rather than assets which will expand productivity. This situation puts us at a serious disadvantage when competing in the international trade markets,

continued....

Section 1. (continued....)
the success of which depends upon the price and quality of manufactured products. Thus, our goods are less attractive in overseas markets.

It will not be easy to solve the problem of inadequate productive capacity. There are two shadows which darken the prospects for resolution. One being a shortage of investment capital and the second being the pessimism with which businessmen view the future.

Between Government deficit spending and the OPEC oil cartel, available investment capital has all but disappeared. The outlook for improvement is dim. This year, the Federal Government will be entering the money markets (in competition with private enterprise)to drain off $80 to $90 billion dollars to finance the forecasted deficit. The OPEC countries are holding billions of dollars which, because of international politics, may or may not be recycled back to the United States. Capital availability problems are compounded further when you consider the huge investment which will be required to obtain energy self-sufficiency and to comply with environmental and health and safety requirements.

The second problem is business confidence. The business sector has watched their inflation adjusted profits decline 58% since 1965 (Testimony from Treasury Secretary Simon). At the same time, there is more and more talk of increased Government regulation and even talk of industry nationalization. Businessmen are fearful of additional taxation which seems inevitable as 1) unemployment funds are depleted, 2) the cities and states face growing financial difficulties, and, 3) Social Security expenditures run well beyond present funding levels.

David Rowe in the University of Pennsylvania's Wharton Forecast states that business confidence has taken such a beating that businesses are wary about investing in new plant and equipment. This is supported by reports recently released by the Commerce Department. These reports state that business concerns are scaling

continued....

Section 1. (continued....)

back their capital spending plans for 1975. Businessmen plan to spend $114.24 billion on plant and equipment in 1975, only 1.6% above the 112.4 billion spent in 1974. This is down from a 4.6% increase forecasted in January, 1975 which was cut back to 3.3% in March, 1975. The Conference Board research organization reported that the nation's 1,000 largest manufacturers decided in the first quarter of 1975 to reduce this year's capital expenditures by $1 billion.

Thus, we can see that the uncertain outlook of business conditions and the lack of investment funds are severely impeding the cure of one of our major economic ills; namely, a shortage of adequate productive capacity. It is not within the scope of this report to resolve all of the problems just discussed. However, we believe that a liberal capital cost recovery program will be one step in the right direction towards encouraging industry to modernize and expand productive facilities as a means of resolving some of the economic problems faced by our country.

SECTION 2. Today's Rules Are Complicated, Achieving A Degree of Bookkeeping Perfection Which Is Not Needed

The tax laws permit the deduction of a reasonable allowance for the exhaustion, wear and tear of property used in business or held for the production of income. This is a relatively simple concept with the purpose of allowing the taxpayer the realization of a return on his capital investment. Unfortunately, the present tax law, in attempting to clarify a "reasonable allowance", has created a preponderance of rules and regulations which serve more to increase the burden of record keeping than to assure fair and reasonable deductions.

Let us briefly review some of the requirements of current tax regulations:

Depreciation Methods

There are three generally used methods of computing depreciation. The most common method is Straight-Line which assumes that depreciation is sustained at a uniform rate throughout the useful life of the property. Depreciation under this method is computed by deducting in equal annual amounts the cost of the property less its estimated salvage value over its useful life.

The other two generally used methods, Double Declining Balance and Sum of the Years-Digits, are termed "accelerated" since they provide for the greatest depreciation in the first year and subsequently smaller deductions each succeeding year. Double Declining Balance is computed by applying a rate of up to 200% of the straight line rate to the decreasing book value of the asset. Under Sum of the Years-Digits, changing fractions are applied each year to the original cost less salvage value.

The above-mentioned methods, however, may not be used for all depreciable property. The tax regulations have placed certain restrictions on the depreciation of used property, realty, and property with less than a three year life.

continued....

Section 2. (continued....)

The substance of these restrictions are as follows:

1. Accelerated methods are applicable only to new property with a useful life of three years or more.
2. The Declining Balance method may be used for used property at a rate of not more than 150% of the straight-line rate.
3. Accelerated methods are not allowed for new real estate except that real estate bought or constructed after July 24, 1969 may be depreciated using the 150% Declining Balance method or any other consistent method which does not give greater allowances in the first two-thirds of useful life than the 150% Declining Balance method. However, in the case of new residential rental property where at least 80% of the gross rentals come from dwelling units, the tax laws permit the use of 200% Declining Balance and Sum of the Years-Digits methods.
4. No accelerated methods are allowable in the case of used realty bought after July 24, 1969 except that used residential rental property with a useful life of at least 20 years may be depreciated at 125% Declining Balance.

Salvage Value

Usually a business asset has very little market value remaining at the end of its useful life. Whether due to physical deterioration or technological obsolescence, the ending value of the property is often minimal. The tax laws state that in no event may an asset be depreciated below a reasonable salvage value under any method of computing depreciation. However, the laws do permit the taxpayer to disregard all or a portion of the salvage value by allowing a reduction in salvage value of up to 10% of the basis of property with a life of at least three years. The effect of these regulations is to require the taxpayer

continued....

Section 2.
Salvage Value (continued....)

to estimate the value his newly acquired property will have up to twenty or thirty years in the future and to maintain detailed records of yearly depreciation charges to assure that he does not depreciate the minimal salvage value. The value of this restriction appears somewhat minimal itself since upon disposal of the property, whether at the end of its useful life or earlier, any difference between the undepreciated cost and its disposal value will be recognized as a taxable gain or loss. Whether the property has been depreciated down to salvage value or to no value has no effect on the total expense taken over the life of the property. The only difference exists in the timing of the expense and that effect is usunlly very slight.

Bonus Depreciation

In addition to the annual depreciation allowed under the methods previously described, the tax regulations permit an additional first year deduction of 20% of the cost of property having a useful life of at least six years. This "bonus" depreciation is limited to $2,000 in any year and the taxpayer is required to maintain records specifically indentifying the property eligible for additional first year depreciation and how and from whom the property was acquired.

Proration of Depreciation Allowance

In the event that depreciable property is not acquired between December 16th or January 15th of any given year, the tax regulations require the taxpayer to calculate by half months the percentage of a year's depreciation which may be claimed for each asset. In effect, this proration requires the taxpayer to split one year's depreciation deduction in increments of half months between the first and last years of the assets life. The amount involved (a portion of one year's

continued....

Section 2.
Proration of Depreciation Allowance (continued....)

depreciation) does not seem to justify the record keeping burden imposed by this regulation.

Capitalization Minimum

At the present time, the Internal Revenue Service generally allows the current deduction of purchases under $500 rather than requiring the capitalization of these minimal expenditures. Although this in itself does eliminate substantial record keeping costs, additional savings could be achieved by increasing this limit to $2,000. Since these purchases generally have a life of only two to three years and are replaced at the end of their usefulness, the actual annual tax deduction generated by expensing in the year of purchase would closely approximate the annual deduction presently allowed from spreading the cost over a two or three year period where various items are replaced each year.

ADR

The Class Life Asset Depreciation Range System (ADR) was established in an attempt to reduce controversy between the taxpayer and the Internal Revenue Service by setting forth acceptable quidelines for the taxpayer's use in formulating his depreciation policies. Unfortunately, since the System was accompanied by complex requirements and regulations, many taxpayers have hesitated to take advantage of the liberalized depreciation rates inherent in ADR due to the rigors of record keeping compliance required by its use. A few of the basic principles of ADR are briefly described in the following paragraphs.

The Regulations have established a series of broad industry classes of assets each with a class life. The taxpayer is allowed to select, from a range extending 20% above and below the class life, a useful life over which to depreciate his property. He may use any depreciation method he desires within the

continued....

Section 2.
ADR (continued....)

restrictions on used and realty property previously described. The depreciation method may be applied to assets individually or to a group of assets with the same class life placed in a "vintage account" by the year placed in service. Separate vintage accounts must be maintained for new and used assets, assets subject to the elective 10% salvage reductions, and assets on which additional first-year depreciation has been elected. A separate depreciation reserve must also be maintained for each vintage account.

Under ADR, retirements are separated into two categories ordinary and extraordinary. All retirements are considered ordinary except for the retirement of certain types of property described in the Regulations. The retirement proceeds of ordinary retirements are simply added to the depreciation reserve of the vintage account from which the asset is retired thereby reducing the depreciable basis of the remaining assets in that account. Extraordinary retirements, however, are removed from the asset and depreciation reserve accounts and the gain or loss on disposal is recognized in the year of retirement.

Another requirement of ADR is the mandatory use of one of two first-year conventions:

1. The half-year convention - Regardless of when the asset is placed in service, a half-year's depreciation is taken in the first year. Similarly a half-year's depreciation is claimed on extraordinary retirements in the year retired.
2. The modified half-year convention - A full year's depreciation is taken on all assets placed in service during the first half of the year. Second half additions get no depreciation deductions in the first year. Extraordinary retirements receive a full year's depreciation, a half-years depreciation, or none, depending on the half of the year in which the property was acquired and retired.

continued....

Section 2.
ADR (continued....)

In an effort to minimize controversy over the repair versus capital expenditure question, ADR established a "percentage repair allowance" rule. Basically the rule permits the mechanical computation of a dollar allowance which the taxpayer may use as the maximum deduction for questionable "repair" expenditures. The deductibility of expenditures under this limit which are clearly not capital items will not be contested by the IRS. Any repair expenditures which exceed the repair allowances must be capitalized as property improvements. The percentage repair allowance rule election must be made each year and can be elected for certain classes and not for others. In reality establishment of the percentage repair allowance rule accomplished very little. The IRS and the taxpayer must still come to agreement over whether an item "clearly" is or is not a capital asset.

The tax requirements that we have touched upon in this section are but a small part of the rules and regulations that businessmen must comply with under present depreciation accounting. The impact of these voluminous requirements are felt most heavily by small businesses in the area of record keeping. A typical small manufacturing company might maintain 400 individual asset cards. Each card will contain information as to the date of purchase, description of asset, depreciation method, useful life, salvage value and the amount of additional first year depreciation elected if any. In order to determine depreciation for the year, the businessmen must compute depreciation for each card taking into consideration the part year conventions, salvage value, additional first year depreciation already taken, method of depreciation involved, and total depreciation taken to date. Depreciation calculated in this manner of each asset is then summarized to arrive at the total depreciation expense for the year.

continued....

<u>Section 2</u>.

ADR (continued....)

This procedure repeated in company after company each year imposes an unnecessary burden upon small business. In the following sections we will outline several proposals which will effectively reduce record keeping costs without adversely effecting tax revenues.

SECTION 3. Depreciation Can Be An Effective Vehicle For Generating Funds Needed To Replace Plant And Equipment If Proper Recognition Is Given To Inflation

Accounting theory states that capital assets employed by a business concern should be systematically depreciated by charging a percentage of cost (based on asset useful life) against annual operating income in order to set aside a portion of each year's profit for future asset replacement.

In 1954, the Joint Committee on Internal Revenue Taxation (for the House Ways and Means Committee) stated it would be appropriate to expand on this concept by permitting depreciation methods which would set aside funds at a more rapid pace to compensate for the inflationary trend in the cost of replacement assets. At that time inflation was running between 1% and 3% a year. Possibly because of this relatively low rate of inflation, initially proposed liberal depreciation rules never found their way into final legislation.

Today, the impact of inflation is much more severe. To illustrate the dramatic impact of inflation on the cost of replacement machinery and equipment, a comparison of wholesale prices for various categories of machinery and equipment may be informative. Application of the Bureau of Labor Statistics Wholesale Price Indices to selected categories of machinery and equipment, each of which was purchased for $10,000 in 1967, would result in the following replacement costs at the respective dates:

continued....

Section 3. (continued....)

Machinery and Equipment Representative Wholesale Replacement Prices

	All * Categories	Agricultural	Construction	Metal Working	General Purpose
1969 (average)	10,640	10,850	11,000	10,780	10,690
1971 (average)	11,550	11,720	12,140	11,730	11,910
1973 (average)	12,170	12,590	13,070	12,550	12,700
1974 (average)	13,940	14,380	15,230	14,690	15,120
November, 1974	15,270	15,970	16,970	16,190	16,890
April, 1975	15,970	16,670	18,380	16,960	17,610

(* Categories excluded from illustration are miscellaneous, electrical and vehicular equipment; the average 1974 replacement prices are $13,950, 12,500 and 12, 920, respectively).

The impact is even more dramatic if you compare replacement costs of individual items. The estimated Asset Depreciation Range (ADR) useful life of metalworking machinery and equipment is 12 years. Thus, it is possible that a machine purchased the first year of January, 1963 may require replacement by the end of December, 1974. If the machine cost $10,000 at the date of purchase, the replacement cost at the end of 1974 would be approximately $17,500. Under ADR rules, this asset could be depreciated in 9.5 years. If the company is successful in financing the growth of its business with retained earnings, it must rely on depreciation to provide funds for the replacement of old assets. Tables 1 and 2 calculate annual funds which are generated by employing the most advantageous ADR depreciation method and also calculates the compound growth of funds generated by depreciation if they were invested in certificates of deposit.

continued....

Section 3. (continued....)

TABLE 1

ANNUAL DEPRECIATION OF A METALWORKING MACHINE COSTING $10,000 WHEN PURCHASED JANUARY 1, 1963

Double Declining Balance Depreciation

Year (1)	Expense (2)	Reserve (3)	Net Book Value (4)
1963	2,105	2,105	7,895
1964	1,662	3,767	6,233
1965	1,312	5,079	4,921
1966	1,035	6,114	3,886
1967	813	6,932	3,068
1968 (5)	682	7,614	2,386
1969	682	8,296	1,704
1970	682	8,978	1,022
1971	682	9,660	340
1972 (June 30)	340	10,000	0

(1) ADR Asset Guideline Class 35.1 - Lower limit depreciable life, 9½ years.

(2) 21.05% times cost in year 1 and net book value thereafter.

(3) Prior year reserve balance plus current year expense.

(4) Original cost less annual reserve balance.

(5) Switch to Straight-Line depreciation method.

TABLE 2

CASH ACCUMULATED BY INVESTING FUNDS GENERATED FROM ANNUAL DEPRECIATION CHARGES IN CERTIFICATES OF DEPOSIT

continued....

CASH ACCUMULATED BY INVESTING FUNDS GENERATED FROM ANNUAL DEPRECIATION CHARGES IN CERTIFICATES OF DEPOSIT

Year (1)	Certificate of Deposit Interest Rate % (2)	Depreciation Funds (3)	Funds Subject to Interest (4)	Annual Interest Earned (5)	Cash Balance (6)
1963	4.00	2,105	1,053	42	2,147
1964	4.50	1,662	2,978	134	3,943
1965	5.50	1,312	4,599	253	5,508
1966	5.50	1,035	6,026	331	6,874
1967	5.00	818	7,283	364	8,056
1968	5.00	682	8,397	420	9,158
1969	5.00	682	9,499	475	10,315
1970	5.75	682	10,656	613	11,610
1971	5.75	682	11,951	687	12,979
1972	5.75	340	13,319	766	13,745
1973	5.88	-	13,745	808	14,553
1974	6.00	-	14,553	873	15,426

(1) ADR estimated useful life of assets defined in guideline class 35.1.

(2) Statistical Abstract of the United States 1974 - Federal Reserve Bulletin - Maximum Interest Rates Payable on Time and Savings Deposits: 1962 to 1974.

(3) Table - Column (2)

(4) One-half current year depreciation (average time on deposit) plus prior year cash balance.

(5) Column (4) multiplied by column (2)

(6) Column (3) plus column (5) plus prior year column (6)

Tables 1 and 2 illustrate that even with the most ideal financial planning (i.e., funding annual depreciation charges) the company in our illustration would be $2,074[1] short of the necessary funds needed to replace the metalworking machine purchased in 1963. In practice, very few companies are able to

continued....

Section 3. (continued....)

accumulate cash by funding depreciation. Fewer, if any, fund cash to meet asset replacement costs. This is true because, generally speaking, capital cost recovery (depreciation) and profit reinvestment do not provide enough funds to meet growing working capital and plant financing needs of companies experiencing even the most modest rates of growth.

[1] Replacement cost, $17,500 less 1974 cash balance, Table 2 column (6) of $15,426

continued....

Section 3. (continued....)

The following tables 3 and 4 present the magnitude of corporate financing problems:

TABLE 3

COMPARISON OF BUSINESS EXPENDITURES FOR NEW PLANT AND EQUIPMENT TO FUNDS PROVIDED FROM UNDISTRIBUTED PROFITS AND DEPRECIATION OF PLANT AND EQUIPMENT (1)

(in billions of dollars)

Year	Plant and Equipment Expenditures	Undistributed Profits and Depreciation	Required Funds Unavailable from Operations
1950	20.2	17.9	2.3
1955	29.5	29.2	.3
1960	36.8	34.4	2.4
1965	54.4	56.6	2.2
1969	75.6	60.7	14.9
1970	79.7	59.4	20.3
1971	81.2	69.9	11.3
1972	88.4	77.5	10.9
1973	99.7	81.8	17.9
1974	112.7	70.1	42.6

(1) U. S. Bureau of Economic Analysis, Survey of Current Business.

TABLE 4

INCREASED INVESTMENT IN WORKING CAPITAL (1)

(in billions of dollars)

continued....

INCREASED INVESTMENT IN WORKING CAPITAL (1)

(in billions of dollars)

Year	Net Working Capital	Increase from Prior Year
1969	185.7	
1970	187.4	1.7
1971	204.8	17.4
1972	224.3	19.5
1973	245.3	21.0

(1) U. S. Securities and Exchange Commission, Statistical Series, Net Working Capital of Nonfinancial U. S. Corporations.

Tables 3 and 4 clearly illustrate the impossibility of financing business growth with depreciation and profits. Of even more concern is the trend of excess investment needs over available funds.
Table 4 shows an increasingly negative trend.

At this point, we should review the manner in which period to period depreciation charges affect tax revenues.

SECTION 4. Timing Differences - How They Affect Tax Revenues

It is not unusual to view tax reform as being synonomous with tax avoidance. Quite often, this is not so. A specific case in point is the liberalization of time periods a company may employ to depreciate their plant and equipment. A new law that will accelerate present depreciation time periods merely defers to another period revenue that would be otherwise taxable. To understand this concept, the following illustration, presented on Table 5, will isolate the operating results of three hypothetical companies (A, B and C) by computing tax revenues for a five-year period on a straight-line basis and then, on an accelerated basis which would allow the companies to write-off assets in 2 1/2 years. Each company has an undepreciated investment of $200,000 at the beginning of year 1 and makes no additional capital expenditures during the five-year period. The earnings of Company A are level. Company B's earnings are accelerating while Company C is in a declining earnings pattern.

Table 5 shows that under each set of operating conditions (level, growing, declining), total tax collections will be equal at the end of the useful lives of plant and equipment. Thus, liberal depreciation rules will not result in tax avoidance, but will only affect the timing of tax collections.

continued.....

TABLE 5
FIVE-YEAR COMPUTATION OF INCOME TAX USING
STRAIGHT-LINE AND ACCELERATED DEPRECIATION METHODS
(amounts in dollars)

	Company A					Company B					Company C				
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	Year 4	Year 5
Income before charges for depreciation	100,000	100,000	100,000	100,000	100,000	100,000	110,000	120,000	130,000	140,000	100,000	90,000	80,000	70,000	60,000
Depreciation expense:															
Straight-line basis	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Accelerated basis	80,000	80,000	40,000	-	-	80,000	80,000	40,000	-	-	80,000	80,000	40,000	-	-
Taxable income:															
Straight-line basis	60,000	60,000	60,000	60,000	60,000	60,000	70,000	80,000	90,000	100,000	60,000	50,000	40,000	30,000	20,000
Accelerated basis	20,000	20,000	60,000	100,000	100,000	20,000	30,000	80,000	130,000	140,000	20,000	10,000	40,000	70,000	60,000
Income tax (at a 50% tax rate):															
Straight-line basis	30,000	30,000	30,000	30,000	30,000	30,000	35,000	40,000	45,000	50,000	30,000	25,000	20,000	15,000	10,000
Accelerated basis	10,000	10,000	30,000	50,000	50,000	10,000	15,000	40,000	65,000	70,000	10,000	5,000	20,000	35,000	30,000
Accumulated tax revenue at the end of each year:															
Straight-line basis	30,000	60,000	90,000	120,000	150,000	30,000	65,000	105,000	150,000	200,000	30,000	55,000	75,000	90,000	100,000
Accelerated basis	10,000	20,000	50,000	100,000	150,000	10,000	25,000	65,000	130,000	200,000	10,000	15,000	35,000	70,000	100,000

Section 4. (continued.....)

Table 5 , effectively demonstrates that over a period of years, the Treasury will realize the same total revenue regardless of the depreciation methods employed by taxpayers. However, on a short-term year-to-year basis, liberalized depreciation methods will have a negative impact on tax revenues in early years and a favorable impact in later years. Summarizing information presented in Table 5 , Table 6 presents the tax revenue impact of accelerated depreciation over straight-line depreciation as follows:

TABLE 6

INCOME TAX REVENUES GENERATED BY ACCELERATED DEPRECIATION OVER (UNDER) REVENUE RESULTING FROM STRAIGHT-LINE DEPRECIATION COMPANIES A, B AND C COMBINED

Year	Amount
1	(60,000)
2	(60,000)
3	-
4	60,000
5	60,000

Thus, the Treasury will face some intitially lean years if depreciation rules are liberalized. Table 6 , however, does not present a realistic picture of what will happen to tax revenues if depreciation rules are liberalized. The depreciation regulation changes we will be proposing in a later section tie resulting tax benefits to a program of reinvestment in plant and equipment or the purchase of government obligations. At this point, a review is necessary to determine what tax implications result from a program where tax benefits are reinvested in capital equipment. Before this can be successfully accomplished, a brief explanation of the "Return On Invested Capital (ROIC)" concept may be appropriate in explaining the total effect tax incentives have on tax revenues.

continued....

SECTION 6. How The "Return On Invested Captial"Concept Will Affect Future Tax Revenues

In some respects, capital investment decisions are akin to gambling. A businessman, pushed by a growing demand for goods and services or striving to improve productivity, is willing to gamble that a cash investment in capital equipment will be rewarded by the return of cash invested plus an attractive profit. If the businessman cannot invest in a capital equipment project that will return his capital and a relatively high profit return, theoretically, he will reject the project and invest his excess funds in safe institutional time deposits or other sound investment instruments. In practice, capital investment decisions produce results which range from highly successful to dismal failures. Table 7 presents a score card of the results of business capital investment decisions. The Table presents percentage profit returns which were computed by dividing net income reported on annual corporate income tax returns by the value of shareholders' equity:

TABLE 7

PROFIT TO SHAREHOLDERS' EQUITY

Year	% Return
1965	13.0
1966	13.4
1967	11.7
1968	12.1
1969	11.5
1970	9.3
1971	9.7
1972	10.6
1973	12.8
Average	11.5

continued....

Section 5. (continued.....)

Thus, Table _7_ shows that over the years in question, the averaging of investment successes and failures results in an average capital return of 11.5%

At this point, we can bring all the ROIC factors together in a hypothetical operating situation to determine what impact investment returns have on tax revenues. To accomplish this we will utilize the five-year operating results of Company B presented in Table _5_ and will add three additional operating years which report mature or flat earnings growth. First tabulation (Situation 1.) presents the five-year results of operations employing the straight-line depreciation method. The second tabulation (Situation 2.) will present the same set of operating facts except that accelerated depreciation (a program we call 50% ADR, which will be explained later) will be substituted for straight-line depreciation and the excess of accelerated over straight-line depreciation will be reinvested in capital equipment to generate an 11.5% investment return. The following Tables _8_ and _9_ provide computations of depreciation and reinvestment earnings under Situations 1 and 2.

continued....

TABLE 8

INCOME TAX IMPACT OF LIBERALIZING DEPRECIATION RULES
GIVING CONSIDERATION TO THE CONCEPT OF RETURN ON INVESTED CAPITAL

	Company B (Growth Period)						Company B (Maturity Period)			
	Year 1	Year 2	Year 3	Year 4	Year 5	Total	Year 6	Year 7	Year 8	Grand Total
Situation 1.										
Income before charges for depreciation	$100,000	$110,000	$120,000	$130,000	$140,000	$600,000	$140,000	$140,000	$140,000	$1,020,000
Depreciation expense (straight-line)	40,000	48,000	57,600	61,120	61,120	267,840	21,120	13,120	3,520	305,600
Taxable income	60,000	62,000	62,400	68,880	78,880	332,160	118,880	126,880	136,480	714,400
Income tax (at 50%)	$ 30,000	$ 31,000	$ 31,200	$ 34,440	$ 39,440	$166,080	$ 59,440	$ 63,440	$ 68,240	$ 357,200
Situation 2.										
Income before charges for depreciation	$100,000	$110,000	$120,000	$130,000	$140,000	$600,000	$140,000	$140,000	$140,000	$1,020,000
Income from reinvesting the excess of accelerated over straight-line depreciation in capital equipment (11.5% investment return) Table ___ annexed	___	4,600	10,120	12,144	12,144	39,008	12,144	12,144	12,144	75,440
	100,000	114,600	130,120	142,144	152,144	639,008	152,144	152,144	152,144	1,095,440
Accelerated depreciation expense:										
Original capital equipment	80,000	80,000	40,000			200,000				200,000
Reinvestment capital equipment	___	16,000	35,200	34,240	16,640	102,080	3,520	___	___	105,600
	80,000	96,000	75,200	34,240	16,640	302,080	3,520	___	___	305,600
Taxable income	20,000	18,600	54,920	10[illegible],904	135,504	336,928	148,624	152,144	152,144	789,840
Income tax (at 50%)	$ 10,000	$ 9,300	$ 27,460	$ 5[illegible],952	$ 67,752	$168,464	$ 74,312	$ 76,072	$ 76,072	$ 394,920
Situation 2. income tax over (under) Situation 1. income tax	$(20,000)	$(21,700)	$ (3,740)	$ 19,512	$ 28,312	$ 2,384	$ 14,872	$ 12,632	$ 7,832	$ 37,720

TABLE 9

COMPUTATION OF ACCELERATED AND STRAIGHT-LINE DEPRECIATION TO DETERMINE EXCESS FUNDS AVAILABLE FOR REINVESTMENT IN CAPITAL EQUIPMENT AND COMPUTATION OF EARNINGS PROVIDED FROM REINVESTMENT OF EXCESS DEPRECIATION FUNDS

	Year								
	1	2	3	4	5	6	7	8	Total
Accelerated depreciation:									
Initial asset investment	$80,000	$80,000	$40,000						$200,000
Reinvestment of excess depreciation:									
Year 1		16,000	16,000	$ 8,000					40,000
Year 2			19,200	19,200	$ 9,600				48,000
Year 3				7,040	7,040	$ 3,520			17,600
Total	80,000	96,000	75,200	34,240	16,640	3,520			305,600
Straight-line depreciation:									
Initial asset investment	(40,000)	(40,000)	(40,000)	(40,000)	(40,000)				(200,000)
Reinvestment of excess depreciation:									
Year 1		(8,000)	(8,000)	(8,000)	(8,000)	(8,000)			(40,000)
Year 2			(9,600)	(9,600)	(9,600)	(9,600)	$ (9,600)		(48,000)
Year 3				(3,520)	(3,520)	(3,520)	(3,520)	$ (3,520)	(17,600)
Total	(40,000)	(48,000)	(57,600)	(61,120)	(61,120)	(21,120)	(13,120)	(3,520)	(305,600)
Accelerated depreciation over (under) straight-line depreciation	$40,000	$48,000	$17,600	$(26,880)	$(44,480)	$(17,600)	$(13,120)	$ (3,520)	-
Cumulative value of investment arising from reinvestment of funds provided by excess depreciation		40,000	88,000	105,600	105,600	105,600	105,600	105,600	105,600
Additional pretax earnings at an 11.5% rate of return on invested funds		$ 4,600	$10,120	$ 12,144	$ 12,144	$ 12,144	$ 12,144	$ 12,144	$ 75,440

Section 5. (continued....)

Table 8 verifies the positive impact which will result from liberalization of depreciable asset lives. Over the depreciable lives of the assets in question (Situation 2.), accelerated depreciation and resulting reinvestment of excess funds produces $394,920 in total income tax revenue compared to Situation 1. which generates total income tax revenue of $357,200. This is a 10.6% improvement in tax revenues. Although the examples are simplified, the concepts are sound. Even during Company B's growth period where operations are absorbing the heaviest depreciation charges, cumulative tax revenues at the end of five years are higher in Situation 2. than in Situation 1. When Company B's growth levels off (Maturity Period years 6 through 8), income tax revenue gains improve dramatically.

A final question that needs to be answered is what financial impact results from comparing a steady flow of income tax revenue (Situation 1.) to a lower initial flow which improves as years go by (Situation 2.)? To answer this question, it is necessary to discount each year's income tax amount at a current interest rate to determine today's value of future revenues. The theory behind the discounting concept states that a dollar in hand today is worth more than a dollar in hand one year from today. Today's dollar could be deposited in a savings account at 8% and it would be worth $1.08 one year from now. Thus, comparing the value of a dollar today to a dollar to be received one or more years from now requires that the future dollars be discounted by a growing percentage as the year of receipt is extended.

Table 10 therefore, presents the present value of future income tax receipts. Again, Situation 2. produces the most favorable result. Discounted tax revenues are improved by $14,497, a 6% improvement over Situation 1. ($257,072 less $242,575).

continued....

TABLE 10

PRESENT VALUE OF INCOME TAX REVENUE
PRODUCED BY SITUATIONS 1. AND 2.

Year	Income Tax Revenue			Present Value of Future Income Tax Revenue	
Year	Situation 1.	Situation 2.	Discount Rate (8%)	Situation 1.	Situation 2.
1	$ 30,000	$ 10,000	.926	$ 27,780	$ 9,260
2	31,000	9,300	.857	26,567	7,970
3.	31,200	27,460	.794	24,773	21,803
4	34,440	53,952	.735	25,313	39,654
5	39,440	67,752	.681	26,859	46,139
6	59,440	74,312	.630	37,447	46,817
7	63,440	76,072	.583	36,986	44,350
8	68,240	76,072	.540	36,850	41,079
	$357,200	$394,920		$242,575	$257,072

SECTION 6. Liberal Depreciation Policies of Other Industrialized Nations[1]

Other industrialized nations have generally adopted provisions relating to cost recovery allowances and capital investment incentives that are more favorable than those provided in the United States. This stems from the need to rebuild in order to overcome the ravages of war. There has also been a greater realization that rising productivity creates a rising level of per capita income and a better standard of living. In the United States, we appear to have relied more on rising demand to stimulate production while at the same time remaining complacent about the need to modernize and keep up with technology.

Not only have the European nations adopted tax policies fostering capital investment but they are relying ever more heavily on indirect taxes, such as the value-added tax, which do not impose a tax burden on investment to finance government expenditures. In the absence of such a neutral tax, U. S. investment bears a larger share of the cost of government than does investment of its trading partners.

The following table summarizes a comparison of cost recovery for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants, or deductions generally permitted. The deductions in the United States have been determined under the double declining balance method without regard to the limited first year allowances for small businesses.

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[1] Information in this section is reprinted from excerpts of an article appearing in the May 1975 edition of The International Tax Journal - The Treatment of Capital Recovery Allowances in the U. S. and Other Countries by B. Kenneth Sander and Charles T. Crawford.

continued....

Section 6. (continued....)

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of costs of assets)[1] [2]		
		First Taxable Year	First 3 Taxable Years	First 7 Taxable Years
United Kingdom	1	100.0	100.0	100.0
Canada	2	50.0	100.0	100.0
Netherlands	5	14.0	58.0	108.0
Sweden	5	60.0	95.7	130.0
Italy	6	19.6	67.9	100.0
Switzerland	6-2/3	15.0	58.4	90.0
France	8	31.3	67.5	94.9
W. Germany	9	16.7	49.6	88.8
Belgium	10	20.0	48.8	89.0
Luxembourg	10	28.0	60.4	94.4
Japan	11	37.1	63.9	88.1
United States (1975 Law)	10-1/2	29.5	60.7	94.5

The adoption of ADR and the restoration of the investment credit has done no more than raise the level of U. S. capital recovery to the point where we are tied for last among the industrialized countries... At this point, the following statements from the presentation made by Joel Barlow, at the NTA-TIA Symposium on Federal Tax Reform in Washington in July, 1973, seem an appropriate reminder:

"The United States has the lowest capital recovery tax allowances of any of the industrialized nations."

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[1] It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to a rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowances presented in the table above. The United States does not permit this approach.

[2] This reprint excludes table footnotes which explain computational methods and a comparison of pre-1975 methods.

continued....

Section 6. (continued....)

"The United States has the highest percentage of overage obsolete production facilities in relation to GNP of any of the industrial nations."

"The United States has the lowest rate of productivity increase of any of the industrial nations."

"The United States relies more heavily than any other industrialized nation on income taxation with its penalty on productivity and efficiency."

SECTION 7. THE 50% ADR OR CAPITAL COST RECOVERY TAX REFORM PROGRAM

Based on the information presented in prior sections, it seems appropriate that a conceptual change in present depreciation methods would incorporate features that would permit business concerns to:

- Recover capital investment costs more quickly to generate funds for reinvestment and offset the effects of price inflation.
- Eliminate many of the petty bookkeeping rules found in present depreciation rules and regulations.

We have reviewed the capital recovery allowance concept contained in H. R. 7543, "The Capital Recovery Act of 1975 sponsored by Representative Waggonner (D.-La.) and Representative Archer (R.-Tex.). In general, we are very pleased with the various sections of the Bill; particularly the depreciation rate percentages which permit cost recovery in five and ten years respectively for equipment and buildings acquired (paid for) after December 31, 1975.

We do believe certain revisions would improve the effectiveness of the Bill. Specifically, the bill should incorporate the mandatory reinvestment program described in our depreciation reform proposals. These programs will eliminate potentially abusive situations where cash flow generated by the liberal depreciation charges may, in some circumstances, sit in business bank accounts.

Another area of concern, results from the fact that H. R. 7543 restricts rapid cost recovery to assets acquired after December 31, 1974. In our opinion this feature limits the prospect of immediate economic stimulation that is needed to pull the Country out of the present recession. Our depreciation reform proposals liberalize depreciation write-offs on assets presently in service as well as future acquisitions. This not only improves upon the tax benefit features

continued....

Section 7. (continued....)

of H. R. 7543 but it also eliminates the accounting problem of maintaining two sets of tax depreciation records as would be required by the H. R. 7543 proposals.

Finally, H. R. 7543 excludes agricultural capital investments from the liberalized write-off provisions. In our opinion, agricultural assets should also qualify for the favorable provisions of H. R. 7543.

We are recommending that the traditional useful life concept of depreciation be abandoned in favor of a less complex capital cost recovery (CCR) program. CCR will provide small businesses the flexibility to internally generate capital by employing a liberal, noncumbersome, rapid depreciation write-off method which will maximize depreciation charges during periods when funds are needed for expansion.

We choose CCR because it achieves all the benefits of rapid depreciation without a maze of complex rules. Our recommendation is based on two alternative methods. Method 1 is called 50% ADR which employs double declining balance depreciation. Method 2 is called capital cost recovery which computes depreciation using a declining balance method employing a variable depreciation percentage depending on present asset guideline period lives. As stated in our discussion of H. R. 7543 we are in favor of the 5 and 10 year asset write-off provisions of the Bill However, because of certain Bill omissions and the fact that the bill may not attract concensus support, we are presenting reform methods 1 and 2, which in our opinion, are reasonable alternatives to H. R. 7543.

continued....

Section 7. (continued....)

METHOD 1. 50% ADR

Under 50% ADR, depreciable lives would be stated in a range of years for each pool. Present ADR asset guide line lives would be the starting point for computing 50% ADR depreciation. The ADR life periods would range 50% above or 50% below present asset guide line lives. Taxpayers would select, at their discretion, a rate which falls between the upper and lower limits. Thus, an asset with a 10-year useful life could be depreciated from between 5 to 15 years. It may be appropriate to restrict the depreciation rate to a straight-line basis for assets having an asset guide line period of 5 years or less. This would restrict cost recovery to a liberal 2½ year period, or less, depending on the ADR asset guide line life. Assets having a guide line period useful life of more than 5 years would be eligible to use accelerated depreciation methods. In the same vein, assets with a useful life of 25 or more years could be restricted to a 40% ADR factor. Again, the purpose would be to prevent too rapid a write-off period.

METHOD 2. CAPITAL COST RECOVERY

As mentioned above we favor the Capital Cost Recovery method. We choose this method because of the ease of computation routines. CCR depreciation is computed by applying a range of percentages to the undepreciated value of a category of assets (the categories will be explained later). This is commonly referred to as a declining balance depreciation method. The range of percentages are based, as with 50% ADR, on asset guideline period lives presently employed with conventional ADR. We believe consideration should be given to the following CCR rates:

continued....

Section 7.
Method 2. (continued....)

ASSET GUIDELINE PERIOD LIFE	CCR DEPRECIATION RATE %
2 to 15 years	50
16 to 30 years	20
31 or more years	10

In both the 50% ADR and the Capital Cost REcovery methods, we have suggested a range of years and rates at which groups of assets may be depreciated. If and when depreciation reform is considered by Congress, porposed legislation may increase or decrease these rates. The point we want to make however, is that either method (50% ADR or Capital Cost Recovery) can be tailored to achieve the same result. For example, CCR depreciation on a 25 year asset depreciated at a 20% declining balance rate will produce the same annual depreciation expense as the 50% ADR method (employing the 40% limitation for assets with a useful life of 25 or more years. See the description of the 50% ADR method). The only difference between the two methods being a slightly higher ADR depreciation in later years. This results from the fact that 50% ADR would permit a switch to straight-line depreciation generating more expense in later years than the CCR method which builds in salvage value by applying a fixed depreciation percent to an ever decreasing net book amount. On the other hand, CCR will produce higher or lower annual depreciation than 50% ADR epending on the asset guideline class life employed. Both methods, 50% ADR and Capital Cost Recovery, will produce higher annual depreciation charges than are achieved using present-day ADR methods.

To illustrate some of the concepts just discussed, Tables 11 to 14 present 3 hypothetical situations where a pool of like assets are being added to at the rate of $1,000 a year until the pool reaches $10,000. Each table records the annusl depreciation calculated for each $1,000 asset increment with respect to

continued....

TABLE 11

CONVENTIONAL ADR DEPRECIATION EMPLOYING
MAXIMUM ACCELERATED METHODS ON ASSETS
HAVING A 12 YEAR USEFUL LIFE (80%-10 YEAR WRITE OFF)

Cost	Reserve	Annual Expense	Depreciation Expense By Year And Asset																		
			1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
$ 1,000	$ 200	$ 200	$200	$160	$128	$102	$ 82	$ 65	$ 66	$ 66	$ 66	$ 65									
2,000	560	360		200	160	128	102	82	65	66	66	66	$ 65								
3,000	1,048	488			200	160	128	102	82	65	66	66	66	$ 65							
4,000	1,638	590				200	160	128	102	82	65	66	66	66	$ 65						
5,000	2,310	672					200	160	128	102	82	65	66	66	66	$ 65					
6,000	3,047	737						200	160	128	102	82	65	66	66	66	$ 65				
7,000	3,850	803							200	160	128	102	82	65	66	66	66	$ 65			
8,000	4,719	869								200	160	128	102	82	65	66	66	66	$ 65		
9,000	5,654	935									200	160	128	102	82	65	66	66	66	$ 65	
10,000	6,654	1,000										200	160	128	102	82	65	66	66	66	$65
10,000	7,454	800																			
10,000	8,094	640																			
10,000	8,606	512																			
10,000	9,016	410																			
10,000	9,344	328																			
10,000	9,607	263																			
10,000	9,804	197																			
10,000	9,935	131																			
10,000	10,000	65																			
			$200	$360	$488	$590	$672	$737	$803	$869	$935	$1,000	$800	$640	$512	$410	$328	$263	$197	$131	$65

TABLE 12

50% ADR DEPRECIATION EMPLOYING MAXIMUM ACCELERATED METHODS ON ASSETS HAVING A 12 YEAR USEFUL LIFE
(50%-6 YEAR WRITE OFF)

Cost	Reserve	Annual Expense	Depreciation Expense By Year And Asset														
			1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
$ 1,000	$ 334	$ 334	$334	$222	$128	$ 99	$ 99	$ 98									
2,000	890	556		334	222	148	99	99	$ 98								
3,000	1,594	704			334	222	148	99	99	$ 98							
4,000	2,397	803				334	222	148	99	99	$ 98						
5,000	3,299	902					334	222	148	99	99	$ 98					
6,000	4,299	1,000						334	222	148	99	99	$ 98				
7,000	5,299	1,000							334	222	148	99	99	$ 98			
8,000	6,299	1,000								334	222	148	99	99	$ 98		
9,000	7,299	1,000									334	222	148	99	99	$ 98	
10,000	8,299	1,000										334	222	148	99	99	$98
10,000	8,965	666															
10,000	9,409	444															
10,000	9,705	296															
10,000	9,902	197															
10,000	10,000	98															
			$334	$556	$704	$803	$902	$1,000	$1,000	$1,000	$1,000	$1,000	$666	$444	$296	$197	$98

TABLE 13

CAPITAL COST RECOVERY DEPRECIATION
EMPLOYING A 50% DECLINING BALANCE RATE

Cost	Net Book Value (Prior Year Net Book Value Plus Current Year Additions)	Reserve	Annual Expense	Depreciation Expense By Years													
				1	2	3	4	5	6	7	8	9	10	11	12	13	14
$ 1,000	$1,000	$ 500	$500	$500													
2,000	1,500	1,250	750		$750												
3,000	1,750	2,125	875			$875											
4,000	1,875	3,062	937				$937										
5,000	1,937	4,031	969					$969									
6,000	1,969	5,015	984						$984								
7,000	1,985	6,007	992							$992							
8,000	1,992	7,003	996								$996						
9,000	1,996	8,001	998									$998					
10,000	-,999	9,000	999										$999				
10,000	1,000	9,500	500											$500			
10,000	500	9,750	250												$250		
10,000	250	9,875	125													$125	
10,000	0	10,000	125														$125(1)
				$500	$750	$875	$937	$969	$984	$992	$996	$998	$999	$500	$250	$125	$125

(1) Abbreviated for illustrative purposes.
In practice the balance would continue declining.

Section 7.
Method 2. (continued....)

conventional ADR in Table 11 and 50% ADR in Table 12. Table 13 presents the composite depreciation calculations made each year following the Capital Cost Recovery method. Finally, Table 14 summarizes annual depreciation expense computed using the 3 methods.

TABLE 14

ANNUAL DEPRECIATION EXPENSE SUMMARY

Year	Table 11 Present ADR (80% or 10 Years)	Table 12 50% ADR (50% or 6 Years)	Table 13 Capital Cost Recovery (50% of Net Book Value)
1	$ 200	$ 334	500
2	360	556	750
3	488	704	875
4	590	803	937
5	672	902	969
6	737	1,000	984
7	803	1,000	992
8	869	1,000	996
9	935	1,000	998
10	1,000	1,000	999
11	800	666	500
12	640	444	250
13	512	296	125
14	410	197	125
15	328	98	
16	263		
17	197		
18	131		
19	65		
Total	$10,000	$10,000	$10,000

Section 7.
Method 2. (continued....)

The above Tables point out several interesting situations. For example, in the early years of Capital Cost Recovery, higher annual depreciation charges are achieved than under 50% or conventional ADR. By year 6, 50% ADR depreciation begins to exceed CCR depreciation. By year 11, conventional ADR produces higher annual depreciation than either of the proposed methods. When you consider the realities of inflation and the potential of technological obsolescence, it appears that either one of the proposed methods would be preferable to the conventional ADR method. But when you compare all three methods for ease of computation, Capital Cost Recovery proves to be the most attractive. CCR requires fourteen separate calculations compared to sixty-50% ADR calculations and one-hundred conventional ADR calculations. The sheer simplicity of CCR makes the method an attractive alternative.

At this point, we would like to summarize procedures we are recommending for consideration when the various congressional committees begin drafting tax reform measures which will affect tax depreciation accounting.

CAPITAL COST RECOVERY/50% ADR TAX DEPRECIATION PROGRAM

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continued....

Section 7. (continued....)

1. Depreciable assets are pooled into basic functional categories.
   We believe the following groupings would be appropriate for most business concerns:
   a. Depreciable real estate
   b. Machinery equipment and fixtures
   c. Furniture and fixtures
   d. Transportation equipment
   e. Other (special tooling, dies, etc.)

   These groupings, for the most part, will conform with present Asset Depreciation Rand (ADR) class lives. Thus, it would not be necessary to re-define guideline class asset descriptions. However, all assets in pools (a) through (e) would be depreciated within the class life range which most closely matches the description of pooled assets. There would be no real need to segregate new and used assets because under 50% ADR or Capital Cost Recovery, useful life is no longer the basis behind spreading depreciation charges.

2. Each year, a dual depreciation computation would be made for assets recorded in each pool:
   Straight-Line - The cost of each year's additions would be divided by the the Asset Guideline Period life (mid-life) assigned to the respective pools and the result of these calculations would be added to the current year straight-line depreciation of prior year asset additions to determine the year's total expense.
   Accelerated - Depreciation would be determined using either 50% ADR or Capital Cost Recovery as explained above in Method 1. and 2. This second computation would produce depreciation used to determine taxable income.

continued....

Section 7. (continued....)

For maximum effectiveness, the program should be flexible. Thus, we recommend that annual tax depreciation charges should be determined on an optional basis from zero to the maximum amount permissable.

Reinvestment Program - To assure that liberalized depreciation rules produce the intended result (namely, to provide business concerns with funds for reinvestment in plant and equipment), we recommend that alternative reinvestment programs be made mandatory. Under these alternatives, the tax benefit of accelerated depreciation (50% ADR or CCR) over straight-line depreciation in any given year must be:

a. Less than or equal to fixed asset additions in the year depreciation is recorded.
b. Less than or equal to fixed asset additions in the year following the year depreciation is recorded.
c. Invested in government securities to the extent that (a.) and (b.) are not met.

Cash which is invested in government securities would become unrestricted in future years when straight-line depreciation begins to exceed accelerated depreciation or when funds are needed to purchase plant and equipment. There should also be carryover provisions where the excess of a year's fixed asset additions over amounts required in (a) above could be indefinitely carried forward to future years. These concepts are explained on Tables 15 and 16 .

From a theoretical point of view, the reinvestment program is sound. In accounting, depreciation charges are intended to generate funds for replacement of plant and equipment. To this extent, reinvestment of additional tax depreciation benefits in plant and equipment or in government securities (until such time as they decide to make equipment purchases) provides assurance that companies are doing what theory dictates.

continued....

TABLE 15

ILLUSTRATION OF GOVERNMENT SECURITY REINVESTMENT PROGRAM

Year	Transaction	Depreciation Expense: Book	Depreciation Expense: Tax	Depreciation Expense: Book Over (Under) Tax	Fund Into And (Out) of Government Securities(1)
1.	Excess tax depreciation is not reinvested (nor will be next year) in plant and equipment.	$10,000	$20,000	$(10,000)	$5,000
2.	Depreciation is recorded and security investment funds are partially recouped.	10,000	4,000	6,000	(3,000)
3.	Depreciation is recorded and the balance of security investment funds are recouped.	10,000	6,000	4,000	(2,000)
	Summary	$30,000	$30,000	$ -	$ -

(1) Assuming the tax benefit is determined using a 50% income tax rate.

TABLE 16

ILLUSTRATION OF EXCESS ASSET ADDITION CARRYOVER PROVISIONS

Year	(A) Value of Asset Additions	(B) Tax Benefit Excess of Accelerated Depreciation Over Straight-Line	(C) Asset Addition Value Carryover (A)-(B)
1	$1,000	$ 600	$400
2	-	100	(100)
3	-	300	(300)
Summary	$1,000	$1,000	$ -

<u>Section 7</u>. (continued....)

3. Many of the present tax depreciation rules and regulations would be abandoned. As we pointed out in the Present Practices section, many of these rules seem to strive for a degree of accounting perfection that is unrealistic when you consider revenue impact and the concept of timing differences which smooth out year-to-year differences. Therefore, in the interest of promoting tax reform which achieves meaningful simplification of procedures, we recommend that the following procedural concepts be abandoned:

   <u>First (and Last) Year Conventions,</u> which limit the amount of initial and final year depreciation to various percentages of a full year's depreciation, would be dropped. The concepts are inconsistent with our recommendations and they promote a degree of accuracy that is not needed.

   <u>Additional First Year 20% Depreciation Bonus</u> gives companies a maximum $2,000 charge against taxable income which would become obsolete if depreciation write-off rates were sufficiently liberalized.

   <u>Salvage Value Accounting Requirements</u> - would be abandoned because (1) most companies find legitimate ways of ignoring the concepts and (2) the concepts are structured for a contingency (eventual sale of equipment) which is inconsistent with the operating philosophy of most business concerns. For example, most companies are in the business of manufacturing and/or selling products. It is not their primary objective to sell plant and equipment used in the manufacturing process; the occurrence of such sales are incidental. Therefore, salvage value accounting routines incorrectly affect the depreciaiton taken on all operating assets, not just the occasional assets that are sold. Because of this inconsistency and because of the insignificant revenue impact or salvage value accounting, the concept should be abandoned.

   <u>The $500 Write-Off of Minor Capital Assets</u> - would be abandoned in favor of a much higher limit, possibly $2,000. This would eliminate much of the nuisance

continued....

Section 7. (continued....)

accounting which is presently very costly to business concerns. Many such assets have a useful life of between one and three years. On an individual asset basis, you are dealing with a tax revenue impact of $1,000 in one year compared to $333 over three years. It hardly seems fair to burden overworked bookkeeping departments with such an insignificant concept.

Detailed Fixed Asset Records - would be abandoned in favor of summary records which would record depreciation on a vintage basis in the case of 50% ADR or on a composite basis in the case of Capital Cost Recovery. In place of the individual asset depreciation records, listings of individual assets would be maintained by year of addition. The listings would provide adequate asset descriptions and their cost. When as asset is sold, it is located on the listing to determine its cost. Depreciation is calculated from the year of acquisition in order to determine gain or loss. Cost and accumulated depreciation are removed from the appropriate accounts and the resulting gain or loss is recorded in the appropriate accumulated depreciation pool. This routine conforms with present ADR accounting procedures which spread the effect of the gains or losses over the remaining life of assets in a pool.

ADR Repair Allowance provisions would be abandoned for two reasons: (1) A liberal ADR or CCR program would eliminate the need for a repair allowance. (2) The ADR Repair Allowance provisions are a classic example of legislation which is intended to benefit but because the rules are so complicated, and the record keeping requirements are so excessive, few business concerns take advantage of the provisions. I know of no companies who are following ADR repair allowance accounting.

4. Finally, we recommend that our 50% ADR or Capital Cost Recovery accounting procedures be applicable to plant and equipment on hand at the date reform legislation becomes law, not just prospectively. This will impose a burden

continued....

Section 7. (continued....)

on businessmen to convert their fixed asset record keeping systems to the new format. However, the new formats are not complex. Thus, the resulting benefit will far outweigh conversion costs. Also, if the new law were elective, business concerns that do not want to make the changes would not have to do so.

In summary, let me point out the benefits of the reform measures we have recommended. The programs provide enough flexibility to permit businessmen to control cash flow. The programs will help ease the inflationary crunch which has hit the capital equipment market. The programs, particularly the Capital Cost Recovery method, are not complex; at the same time, they are fair. They should prove very useful in eliminating much of the needless red tape which complicates present-day depreciation accounting. The programs will ensure a surge in capital investment spending which will mean more jobs and a growing tax revenue base, both of which are vital if our economic ills are to be cured.

The programs we have presented should be looked at as an outline of what can be accomplished when writing reform legislation. We ask you to keep one fact in mind. Many honorable legislative objectives have been destroyed when original concepts were abandoned along the road to passage. In considering our detailed depreciation reform proposals, please keep the basic structure intact:

- Early Recovery of Capital Investments.
- Achieved in a Fair and Rational Manner.
- Which Abandons Inconsequential Bookkeeping Routines.

APPENDEX A

COUNCIL OF SMALLER ENTERPRISES

MEMBERSHIP SURVEY RESULTS

TOPIC: DEPRECIATION

We conducted a survey of our members asking four brief questions concerning their opinions about present depreciation rules and regulations. Surveys were mailed to each one of our 800 members. From this mailing, we received replies from 78 members. To the question:

> "Do you or your accounting personnel believe present depreciation record keeping requirements are too complicated?"

37 members answered "yes" and 41 answered "no".

The overwhelming majority of ~~our members~~ answered "no" to the question:

> "Are the present useful lives which are used to compute depreciation expense adequate to generate cash for reinvestment in replacement assets?"

The actual tally was 16 "yes" and 58 "no" with 4 not responding.

As you would expect, most of our membership would favor the quick write-off of plant and equipment. 58 members responded positively (20 negatively) to the question:

> "Would you be in favor of rapid write-off (quick depreciation) of capital assets if the benefit (cash tax savings) of such a program were required to be reinvested in new (or used) capital assets?"

A final survey question requested the following information from our membership:

> "Please provide the following information with respect to a piece of equipment you have recently replaced with a piece of new or used equipment of like specifications".

	Asset Replaced	New or Used Replacement Asset (Circle new or used)
Description of Asset	________	________
Date acquired	________	________
Asset cost basis	________	________

The following table presents a selection of some of the replies.

APPENDIX A

MEMBERSHIP SURVEY RESULTS, Continued

Description (1)	Asset Replaced		Replacement Asset	
	Date Acquired	Cost Basis $	Date Acquired	Cost Basis $
Lift truck	1971	9,500	1975	13,000
Punch press (META)	1963	12,000	1975	30,000
GMC truck	1970	5,570	1975	9,267
Plating machine	1966	150,000	1973	250,000
Truck	1969	14,334	1975	21,192
Bridgeport verticle milling machine	1966	2,655	1975	3,450(u)
Lift truck	1969	4,567	1974	5,895(u)
Screw driving machine	1950	750	1975	3,100
Oldsmobile (replaced by Ford) wagons	1969	3,507	1973	4,210
Tractor	1970	9,088	1975	25,362
Caliper meter	1972	1,510	1975	2,125
Cash registers	1972	3,150	1975	5,300
Ironworker	1969	4,000(u)	1975	20,000

One of our members, an equipment distributor, reported the following purchase price listing on a line of engine generators (model 30KW) distributed by his Company:

Date	Purchase Price $	Comments
1963	3,850	
1971	4,150	
Oct. 1973	4,243	Based on a 2.25% price increase
Feb. 1974	4,464	Based on a 5.20% price increase
June 1974	4,732	Based on a 6.00% price increase
Aug. 1974	5,300	Based on a 12.00% price increase
Nov. 1974	6,678	Based on a 26.00% price increase
Feb. 1975	6,880	Based on a 1.50% price increase per month after Jan. 31, 1975
June 1975	7,123	Based on a .50% price increase
July 1975	7,123	Firm prices were establishedon this date

(1) Assets are new unless they are coded (u) for used

INCREASE THE ACCUMULATED RETAINED
EARNINGS CREDIT

BACKGROUND INFORMATION:

Section 531 of the Internal Revenue Code of 1954 imposes an additional tax, at rates varying from 27½% to 38½% on a corporation which is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided or distributed".

The tax does not apply to a personal holding company, a foreign personal holding company, or a corporation exempt from tax under subchapter F, as technically defined. However, if a corporation is "a mere holding or investment company", a term which is not technically defined, but not a domestic or foreign personal holding company, this in and of itself is, by the clear language of the CODE, prima facie evidence of the requisite purpose to avoid the income tax with respect to shareholders.

The Section 531 tax is generally understood to be a penalty tax. It is computed on federal taxable income after reduction for any dividends-paid deduction, and after adjustments for certain items including an allowance for federal corporate income taxes, and an allowance for the accumulated earnings credit (which begins with a "one-shot" minimum credit of $150,000 for all corporations except holding or investment companies--unless, of course, the prior accumulations are equal to or in excess of the minimum figure).

With one debatable exception (insofar as decided cases are concerned), the accumulated earnings penalty tax has been applied only to closely held domestic corporations. This type of corporation generally falls within the definition of a small business.

continued....

Background Information (continued....)

On January 13, 1969, the Supreme Court of the United States, speaking through Mr. Justice Marshall, delivered its opinion in U.S. V. Donruss Company. This case held that the tax avoidance "purpose" need not be the "dominant, impelling, or controlling" purpose for the accumulation in order for imposition of the tax. The Court's construction of Section 531 has the practical effect of limiting the Commisssioner's burden to showing that only "one of the purposes" of the accumulation was tax avoidance. Consequently, if the corporate taxpayer is to prevail, it must show that any accumulation not retained for the reasonable needs of the business (and therefore, not entitled to be credited under Section 535 (c)) was made without any intention to avoid shareholder tax.

Until the 1954 Code, the defending corporation was required to prove this lack of intent based solely on the subjective motives of the shareholders. This negative proof problem commonly called the "subjective test", has given way to a more important "objective test" by the addition of Section 533 (b) and 535 (c) computation of accumulated taxable income for "such part of the earnings and profits for the taxable year as are returned for the reasonable needs of the business***".

The practical result of Donruss was to emasculate the subjective test and place strict emphasis on the objective test. Therefore, the preparation for a judicial or administrative defense must begin with the requirements for working capital together with anticipated planned extraordinary expenses for a deduction under the Section 535 (c) credit.

Liquidity and Earned Surplus Concepts

As the penalty tax developed, it was tied to the concept of earned surplus. Consequently, for a number of years courts tended to analyze in terms of surplus alone to determine whether there was an unreasonable accumulation. A better

Liquidity and Earned Surplus Concepts (continued....)

approach, however, should include a consideration of the liquidity of a corporation and whether it can pay dividends because it has liquid assets which are not needed in the business. In adopting a liquidity approach, the focus is on the amount needed for working capital since the presumption exists that productive physical assets, such as plant and equipment, which have any reasonable relationship to the business are obviously assets which are not available for the payment of dividends.

In 1960, the Fourth Circuit pioneered the liquidity approach in Smoot Sand and Gravel Corp. v. Comr., where the court stated that-

> "to the extent that the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impuity".

Thereafter, in a series of decisions, the theory underlying Smoot Sand and Gravel was followed, until recently when the Second Circuit sought to circumscribe the rule in Sears Oil Co. v. Compr. There the court stated the following:

> "It is somewhat of an over simplification to say as a generality that to the extent that surplus has been translated into inventory or other assets related to the business, "the corporation accumulates surplus with impunity". The inventory must be needed in the business; to the extent that it is not, it cannot be accumulated with impunity.

The reasoning supplied by the Second Circuit is just as applicable to accounts receivable. A failure to collect receivables, thus unreasonably allowing them to accumulate, might furnish the Commissioner with an argument that the liquidity of the corporation had been tampered with to avoid the payment of dividends.

continued....

<u>Liquidity and Earned Surplus Concepts</u> (continued....)

As a practical matter, inventory accumulation and collection rates of accounts receivable will be determined by the ordinary business exigencies of the particular company. Only in the rarest situations should the company be required to justify either inventory or uncollected accounts receivable. Such a requirement would create a heavy burden on the taxpayer and present it with a problem not susceptible of proof because of the practical circumstances of everyday operation. In fact, it would create a double burden in that the company would have to prove business relationship and resonableness now or in the anticipated future. The presumption should be that all inventory and all accounts receivable are assets of the business and may be accumulated with impunity.

The Second Circuit's approach substitutes the judgement of the Commissioner for that of corporate management. Apparently the Second Circuit failed to recognize that the doctrine pioneered by the Fourth Circuit in Smoot Sand and Gravel was intended to consider the relationship of inventories and collections to their respective turnovers. The court commented on that relationship in its discussion of working capital; it said:

> "Working capital needs of the business vary, being dependent upon the nature of the business, its credit policies, <u>the amounts of inventories</u> and <u>rate of turnover</u> and <u>the amount of accounts receivable</u> and <u>the collection rate</u> thereof, the availability of credit to the business, and similar relevant factors".

The relationship of the turnovers of receivables and inventories to the liquid needs of the corporation will, in most cases, obviate the problem with which the <u>Sears</u> case concerns itself and make unnecessary the extreme position advocated in that case.

Adoption of the liquidity approach narrows the analysis to a comparison

continued....

Liquidity and Earned Surplus Concepts (continued....)

of the liquid assets on the one hand and working capital requirements plus extraordinary expenses involved in the operation of the business on the other. An unjustified excess will result in the application of the penalty tax as a practical matter if the Donruss case is taken to its logical conclusion. Therefore, the starting place in justification of a liquid retention is the extraordinary anticipated expenses.

Credit for "Reasonable Needs of Business"

Section 535 (a) provides as a deduction allowed in determining the accumulated taxable income the "accumulated earnings credit". That credit is defined in part as "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of business***". The credit is further expanded by Section 537 which broadens the definition by including "reasonably anticipated future needs" (as well as stockholder redemption needs), which, of course, extends consideration of the needs of the business to future business acquisitions.

The stockholder redemption needs apply to funds used to redeem the stock of a stockholder under Section 303 (for payment of death taxes) in the year of death of thereafter, and was added to the Code by the Tax Reform Act of 1969 to reverse the Dickman Lumber Co. v. U. S.

The Treasury Regulations under Section 537 relate the concept of the reasonable needs of the business to that undefined and uncertain standard known as the "prudent" man rule. The regulations state:

> "the amount that a prudent business man would consider appropriate for the present business purpose and for the reasonably anticipated future needs of the business***".

This determination is to be made at the end of the taxable year. Future needs are

continued....

<u>Credit for "Reasonable Needs of Business"</u> (continued....)
required to have a "specific, definite, and feasible" plan.

Although the regulations say subsequent events cannot be used to prove an accumulation as unreasonable, in practice Revenue Agents, Appellate Division Conferees, and the courts appear to consider subsequent events tending to show an unreasonable accumulation while paying lip service to the interdiction. This cuts both ways, since the taxpayer frequently uses the subsequent events to bolster his reasonable accumulation, sometimes proving an otherwise nebulous future plan.

If a "specific, definite and feasible plan" exists, the following purposes among others are permitted for the accumulation of earnings and profits under the regulations:

1. To provide for bona fide expansion of business or replacement of plant;
2. To acquire a business enterprise through purchasing stock or assets;
3. To provide for the retirement of bona fide indebtedness created in connection with a trade or business;
4. To provide necessary working capital for the business such as the procurement of inventories; or
5. To provide for investments or loans to suppliers or customers if necessary in order to maintain business of the corporation.

Conversely, the regulations also state some of the grounds for which accumulations are improper. Those enumerated are:

1. Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;
2. Loans having no reasonable relation to the conduct of the business made to relative or friends of shareholders, or to other persons;
3. Loans to another corporation, the business of which is not that of

continued....

the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations:

4. Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or
5. Retention of earnings and profits to provide against unrealistic hazards.

The reasonable needs of the business divide themselves into two general categories. At one extreme is working capital which provides the funds for the day-to-day operational activities. At the other extreme are expenditures which are noncurrent in nature and usually involve a substantial purchase of a fixed asset which will not be exhausted in one operating cycle, fiscal year, or accounting period. In many cases, the retentions for extraordinary needs, either immediately or in the future, will be so large that the current assets which remain available for current operating funds or working capital would be inadequate.

Working Capital View

A portion of every active corporation's "liquid assets" must be used in the operation of the business, that is, a corporation must have a certain amount of "working capital", which is generally defined as the excess of current assets over current liabilities. Thus, it is always necessary to determine the amount of working capital necessary for the business. The Section 531 Audit Guidelines contain an extensive discussion of working capital and contain an express direction that the examining agent compute the so-called Bardahl formula "for most taxpayers".

The Bardahl formula is an operating cycle approach, which determines the

continued....

Working Capital (continued....)

amount of the corporations' working capital requirements by determining the amount needed for one full normal business cycle of the corporation. Usually a business cycle will be the period from the purchase of a product through sale from inventory to collection of accounts receivable. If the application of the Bardahl formula indicates that a corporation needs working capital in the amount of $500,000, the corporation must (assuming the applicability of the formula) generally explain any excess of working capital of $500,000 by pointing, for example, to long-term indebtedness, expansion plans, contingencies or other commitments which constitute reasonably anticipated needs of the business.

While cases before the courts have often been decided with different results, the businessman is perplexed and for fear of a penalty tax, often makes decisions which are not economically sound.

Before the Donruss decision taxpayers could impress the courts, at times, with their wisdom of conservative business policies, as for example:

In Bremerton Sun Publishing Co.,44 TC 566 (1965), the taxpayer demonstrated a number of reasonable needs for an accumulation, but the amount so established fell short of the sum actually accumulates. Nevertheless, the taxpayer had maintained a constant dividend rate as its business had expanded. The court found that "the only reason for the excessive retention of earnings was the conservative policies of directors and not their concern for the surtax liability...".

In Hardin's Bakeries, Inc., 67-1 USTC 9253, 19 AFTR 2d 647 (DC Miss., 1976), the court toroughly approved of the taxpayers' conservative approach to the "many perplexing and difficult problems which require foresight and planning". Therefore, the court found that there was not tax avoidance purpose behind the

continued....

accumulation of a sum well over four times the taxpayer's largest annual taxable income in the years in issue. However, in a later case involving the same taxpayer, Hardin, 72-1 USTC 9464 29 AFTR 2d 72-1 1446 (CA-5, 1972), affg. 70-2 USTC 9676 26 AFTR 2d 70-5852 (DC, 1970), the Fifth Circuit upheld the District Court's findings that earnings were accumulated beyond the reasonable needs of the business. Significantly, the Fifth Circuit accepted the Commissioner's use of the Bardahl formula to demonstrate limited working capital needs, and rejected the taxpayer's contention that additional funds were required above and beyond those shown by application of the formula.

The court in T.C. Heyward & Co., 66-2 USTC 9667, 18 AFTR 2d 70-5852 (DC N.C., 1966), began its opinion: "Either Mr. T.C. Heyward, Sr. was extremely naive about the tax structure or I am equally naive in judging credibility. The taxpayer's accumulations of income were fantastic. I do not believe that one bent upon tax evasion would have the unmitigated gall to attempt it in such an obvious manner." The corporation's president in that case had firmly believed that another depression comparable to that of the 1930's was inevitable, and that only an enormous accumulation of earnings could stave off bankruptcy in such an event.

Thus, the courts and the Internal Revenue impose their judgement upon the businessman today and the results are generally to the businessman's disadvantage.

We do not quarrel with the need for a law or means to penalize abuses or tax avoidance schemes. Our purpose is to impress the law makers with the need for a meaningful adjustment to the accumulated earnings credit. We would like to see

continued....

Working Capital Views, (continued....)

the small businessman freed from the fear of being penalized for conservative business policies. Spending is rewarded while saving is penalized.

It should be noted that, per the Annual Report of the Commissioner, the revenue from deficiencies and penalties represents only ½ of 1% of total income tax revenues. Moreover, since this figure is certainly made up of more than just Section 531 penalties, it is obvious that the Section 531 tax is not a wealthy source of tax revenues.

In order to avoid the unintended and undesirable consequences of this tax, it is proposed that the accumulated earnings credit, which now provides some limited relief by permitting corporations to accumulate up to $150,000 (for years beginning after 1974) of earnings even though the "reasonable needs of the business" may presently not require it, be increased. There are many factors which support an increase. Some of them are set forth in the following:

1. Business contingencies

The regulations state that a "(r)etention of earnings and profits to provide against unrealistic hazards" suggests that earnings have been unreasonably accumulated. However, it is clear that real business contingencies are not "unrealistic hazards" even though the ultimate monetary impact may be uncertain. Thus, the courts have recognized the right to accumulate funds in the face of unsettled conditions in the industry as a whole, threat of strike, and risks peculiar to the industry.

The courts have not yet permitted a corporation to have a reserve for general unidentified contingencies. It would seem to be desirable to permit a corporation to accumulate and retain in liquid form an amount sufficient to ensure that a recession or change in market conditions will not cause the corporation great hardship. The analysis of some courts, which in effect insist upon an accounting

continued....

1. Business contingencies, (continued....)

for every dollar of surplus, seems to require that the corporation forever operate two steps ahead of the sheriff. The mere fact that the amount of such a contingency fund might be difficult to fix should not seriously militate against the merits of the idea. A reasonable reserve might well be an amount equivalent to the working capital required by a corporation for one Bardahl operating cycle. At a minimum we suggest that the credit be raised to $500,000.

The 531 Audit Guidelines recognize the following contingencies:

(a) An actual or potential lawsuit.

(b) A possible liability arising out of some contractual obligation.

(c) A possible business reversal resulting from the loss of a customer.

(d) Accumulations to guard against competition has been justified in some cases.

(e) An accumulation to provide funds to finance a self-insurance plan. This includes key men as well as the more common types of risk insurance.

(f) Accumulations to provide a retirement plan for employees.

2. Small Business Statistics

The impact of small business on the United States economy is discussed in generalities by many knowledgeable people in Washington. What is lacking is the specifics of the economic contribution that small business makes to our private enterprise economy.

Recently, the Senate Select Committee on Small Business issued a comprehensive statistical report on the trends of small business. Since these statistics were based on Census and IRS reports which are 3 or 4 years behind the current year, this report is of historical interest only. Notwithstanding this, some interesting

continued....

2. Small Business Statistics, (continued....)

conclusions on the trends effecting small business between 1963 and 1967 can be drawn.

During the four year period between 1963 and 1976, corporate employment increased by 5.2 million to a total of 38.5 million. A summary of pertinent statistics taken from the Senate report indicates where this employment came from.

CORPORATE EMPLOYMENT 1963 & 1967

	1963	Employment (millions) 1967	Change
Large business *	17.3	15.8	- 1.6
Small business **	9.8	15.9	+6.1
		Sales & Receipts (millions)	
Large business	$312.1	500.3	$+188.2
Small business	423.8	500.6	+76.8

* Large business assumed to be all corporations with $50 million sales and receipts.

** Small business assumed to be all corporations between $100,000 and $49,999,999 - sales and receipts.

One conclusion from this summary is that employment of the small business sector increased while the total employment of large business fell. At the same time, large business increased its sales and receipts 60.3% during the period.

Since many small businesses depend on large business (as subcontractors, suppliers and service agents), the health of large business is important to the health of small business. However, the trend to increased concentration of total business into large business units may not be desireable. Also, if it is the policy of government to foster employment growth, these figures would indicate

continued....

2. Small Business Statistics, (continued....)

that small business is the better source for building employment. These two factors alone, support the need to permanently increase the accumulated earnings credit to $500,000.

Having such an impact on our total labor force and the economy, we must encourage the growth of the small business segments and we must not make it easy for them to reamin economically sound. This can be accomplished by liberalizing the accumulated earnings credit.

3. Financing Arrangements

Anticipated future business needs, though presently not very specific, could, when finally brought to reality, create a real financial problem.

Capital itself come from two principle sources (1) investment by individuals in the stock of a business, or (2) retention of earnings within a business. Independent business generally is too small to tap the stock market for public investment and in any event, high interest rates and inflation have destroyed the stock markets effectiveness in raising capital for even the largest corporations. This leaves business profits as the only current source of capital growth.

Lending institutions are often not eager to make loans to closely held companies. A recent article in "Taxation and Finance" of BNA provides some interesting statistics. It states that the debt equity ratio of small manufacturing corporations was much higher than that of all manufacturing corporations.

In 1973, small manufacturing corporations had a debt-equity ratio of 93.6% while the debt-equity ratio of all corporations was only 62.1%. The composition of debt, however, differs considerably between small and all manufacuturing corporations. Small manufacturing corporations have greater reliance on non-bank sources and on short-term debt. Both of these sources are far more expensive than rates

continued....

2. Small Business Statistics, (continued....)

paid for conventional large corporation borrowings.

Debt Ratios for Manufacturing Corporations, Fourth Quarter 1973

Type of Debt	Small Corporations (1)	All Corporations
Short-term debt:		
Bank	15.4%	9.3%
Other	40.4	20.0
Total	55.8	29.3
Long-term debt:		
Bank	14.6	8.3
Other	23.2	24.5
Total	37.8	32.8
Combined long and short-term debt:		
Bank	30.0	17.6
Other	63.6	44.5
Total	93.6	62.1

(1) Assets under $1 million.

Thus, the interest a small business must pay often exceeds the interest or dividends a large company pays, thus providing one more difficulty for the small business. Being able to use funds generated in his own business, would be a definite advantage to the small businessman.

Impact of Inflation on Small Business

The impact of inflation is of critical importance. It is important to

continued....

Impact of Inflation on Small Business (continued....)

emphasize that, where assets are held for long periods of time, the accumulated effects of inflation are particularly acute when the assets are sold or replaced.

In 1958, the year the accumulated earnings credit was increased from $60,000 (at which level it had been since 1939, the year of enactment of Sec. 531) to $100,000, the consumer price index was 78.5, 1960 being the base year (1960=100). In April 1974, the index was 147.9. The increase over the 16 year period was 88.4%. The consumer price index has risen almost 35 percent in the last 5 years. Thus, even the 1975 increase to $150,000 does not reflect fully the inflation we have experienced since 1958; the credit could easily be increased to $200,000 for all corporations, regardless of size. Since the bite of inflation is more likely to hurt the small business, such an increase is warranted all the more for these small businesses.

Canada has recognized this fact by increasing its allowable accumulated earnings credit to $500,000.

Business Failures

Certain industries are affected more than others by cyclical economic conditions. During recessions business failures increase, a fact the government does not seem to recognize when applying the rules of section 531.

Dun & Bradstreet Inc. - "Business Economics" of August 8, 1975 indicates that business failures are on the rise. From an apparent 36.4 failures rate per 10,000 enterprises in 1973 the failure rate has increased to 46.1 per 10,000. The applicable statistics are as follows:

continued....

APPARENT ANNUAL NUMBER OF FAILURES PER 10,000 LISTED ENTERPRISES

	UNADJUSTED INDEX			ADJUSTED INDEX		
	1975	1974	1973	1975	1974	1973
January	47.3	36.2	35.6	46.8	35.5	34.9
February	51.2	42.8	41.0	44.9	37.5	36.0
March	49.5	43.7	38.4	46.3	40.8	35.9
April	52.0	36.1	37.7	43.4	34.1	35.2
May	45.1	41.3	37.7	43.4	39.7	36.3
June		36.6	37.8		37.0	38.2
July		35.1	33.2		37.7	35.7
August		30.7	36.0		33.4	39.1
September		40.7	34.7		45.2	38.6
October		46.1	35.9		47.0	37.0
November		37.8	36.1		36.3	34.7
December		33.7	32.5		37.0	35.7
Mo. Average		38.4	36.4	46.1	38.4	36.4

Dun's failure index relates the number of failures in each month to the number of industrial and commercial enterprises listed in the Dun & Bradstreet Reference Book. It shows the annual rate at which business concerns would fail if the number of failures and concerns listed in that month prevailed for an entire year. The index is expressed as the annual number of failures per 10,000 listed industrial and commercial enterprises.

The "Unadjusted" figures have been slightly adjusted to equalize, in so far as possible, the number of working days in each month. Seasonal fluctuations have been removed in the adjusted index by the method of deviations from a twelve month moving average. In addition, there are many companies which are not as yet on the

continued....

<u>Business Failures</u>, (continued....)

failure list, but should be. Creditors are not collecting their receivables and often settle for less than 100%

<u>Conclusion</u>

We recommend that new legislation be written to correct present day deficiencies innerent in the application of Code section 531. The legislation should strictly require the imposition of the penalty tax only in cases where tax avoidance is the sole motive behind the retention of earnings. Legislation should increase the accumulated earnings credit to $500,000, without regard to the "reasonable needs of the business".

By increasing the credit to $500,000, the government would insure the creation of a better economic climate for the small business (which will more than offset any loss in revenues) by stimulating jobs, investments and capital growth. It would provide the small business with the opportunity to better compete with the larger publicly held corporations by putting small business on a more equal footing, particularly during critical economic downturns.

- 59 -

NET OPERATING LOSS CARRYOVER
PERIODS NEED TO BE EXTENDED

INTRODUCTION:

New corporations, and particularly smaller enterprises, often undergo a substantial period of operating losses at the beginning of their existence. Because of the inability to carryback such losses and the 5-year limit on carryovers, these corporations may experience the situation where they may not have a sufficient period of time to permit taxable income to reach a level where initial losses can be fully absorbed.
Because of this problem we advocated in testimony earlier this year before the Senate Select Committee on Small Business that the net operating loss carryover period, for corporations which have been in existence less than 3 years, be extended. We are advocating an extension to a period of from 8-10 years.

Why Carryover Period Needs To Be Extended

In support of our position we have conducted a survey of the members of the Council of Smaller Enterprises concerning their experience with the current net operating loss carryover period.

Of those who responded, the total amount of unabsorbed initial losses was $2,870,000. The size of the unabsorbed losses per company ranged from $10,000 to $1,000,000. This represents a substantial sum of money and indicates to us that the current period for net operating losses is too short.

A summary of the results of our survey is indicated below:

Total responses:	77-100%
Number with initial net operating losses	39-51%
Number with initial net operating losses which were then unabsorbed	11-14%

continued....

Why Carryover Period Needs To Be Extended (continued....)

As indicated, over half of the firms responding incurred initial net operating losses. This confirms our belief that such losses, particularly among smaller enterprises, is widespread. Of those who experienced initial net operating losses, 14% were unable to effectively absorb them due to the limited nature of the net operating loss carryover period. These figures tend to emphasize the problem with the net operating loss carryover period as it applies to small business. While existing corporations can take advantage of an 8-year period (by carrying back three years and forward five years), to absorb losses, a new business is limited to a 5-year carryover provision at a time in its corporate existence when it needs a longer period. Since smaller enterprises are dependent on internally generated capital for growth, the current limit on the net operating loss carryover period can have an adverse effect on such growth. If the period were extended, however, the resulting tax benefit could be used to finance the second stage of a smaller enterprises's growth.

Survey Results

The survey also tried to establish what effect an extended loss carryover period would have on a decision to venture into a new business or a new line of business. Of the 11 responses which indicated unabsorbed net operating losses, 9 or 82% felt that an extended net operating loss period would be a factor in deciding whether to start a new business. Of those firms which were able to effectively absorb their initial losses 8 concerns felt that a longer period would be a factor in such a decision while 17 companies felt it would not, with the remainder expressing no opinion. The drop that occurred in the number of firms that felt it would be a factor in an expansion decision can best be explained by the favorable past experience with the current length of the net operating loss carryover pro-

continued....

<u>Survey Results</u> (continued....)

visions. The significant factor is that nearly 30% of those who were able to absorb net operating losses felt that an extended period would be a considering factor when decidiong on new opportunities. Of those forms which experienced no initial net operating losses, 7 or 21% still felt that an extended period would be a factor in an expansion decision while 15 or 44% felt it would not, 12 or 35% expressed no opinion. The fact that 21% felt an extended period was needed in their business (even though they did not incur initial net operating losses) would indicate that an extended carryover period would have a significant impact on the decision to expand business.

<u>Conclusion</u>

Because of the widespread inability of smaller firms to effectively absorb initial net operating losses and the importance of the net operating loss carryover period to a decision to expand, we feel that the net operating loss carryover period for newer businesses should be extended. Smaller firms, which rely so heavily on internally generated capital, whould then continue to expand with resulting long-term favorable impact on employment and taxes.

AMORTIZATION OF PURCHASED GOODWILL SHOULD
BE DEDUCTIBLE FOR TAX PURPOSES

Purposes

The present I.R.S. position of disallowing a deduction for amortization of purchased goodwill rests upon the premise that purchased goodwill has no determinable useful life. We would like to review this position by (1) reference to the Accounting Principles Board Opinion No. 17, (2) a discussion of the apparent inconsistency in the I.R.S.'s position and (3) a look at the positive impact which the proposed change would have on the capital formation question. In addition, we have included a few comments relative to the needless expense inherent in the present system.

Definition Of Terms

First, however, two terms need definition to enhance the understanding of this proposal:

"Purchased goodwill" means the excess of the cost of an acquired company over the sum of the identifiable net assets of that company. This goodwill can not be specifically identified and, therefore, does not include such identifiable intangibles as patents, franchises or trademarks.

"Internally developed goodwill" may be defined as the value placed by the owners/investors of a business on the expected future earnings of the business. Such a value is vague at best and fluctuates with changing expectations. Insofar as certain expenditures conventionally charged to costs of operations (such as research and development or advertising) may contribute to the enhancement of expected future earnings, then to that extent, "internally developed" goodwill is a permissable deduction for tax purposes.

continued....

Generally Accepted Accounting Principles

The Accounting Principles Opinion No. 17 acknowledges the absence of determinable life for purchased goodwill; however, they conclude that "the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefited." Criteria for determining the estimated amortization period are outlined in the Opinion, but it is recommended that the period not be in excess of forty years

The Inconsistancy Problem

An inconsistency in the I.R.S. position seems evident since deduction for internally developed goodwill expenses (of equally indeterminable life) are presently permitted. Likewise, a purchased goodwill deduction is allowed at the time of liquidation of a business.

Allowing deductions for purchased goodwill will obviously provide another source of increased retained earnings for the small businessman's pressing capital needs. Based on the U. S. Internal Revenue Service statistics of Corporate Income, total unamortized intangibles, including goodwill, amounted to $6.8 billion in 1970. If we assume that one-half this amount represents unamortized goodwill, corporations could generate additional cash of $170 million a year if goodwill amortization were tax deductible over a ten year period.

Another aspect of the problem concerns the unproductive expense incurred by business in terms of legal and accounting fees to support the argument that purchased goodwill does not, in fact, exist. Aside from the wasteful implications, there is the matter of discrimination against the smaller concerns who can ill afford this expense. Perhaps a brief discussion would be enlightening. In present practice, when a company acquires another company great effort (and expense) is taken to maximize the value assigned to tangible and other identifiable assets

continued....

<u>The Inconsistency Problem</u> (continued....)

in order that the resultant "purchased goodwill" is minimized. This practice obviously results in higher values being assigned to assets and consequent higher depreciation charges to operations in ensuing years. Frequently, the values are challenged by the I.R.S. and additional time, effort and money are expended "negotiating" a settlement. All this effort and expense could be eliminated by the simple act of allowing deductions for amortization of "purchased goodwill".

<u>Recommendation</u>

Therefore, we recommend that legislation be enacted which would permit the tax deductible amortization of purchased goodwill on a basis consistant with methods used for financial reporting purposes. This legislation would not only resolve an unacceptable inequity but would also be effective in helping small business concerns fulfill their capital formation needs.

UNIFORM STATE TAX FILING REQUIREMENTS ARE NEEDED

INTRODUCTION

Another area of concern to us is the complexity of the taxing and filing requirements of the various states. We concede that, although complaints on this issue are often made, there is little incidence of double-taxation of corporate income by the states, provided the various apportionment formulas are properly used. In fact, we suggest that in many cases companies do not pay all the state tax that would be required were they to fully comply with all state laws.

REVIEW OF TAX FILING FORMS

We believe, however, that the lack of uniformity among the states' taxing provisions imposes hardships on small companies. The costs of maintaining adequate records to properly comply with all state laws is often prohibitive, resulting in the non-compliance mentioned above. We have collected a number of state returns for review and from these it is clear that administrative and preparation costs will mount almost in direct proportion to the number of returns required to be filed. For example, in the area of adjustments to federal income alone, the attached chart illustrates the diverse provisions among various states regarding what adjustments should be made to transpose federal income to state income. It must also be mentioned that this lack of uniformity can, on occasion, cause a form of double-taxation. In certain states a company may be required to use the separate accounting method of computing taxable income for that state which, combined with the use of apportionment formulas in other states, may result in double-taxation of certain income.

SURVEYS AND LEGISLATIVE TESTIMONY

This complexity not only imposes hardships on the companies but may, in fact, lessen the tax revenues of many states. In a survey we conducted for this presentation, we found that 44% of the companies responding on this issue indicated that they would consider expanding to other states if the tax laws were simplified. Furthermore, as previously mentioned, the complexity of the tax laws of the states often causes non-compliance with these laws by the companies, resluting in decreased tax revenues for the states.

In reviewing previous testimony regarding this subject, it is clear that the major concern of the states is the imposition of federal regulation. While the states wish to preserve their revenues, they do recognize the need for uniformity in the tax rules and regulations. It has been their contention, however, that they should be left to their own methods of achieving this uniformity.

We do not wish, nor would we welcome, a law which would create hardships to the states in the form of decreased tax revenues. (In fact, the Council of State Governments itself presented testimony on H. R. 11798 indicating that uniformity of apportionment formulas, for example, would have an effect of less than 3% on state revenues with a possible increase rather than decrease in tax.) Testimony of business groups heard by committees in regard to previous tax bills consistently supports this point; business has no desire to decrease state revenues but does desire uniformity among state taxing provisions. With such uniformity would come possible expansion of business as well as almost certain increased compliance.

Perhaps previous bills have gone too far in their regulation of state tax law. We recommend that states retain their power to set tax rates and

SURVEYS AND LEGISLATIVE TESTIMONY, continued

administer their tax laws. What we seek is uniformity regarding what will be taxed and where it will be taxed. Although the states have often said they are attempting to establish such uniformity, we seem no closer to it today than we were ten years ago. While several states formed the Multistate Tax Compact in 1967, this Compact has not achieved the desired uniformity. The Compact merely set up procedures for cooperation among states in establishing uniformity but its most active function has been the facilitating of audits of multistate companies.

CONCLUSION

In conclusion, we must emphasize that we are seeking tax simplification and uniformity of the tax laws of the states; we are not seeking tax avoidance. Businessmen have consistently maintained that they would prefer the establishment of a clear and concise system for interstate taxation in place of the present system, even though present practices permit some avoidance of tax. We do not believe that, in the foreseeable future, the states will develop such a system among themselves. It remains for Congress, without infringing on the rights or revenues of the states, to establish an equitable system.

SCHEDULE OF ADJUSTMENTS TO FEDERAL INCOME (1)

	Alabama	Arkansas	California	Colorado	District of Columbia	Connecticut	Georgia	Illinois	Indiana	Kentucky	Maryland	Massachusetts	Michigan	Minnesota	Missouri	New Jersey	New York	Ohio	Oregon	Pennsylvania	Rhode Island	South Carolina	Tennessee	Texas	Virginia	Washington	West Virginia	Wisconsin
No special treatment - capital gains and losses	•	•	•																			•	•					•
No NOL deduction	•			•						•		•																
No carryback or carryover of losses	•				•							•										•						
Bond interest - federal, state, local - excluded from gross income	•																											
State and local income taxes not deductible	•		•	•			•		•		•	•	•									•			•			
No 20% 1st year depreciation	•									•																		
Bank dividends taxable		•																										
95% owned subsidiary dividends are exempt		•																										
U.S. bond interest is exempt		•	•	•	•		•		•						•				•	•	•				•		•	•
NOL carryover limited to 3 years		•											•															
No dividends received deduction		•				•										•							•					
Dividend or interest up to $500 from in-state shares or S & L exempt		•																										
State and local bond interest taxable			•	•		•	•	•		•		•	•		•	•	•				•		•		•		•	
Special treatment for dividends and other corporate distribution			•																									
No NOL carryover			•													•												
No foreign tax deduction				•																								
State income tax refunds not taxable				•		•		•																			•	
Federal capital loss carryovers are not allowed						•					•		•															
NOL and net capital loss carried over 5 years						•												•	•									•
Dividends on stocks of Ga. or federal banks and historical companies are exempt							•																					
Dividends from non-U.S. sources are exempt							•																					
Income taxes are not deductible								•						•		•												
Gift or charitable contributions are not deductible									•																			
No property tax deduction									•																			
All dividends are exempt										•	•									•							•	
State income taxes are not deductible										•					•												•	
Capital loss carryback not allowed											•																	
Percentage depletion disallowed											•																	
Interest exempt											•																	
Income (loss) from sale or exchange of U.S. obligations is exempt													•															
Federal income tax deductible															•													•
100% of subsidiary dividends and 50% of other dividends are excluded from taxable income																•	•											
State bond interest is taxable																			•									
Interest on state and local obligations is nontaxable																				•			•		•			
Add tax preference items to FNI																				•								
2 year NOL carryover																							•					
Dividends from 80% or higher subsidiaries are excluded																						•	•					
Bank dividends are exempt																									•			
No NOL carrybacks																												•

(1) A file of all state tax forms listed on this table are available for inspection in the files of the Council of Smaller Enterprises

RECOMMENDATIONS FOR REVISING THE LIFO INVENTORY REGULATION

INTRODUCTION

The LIFO inventory accounting method is not new. It has been used since 1938 by a number of businesses. Measurement of the extent of LIFO use defies precise quantification; however, a study of 2,700 companies in the National Automated Accounting Research system revealed that 216 companies used LIFO. During 1973, 39 companies adopted LIFO and I would estimate that for 1974 the number adopting LIFO would greatly exceed 39 and probably approach the total number of corporations using LIFO prior to 1973. The tendancy towards adopting LIFO has grown greatly among those corporations capable of complying with the complex tax regulations governing the adoption and use of the LIFO inventory accounting methods.

The reason for this growing trend towards the use of the LIFO inventory accounting method is directly related to current high rate of inflation that we all have been suffering through. Under the LIFO method of inventory accounting, the last costs incurred are the first charged against current revenues. While this assumption may be contrary to the physical movement of inventories, the concept is that income is better determined by charging income for an amount equaling the replacement cost of goods sold. Since management will attempt to recover these replacement costs in determining selling price, failure to associate these costs with revenues will result in higher earnings during periods of rising prices due in part to changes in price as opposed to operations. This concept can best be illustrated by the following simplified illustration.

continued....

INTRODUCTION, continued

Assume a manufacturer purchases only two items during its year and sells one of them.

Illustration of the LIFO Inventory Costing Concept

	Using LIFO	Using FIFO
Item 1. On January 1, purchased for	$2.00	$2.00
Item 2. On June 1, purchased for	3.00	3.00
On December 31, Item 1 is sold for	4.00	4.00
Cost associated with the sale	3.00	2.00
Profit	$1.00	$2.00

The difference between the profit of $1.00 when using the LIFO method and the $2.00 under the FIFO method is termed inventory profit. Put another way, inventory profit can be defined as the difference between what an item of inventory originally cost the company and the current cost to replace that item. As can be seen from the illustration, inventory profit is not a real profit as it must be reinvested to purchase a replacement item of inventory. The magnitude and growth of inventory profits is illustrated in Tables I and II.

Theoretically, any business, whether incorporated or not, may value its inventory and determine its costs by use of the LIFO method; in practice, however, a significant number of smaller enterprises find that they are unable to use LIFO because of the ambiquity and complexity of the current regulations. The number of decisions to make just to determine what method of LIFO to adopt is illustrated in Table III. The requirements and problems encountered in applying the mechanicals of these methods are briefly described in the attached appendix.

RECOMMENDATIONS

Our recommendation is that the mechanics of applying LIFO should be clarified and simplified so that all taxpayers who wish to, may more easily apply the

continued....

RECOMMENDATIONS, continued

LIFO method. The current regulations for LIFO have not been substantially revised in the last 12 years. Therefore, our first recommendation is, that the Treasury Department review these regulations and clearly set forth what is and is not an acceptable method of determining the LIFO inventory value. Such current ambiquities as the lack of defination of an adequate sample size, what is a natural business unit and what constitutes a new item should be clarified. The conflict between the Reg. sections should be eliminated. Currently, Reg. 1.471-2(c) provides that any goods in an inventory which are unsaleable in the normal manner because of damage, imperfections,...or other similar causes should be valued at bonafide selling price less direct cost of disposition, while Reg. 1.472-2(c) states that such writedowns are not permissable.

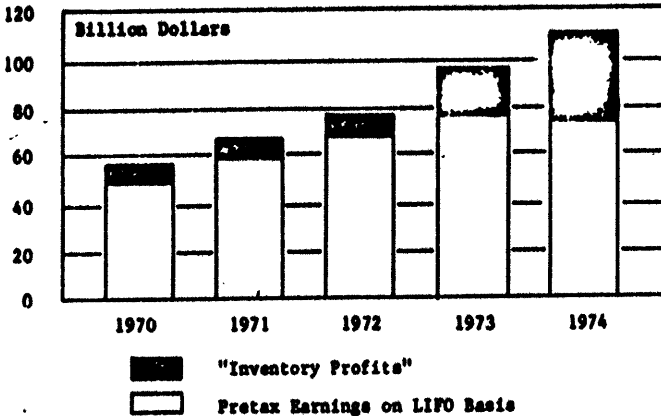
Our second and perhaps more important recommendation is that serious consideration be given to greatly simplifying the mechanics of applying LIFO. Currently most retail enterprises and some wholesalers are spared the time-consuming task of developing internal indexes for applying LIFO. These enterprises are allowed to use indexes developed and published by the Bureau of Labor Standards (BLS Indexes). The Bureau is currently developing and publishing indexes for most types of industrial communities. One page from a monthly report is shown in Table IV as an illustration of the comprehensive nature of the published material. We specifically recommend that serious consideration be given to allowing most enterprises to use these indexes in valuing their inventories. This would greatly reduce the mechanical problems encountered in LIFO inventory accounting methods, thus allowing more small businesses to adopt LIFO.

Irrespective of the methods used in computing the LIFO value of inventory, provisions should be made to mitigate the effects of large year-end inventory amount fluctuations that are attributable to extraordinary events. As the Regulations now stand a very large portion of the LIFO benefit could be eliminated and an enterprise would again be taxed on inventory profit if, for example, its inventory were destroyed in a fire.

TABLE I

WHY LIFO?

HOW "INVENTORY PROFITS" INFLATED CORPORATIONS' TAXABLE INCOME



* First half annualized

Source: U.S. Dept. of Commerce

TABLE II

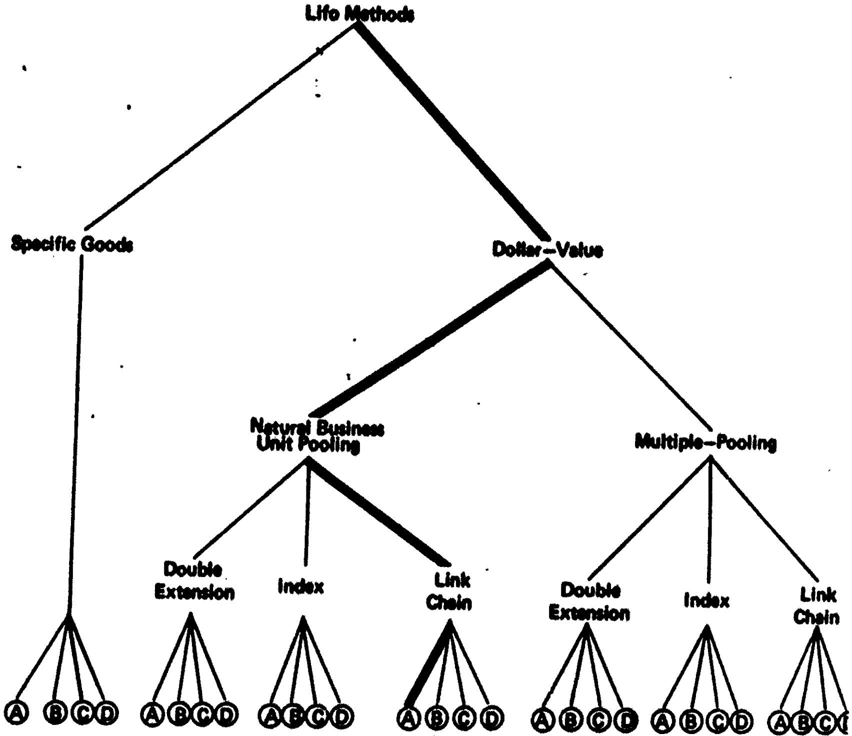
GROWTH OF INFLATION PROFITS IN INVENTORIES OF NON-FINANCIAL CORPORATIONS (BILLION DOLLARS)

Year	Total Pre-tax Profit	Current Income Tax	Inventory Inflation Profit	Annual Income Tax on Inflation
1965	65.8	27.6	1.7	0.8
1966	71.2	30.1	1.8	0.9
1967	66.2	28.4	1.1	0.5
1968	72.4	34.0	3.3	1.6
1969	68.0	33.7	5.1	2.4
1970	55.7	27.6	4.8	2.3
1971	64.1	29.7	4.9	2.4
1972	74.3	35.0	6.9	3.3
1973	96.5	46.6	17.3	8.3
1974 - Q I	140.1*		31.2*	15.0
- Q II			37.9*	

*Annualized

TABLE III

LIFO METHODS OPTIONS TREE



Pricing of Current Year LIFO Layers:

Ⓐ Earliest costs in year
Ⓑ Lastest costs in year
Ⓒ Average costs for year
Ⓓ Other costs in the year

TABLE IV

EXCERPT FROM BUREAU OF LABOR STANDARDS AUGUST 1974 WHOLESALE PRICE INDEX

Table 13. Price indexes for the output of selected census product classes—Continued

[illegible]

1963 CENSUS CODE	PRODUCT DESCRIPTION	OTHER BASES	1974 AUG.	1974 JULY	1974 JUNE	1973 AUG.	1973 ANN AVG
32730	READY-MIXED CONCRETE		150.9	150.4	151.7	133.9	133.3
32740	LIME		164.8	160.2	159.6	119.7	119.4
32750	GYPSUM PRODUCTS		142.8	138.7	137.5	122.4	123.8
32911	NONMETALLIC ARTIFICIAL SIZED GRAINS, POWDERS, ETC.		169.7	167.1	166.7	131.3	132.4
32912	NONMETALLIC BONDED ABRASIVE PRODUCTS, INCLUDING DIAMOND		147.0	146.5	146.5	120.2	120.1
32913	NONMETALLIC COATED ABRASIVES PRODUCTS	12/71	126.1	126.1	122.1	[illegible]	[illegible]
32925	ASPHALT FLOOR TILE		NA	NA	NA	116.3	116.9
32926	VINYL ASBESTOS FLOOR TILE		124.9	110.8	111.1	99.7	99.7
33	PRIMARY METAL INDUSTRIES						
33120	OTHER STEEL MILL PRODUCTS, EXCEPT WIRE PRODUCTS		193.1	188.4	165.6	[illegible]	120.3
33121	COKE OVEN AND BLAST FURNACE PRODUCTS		240.3	221.9	219.4	151.6	142.1
33122	STEEL INGOT AND SEMIFINISHED SHAPES		192.1	184.6	176.2	136.7	136.6
33123	HOT ROLLED SHEET AND STRIP, INCLUDING TIN MILL PRODUCTS		183.6	176.1	162.0	[illegible]	[illegible]
33124	HOT ROLLED BARS AND BAR SHAPES, PLATES, STRUCTURAL SHAPES		[illegible]	180.1	[illegible]	[illegible]	[illegible]
33125	STEEL WIRE MADE IN STEEL MILLS		253.1	197.2	177.6	135.2	136.7
33126	STEEL PIPE AND TUBE MADE IN STEEL MILLS		189.4	183.2	175.8	135.4	136.9
33127	COLD ROLLED STEEL SHEET AND STRIP MADE IN STEEL MILLS		189.2	177.7	163.5	132.1	132.5
33128	COLD FINISHED STEEL BAR AND BAR SHAPES MADE IN STEEL MILLS		167.7	164.4	[illegible]	133.2	132.4
33131	FERROMANGANESE		286.6	184.2	184.2	117.3	115.9
33132	FERROCHROME		212.9	189.1	189.1	[illegible]	137.4
33133	FERROSILICON		215.9	179.9	179.9	[illegible]	126.6
33151	NONINSULATED FERROUS WIRE, ETC. (WIRE DRAWN IN PLANT)		181.5	170.1	172.1	130.3	130.9
33152	STEEL NAILS AND SPIKES		222.3	219.2	213.7	143.6	142.3
33155	STEEL WIRE NOT MADE IN STEEL MILLS		203.1	197.2	177.6	135.2	134.7
33156	FENCING AND FENCE GATES		209.8	202.8	197.3	145.3	140.4
33159	OTHER FABRICATED FERROUS WIRE PRODUCTS, EXCEPT SPRINGS		232.1	231.2	229.8	117.9	135.8
33167	COLD ROLLED STEEL SHEET AND STRIP NOT MADE IN STEEL MILLS		185.2	177.7	143.5	132.1	132.5
33168	COLD FINISHED STEEL BARS, BAR SHAPES NOT MADE IN STEEL MILLS		167.8	164.5	161.8	133.2	132.4
33176	STEEL PIPE + TUBE MADE IN STEEL PIPE + TUBE + OTHER INDUST.		189.3	183.2	175.8	[illegible]	134.9
33211	MOLDS FOR HEAVY STEEL INGOTS	12/67	234.5	204.5	204.5	151.9	132.3
33213	CAST IRON SOIL PIPE AND FITTINGS		172.9	172.9	157.1	115.8	116.8
33214	MISCELLANEOUS GRAY IRON CASTINGS		159.9	159.6	133.9	131.9	131.9
33312	REFINED COPPER MADE BY PRIMARY COPPER REFINERS		216.8	216.5	216.7	151.8	[illegible]
33323	REFINED LEAD MADE BY PRIMARY LEAD REFINERS		181.2	181.8	161.8	119.4	118.7
33336	REFINED ZINC PRODUCTS MADE BY PRIMARY ZINC REFINERS		276.2	250.6	250.6	151.8	151.8
33347	ALUMINUM INGOT MADE IN ALUMINUM REDUCTION PLANTS		164.4	156.4	151.2	98.5	101.3
33348	ALUMINUM EXTRUSION BILLET MADE IN ALUM. REDUCTION PLANTS	12/68	158.2	149.6	146.5	94.2	96.9
33395	PRECIOUS METALS PRODUCED BY PRIMARY REFINERIES		336.5	318.9	366.8	198.6	199.4
33397	OTHER NONFERROUS METALS, PRODUCED BY PRIMARY REFINERIES		281.5	276.8	250.8	144.2	138.9
33412	SECONDARY COPPER (INGOT, SHOT, ETC.)		180.8	205.3	210.8	156.2	143.1
33413	SECONDARY LEAD (INGOT, SHOT, ETC.)		249.8	248.2	251.6	133.9	137.4
33414	REFINED ZINC, EXCEPT MADE BY PRIMARY ZINC REFINERS	12/71	289.9	307.3	307.3	183.3	182.2
33415	PRECIOUS METALS PRODUCED BY SECONDARY REFINERIES		258.7	269.7	273.9	159.4	169.3
33416	OTHER NONFERROUS METALS	12/71	222.5	208.7	195.3	127.8	125.3
33417	ALUMINUM INGOT PRODUCED BY SECONDARY SMELTERS	12/71	219.1	212.2	209.3	122.2	113.3
33512	ROLLED, DRAWN + EXTRUDED COPPER + COPPER-BASE ALLOY PRODUCT		188.1	197.3	232.6	151.3	141.9
33521	ALUMINUM + ALUMINUM ALLOY WIRE MADE IN ROLLING MILLS		175.1	167.2	167.2	98.8	102.3
33522	ALUMINUM PLATE AND SHEET (INCLUDING FOIL STOCK)		160.1	152.3	143.1	136.5	136.6
33523	PLAIN ALUMINUM FOIL		116.4	116.4	114.6	136.3	136.0
33524	ROLLED ALUMINUM ROD, BAR AND STRUCTURAL SHAPES		163.4	132.2	123.2	93.4	93.4
33525	EXTRUDED ALUMINUM ROD, BAR AND OTHER EXTRUDED SHAPES		162.8	152.7	153.2	125.3	125.8
33526	ALUMINUM TUBE AND OTHER ROLLED, DRAWN, ETC. MILL PROD.	12/67	157.3	147.8	139.4	117.8	117.9
33527	ALUMINUM INGOT MADE IN ALUMINUM ROLLING MILLS		165.4	156.4	153.2	98.5	121.3
33528	ALUMINUM EXTRUSION BILLET MADE IN ALUMINUM ROLLING MILL	12/68	158.2	149.6	146.5	94.2	96.9
33560	NONFERROUS MILL PRODUCTS ROLLED, ETC. COPPER AND ALUM.	12/71	151.5	141.4	137.8	113.8	139.6
33571	ALUMINUM AND ALUMINUM-BASE ALLOY WIRE AND CABLE		175.1	167.2	167.2	98.8	102.3
33572	COPPER WIRE, BARE AND TINNED, FOR ELECTRICAL TRANSMISSION		275.3	220.7	235.9	139.7	139.9
33576	APPLIANCE WIRE, CORD AND FLEXIBLE CORD SETS	12/69	175.8	169.2	164.3	125.3	122.5
33577	MAGNET WIRE	12/69	160.2	141.5	150.9	133.9	103.0
33578	POWER WIRE AND CABLE	12/69	158.4	152.8	140.5	[illegible]	99.2
33579	OTHER INSULATED WIRE AND CABLE, N.E.C.	12/69	174.7	169.4	[illegible]	133.7	98.2
33911	DROP, UPSET, AND PRESS STEEL FORGINGS (CLOSED DIE)		172.1	169.9	165.0	141.4	143.4

SEE NOTES AT END OF TABLE.

APPENDIX TO LIFO TESTIMONY

There are basically two general methods of LIFO inventory accounting, the dollar-value method (single pool or multi-pool concept) and specific goods method.

Under the specific goods method, the value of the inventory is normally measured by the physical quantities of the product, i.e., number of pounds, linear feet, cubic yards, etc. For this purpose closely similar items may be included in cost groupings called "Pools." The relationship of an ending LIFO inventory to the base and prior increments is established for each pool simply by comparing quantities expressed in the appropriate unit of measurement.

Experience has shown that the specific goods method, embracing, as it does, a proliferation of pools, is likely to produce unusual fluctuations. Consequently, in the long run, the benefits of LIFO may be lost. It is not uncommon for the quantity of goods in one pool to rise considerably (requiring valuation at current prices for the increase) while another pool is correspondingly reduced. Such disparity in the price level of different pools may contribute to higher reported income (inventory profit) although the true LIFO cost investment in total inventory may not have changed.

For some industries, the specific goods approach may be adequate because the possibility of radical changes in the product mix is remote. For most businesses, however, the specific goods method is not practical. Therefore, the more common dollar-value method is more frequently used.

The dollar-value method spreads the effect of changes in the mix of specific goods in any inventory pool over all units in the pool. A broader range of items may be included in a dollar-value pool than in a specific-goods pool. In the latter cases, because changes are measured in terms of units, of a commodity, the

continued....

pooled items must be substantially identical. Under dollar-value, the test for grouping items into pools is similarity--as to types of raw materials, processing operations applied, interchangeability, or similarity in use.

Dollar-value LIFO is best employed in conjunction with the use of a single pool encompassing all the inventory assets of a natural business unit. The volume of inventory for all purposes is quantified in units of base dollars (original unit costs). Even a total substitution of items during a period would not alter the LIFO value of an inventory if the number of substituted items, were equal in total to the number of the former items.

To illustrate:

BEGINNING LIFO INVENTORY

Item	Quantity	Base Year Cost	LIFO Value
T	100	$ 2	$200
U	10	15	150
V	1	100	100
		TOTAL	$450

ENDING LIFO INVENTORY

Item	Quantity	Base Year Cost	LIFO Value
X	10	$ 20	$200
Y	15	10	150
Z	100	1	100
		TOTAL	$450

The essential mechanics of dollar value can be summarized as follows.

(a) All items in beginning LIFO inventory are assigned a base year unit value. Usually these would be the same as FIFO values except that adjustments to eliminate FIFO market writedowns may be necessary. This "base year inventory" must be kept permanently.

(b) All items in the ending inventory are extended at base prices. If the total calculated is equal to or less than the beginning inventory, no further calculations are necessary.

continued....

(c) If the ending inventory at base prices exceed the beginning inventories amount the excess constitutes a LIFO increment or layer. This increment represents a quantity or "volume" increase, expressed in terms of base dollars.

(d) An increment, as in (c), must be converted to LIFO value by pricing at current levels. The (1) earliest costs, (2) average costs, or (3) latest costs prevailing in the year may be used in pricing increments; the ratio of the inventory at current costs to the inventory at base prices is determined and applied to the increment. The latter calculation is usually referred to as double-extension, or double-pricing.

(e) For purposes of (d) IRS regulations contemplate that the <u>total</u> inventory will be double-priced. That is, the ending inventory will be priced completely at base prices and also at current costs unless the taxpayer can justify the use of a sampling method to determine the index number.

A LIFO inventory summary may appear as follows:

	At Base Cost	Ratio	LIFO Value
1971 Base	$1,000,000	100.0	$1,000,000
1971 Increment	100,000	104.0	104,000
1972 Increment	200,000	106.0	212,000
1973 Decrease	(40,000)	106.0	(42,400)
1974 Increment	40,000	125.0	50,000
Total 1974 LIFO inventory value			$1,323,600

The above tabulation demonstrates the adverse effect of the impairment of low cost base or increment. The 1973 decrease permanently eliminated a portion of the 1972 increment. When the same volume of inventory was restored in 1974 it was necessary to price it $7,600 higher than if there had been no impairment. This results in an additional $7,600 of taxable income without a real increase in inventory amount.

The basic arithmetic LIFO procedures are readily comprehended in theory. However, in practice formidable problems are encountered in identifying items and accumulating the required data. The accounting practices of individual businesses are rarely identical. Procedures for dealing with the various problems, particularly unavailability of data in the desired form and the massive numbers of items in inventory, must be developed on a company by company basis.

continued....

The typical small company may have a manual system of accumulating costs thus placing an extreme burden on them to develope the data referred to above.

Businesses often face a special problem in the form of excessively large numbers of individual items. An inventory containing 10,000 items is difficult to handle under LIFO. One method for coping with a large inventory is the double-extension method which is favored by the Service. Yet the double-extension method is complex and difficult to employ.

The use of the double-extension method is required by the regulations to determine the ratio of current costs to base costs in order to determine and price an annual increment entering a dollar-value pool. As an alternative, an index method (that is, sampling) may be permitted if "...use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items..." The regulations further provide: "An index may be computed by double-extending a representative portion of the inventory contained in a pool or by the use of other sound and consistent statistical methods." However, there is no definition in the regulations which defines what is an "adequate and statistically valid" sampling technique.

Inquiries of IRS, as to the size of an acceptable sampling, have usually elicited the response that 50 per cent of the items and 75 to 80 per cent of the value should be included in the sampling. Obviously a sample of that size is only slightly less cumbersome and difficult to comput than a full double-extension. Additionally, the use of an index method must be justified without any clear guidelines as to when the Service will object to its use.

In summary, LIFO inventory accounting methods produce more accurate gross profit results than the FIFO method which is predominately employed by small business concerns. The LIFO method eliminates inflated profits which (under the

continued....

FIFO method) result because lower historical inventory costs are charged against sales. Historical costs do not give consideration to increased cost of replacement goods and to this extent profits are overstated. LIFO assures the elimination of inflated profits which reduces income taxes on the phantom inventory profit. This reduced tax burden will provide business concerns with the funds needed to replenish inventories. Therefore, we recommend that the difficulties of computing LIFO and the uncertainties of what is and is not an acceptable method be simplified and clarified in order to allow the small business enterprizes to adopt and use LIFO.

SUBCHAPTER S RULES NEED REVISION

INTRODUCTION

In 1958 Congress passed, as part of the Technical Amendments Act of 1958, legislation which allowed corporations meeting certain requirements, with the consent of their shareholders, to elect not to pay the corporate tax on their income, but rather to have their shareholders report the corporation's income on their individual income tax returns. Congress passed this legislation in the belief that "it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."[1] In addition, Congress believed that "permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business....The provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses."[2] The goals of this legislation have been partially successful since over 10% of business enterprises which are corporations have elected Subchapter S status. The fact that the Subchapter S provisions are used by small businessmen can be demonstrated by a survey of clients in our office which indicates that the average Subchapter S corporation has sales of $355,000, total assets of $206,000, net worth of $75,000 and net profits of $26,000. However, statistics point out that the goal of permitting business to select its form of organization without tax consequences being the determining factor,has not been achieved. The fact is,

[1] Senate Report N. 1983, 85th Congress, 2nd Session, Page 87.
[2] Ibid

INTRODUCTION, continued....

that over 80% of all business enterprises still operate as either partnerships or proprietorships. As a result of using these forms of organization, businessmen are subjecting themselves to the risks of unlimited personal liability which would not exist if they organized as corporations.

Taking into consideration the fact that almost all of these partnerships and proprietorships are small businesses, those which Congress in 1958 felt would be the primary beneficiaries of the Subchapter S legislation, the natural question that arises is why is this Code section not used more? Part of the answer, of course, is that it is more difficult to form a corporation under most state laws, and state and local taxes are frequently higher for corporations than for partnerships and proprietorships. The major reason, however, for the failure of Subchapter S to achieve the goal of the 1958 Congress, is that there are several provisions in these sections of the Internal Revenue Code which impose a real hardship on the small businessman. They force him to either take the risk of unlimited liability inherent in operating as a partnership or proprietorship, pay the higher taxes associated with operating as a regular corporation, or, and this is far too often the alternative chosen, simply not take the risks at all which are inherent in and are a necessary part of our capitalistic system. This testimony will concentrate on those provisions which we feel should be revised and updated to make Subchapter S the tool for small business that Congress meant it to be.

PRESENT SUBCHAPTER S INEQUITIES

In order to be assured that there would be few abuses of the newly enacted Subchapter S provisions, Congress set certain eligibility requirements in order for a corporation to elect Subchapter S status. The most well known of these provisions is the one which limits the number of shareholders a

PRESENT SUBCHAPTER S INEQUITIES, continued

corporation may have to ten. In this way, Congress sought to limit the use of the Subchapter S election to small businesses. In so doing, however, it is our feeling that the limit of ten is too restrictive, and should be raised to twenty. In light of inflation and the tight loan market, especially for the small business, it can very easily take more than ten investors to finance a new company. The small businessman can make an investment in his enterprise much more attractive to a potential investor if the use of Subchapter S is available to him. He can offer the investor limited liability and a chance for a greater return on his investment by the elimination of the double tax. Also, there is opportunity to deduct, on the investor's personal tax return, losses the enterprise might suffer in its early years. These advantages can and often do make the critical difference in being able to raise sufficient funds to start a new business. Even where fewer than ten persons are required for the initial funding of the new business, if the number of shareholders is close to ten, investors will be very reluctant to elect Subchapter status. The danger always exists, for example, that a shareholder could die and leave his stock to a spouse or his children. This could, and actually has, caused the involuntary termination of an election. This termination works a hardship on all the investors in that they must either see their after tax income substantially reduced because of double taxation, or dissolve the corporation, which action, in and of itself, can have adverse tax consequences. As already discussed, the continued operation of the business as a partnership would subject the owners to the risks of unlimited liability. Because of these dangers, there are, as a practical matter, very few Subchapter S corporations with more than five shareholders. In a survey of Subchapter S corporations which are clients of our firm, only 10% had more than five shareholders; the average number of

<u>PRESENT SUBCHAPTER S INEQUITIES</u>, continued

shareholders was three. A survey of partnerships indicated that 20% had over ten partners and would thus not be eligible for Subchapter S status. The survey found the average number of partners was slightly over seven. An increase in the shareholder limit from ten to twenty would obviously increase the opportunities for the use of Subchapter S, while still restricting its use to small businesses. The change should have almost no effect on tax revenues in that most of the existing businesses that would take advantage of the increased limit are those that are now operating as partnerships. The change should actually stimulate more investments by small businessmen, which ultimately would generate additional tax revenues. This approach agrees with Treasury Department proposals to the House Ways and Means Committee to eliminate or reduce the double tax, in order to promote substantial new capital investments.

Another provision which severely restricts the use of Subchapter S is the prohibition against trusts being shareholders. This restriction was, I believe, originally enacted to prevent the use of the Subchapter S provision for tax avoidance purposes. Most of the opportunities for manipulation were taken away by the Tax Reform Act of 1969, so it is our feeling that this provision is outdated, and in certain circumstatnces works to defeat the purpose of Congress in enacting the Subchapter S provisions. For example, there would appear to be no reason for excluding voting trusts as shareholders. The use of a voting trust would not be uncommon by the small businessman in the situation where he is forced to give up a substantial part of his equity in order to raise capital from outside investors, but desires to maintain control of his company. All of the beneficiaries would be shareholders of the corporation and each beneficiary would be counted as a shareholder for purposes of the number limitation. A

PRESENT SUBCHAPTER S INEQUITIES, continued

grantor trust is another instance where shares being owned by a trust should not prevent a Subchapter S election. The grantor is still being taxed on income from the corporation so the fact that he desires to place his stock in trust should not prevent the Subchapter S election. Perhaps the one situation where the provisions of the Code operate most harshly in causing a severe hardship to shareholders of a Subchapter S corporation, is the involuntary termination of the elction which results when a shareholder dies and his shares revert to a trust for the benefit of his family. Again, as discussed previously, both the family of the deceased shareholder as well as all the other shareholders are forced for no apparent reason into either having their income substantially reduced or taking some other steps, such as a corporate liquidation. These steps can be costly and full of risk, but are sometimes currently necessary in order that the shareholders may maintain their previous level of after tax income. Clearly, in the above situations, all of which are not uncommon to the small businessman, there appears to be no reason for the prohibition of trusts as shareholders of a Subchapter S corporation. To the contrary, it seems to work against the goals set out by Congress when the legislation was originally enacted.

With almost all elective benefit provisions of the Internal Revenue Code, Congress and the Internal Revenue Service require strict compliance with the law and the administrative procedures which surround it. Subchapter S is not an exception to this rule, nor are we asking it to be made one. However, there are certain termination provisions which are overly strict and which can cause inadvertant or intentional termination beyond the control of the majority of the corporation's stockholders. Under present law, if a new shareholder fails to file

PRESENT SUBCHAPTER S INEQUITIES, continued

a consent to the Subchapter S election within thirty days after he acquires his shares, no matter how small the percentage ownership, the election is automatically terminated retroactively to the beginning of the fiscal year in which the shares were acquired. While we agree that the original election should be a unanimous one, it does not seem fair that a single new shareholder should be able to terminate the election by failing to file a consent. Termination should only be caused by affirmative action of the majority of the shareholders. This change in the law would help prevent inadvertant terminations and also prevent a single small shareholder from causing a calamity for all of the other shareholders.

Also with respect to the termination of a Subchapter S election, the present law permits a voluntary revocation of the election only if it is made within the first month of the taxable year for which the revocation is to be effective. We believe that with the unanimous consent of all shareholders, a Subchapter S corporation should be permitted to revoke its election, retroactive to the beginning of the year, at any time during the taxable year.

One of the Subchapter S benefits Congress wanted to pass on to small business was the availability of the loss pass-through from corporations to individual shareholders. While the provisions of Subchapter S do provide for this pass-through, there is one severe limitation which does not exist in partnership law and which does create a significant difference in the tax results between operating as a partnership as opposed to a Subchapter S corporation. Under both partnership and Subchapter S law, the individual may deduct losses only up to the extent of the basis for his investment in an enterprise. Under partnership law, if in the current year the loss exceeds the basis, and in a later year the partner increases his basis through additional investment, he is then permitted to deduct the excess loss in the later year. However, the shareholder

PRESENT SUBCHAPTER S INEQUITIES, continued

in a Subchapter S corporation does not receive the same benefit. If in a particular year the shareholder's share of the corporation's loss exceeds his basis, the deduction for the excess loss is lost forever. No matter how much additional money he may invest in later years, he can never deduct that excess loss. There is no reason for this disparity in the treatment between a partner in a partnership and a shareholder in a Subchapter S corporation. A change in this area of the law is one which will not only eliminate an obvious inequity, but will also assist in more fully achieving the goals of Congress through creating a substantial incentive for investing additional funds in a small business which might otherwise fail because of losses in its early years of operation.

Another provision of the law pertaining to Subchapter S which does not seem to correspond to Congress' goals for small business is the prohibition of distributing property other than cash to shareholders as a distribution of previously taxed income (i.e. income upon which the shareholders have already paid taxes but which has not yet been distributed to them). It is often impracticable and can cause a substantial hardship on the small businessman to be forced to make cash distributions to the shareholders. Since the tax has already been paid on this income, there would seem to be no reason for preventing the small businessman from using property, such as notes or debentures, to make a distribution of previously taxed income to his shareholders. Under present law, the shareholders could in certain circumstances be forced to pay tax on the property as an additional dividend, even though they have already paid tax on substantial amounts of income which they have not yet received. A change in this provision of the law would make it easier for the small businessman

PRESENT SUBCHAPTER S INEQUITIES, continued

to re-invest a part of his profits without having to fear adverse tax consequences.

SUMMARY

In summary, I would like to point out that all Subchapter S changes we have suggested have two things in common. First, they are all designed to aid the small businessman, who today is in more need of help than almost anyone else. If Subchapter S inequities can be eliminated, the same small businessman can become a significant contributor to any future economic upturn within our country. These revisions will ease the burden of the small businessman in both raising capital and operating his business under the provisions of Subchapter S. Secondly, none of the suggested changes will cause any significant loss of tax revenue; rather, they should stimulate the growth of small business to the degree that they will ultimately add to the total tax revenues.

SUPPORT FOR INCREASING SURTAX EXEMPTION TO $100,000

INTRODUCTION

One area which would provide an immediate influx of capital to corporate entities would be a permanent increase in the corporate surtax exemption to $100,000.

As long ago as 1918, Congress recognized the need to provide a two tier system of corporate taxation. In 1935, Congress adopted a $25,000 surtax exemption. By proposing an increase to $100,000, we are proposing that in terms of constant dollars, the surtax be returned to the original level.

While such an increase would benefit all corporations with income in excess of $25,000, the primary benefit would be concentrated in smaller business. For a corporation with $100,000 in taxable income, the proposed increase would amount to a 47% tax reduction on the tax that would otherwise be owed, and would provide an additional $19,500 in available investment funds. As a corporation's taxable income increased above the surtax limitation of $100,000, the percentage of tax reduction would become progressively insignificant. For a corporation with $1,000,000 in taxable income, the reduction would only be 7%.

RESEARCH RESULTS

Our research[1], presented on the attached table Effects of Increasing the Surtax Exemption to $100,000, disclosed that approximately 74% of the tax benefit from increasing the surtax exemption would be received by corporations with net assets of less than $5 million. In terms of dollars, this would

[1]Comparative statistics for 1970 corporate returns.

RESEARCH, continued

represent a capital infusion of approximately $1.4 billion to these small businesses. Based upon an historical relationship of after tax earnings retained in the business, we have estimated that these small corporations would retain approximately $1.1 billion or 80% of the total benefit would be reinvested in the business.

Our research has projected an initial revenue loss at approximately $2 billion. This initial revenue loss would be offset by increases in employment, real wages, and business output. In a study prepared by Mr. Norman B. Ture of Norman B. Ture, Inc., for the National Association of Wholesaler/Distributors, it was projected that by 1977, based upon historical relationships, an increase in the surtax exemption to $100,000 would increase full time employment by 720,000 and total real wages by $10 billion. The study projected an increase of total business sector output of $17.2 billion also by 1977. Our research and the aforementioned study indicates that in the relatively short term, the initial revenue loss would be completely offset by increased federal taxes on the increased real wages and output.

CONCLUSION

Therefore, the logical conclusion that can be drawn from the study, is that the proposed $100,000 increase in the surtax exemption would not result in a long term revenue loss to the Treasury and would place the majority of the benefit in the small corporate sector where it is sorely needed.

EFFECT OF INCREASING THE SURTAX EXEMPTIONS TO $100,000

	Total All Corporations	Size of Total Assets											
		No Assets	$1 to $100,000	$100,000 to $250,000	$250,000 to $500,000	$500,000 to $1,000,000	$1,000,000 to $5,000,000	$5,000,000 to $10,000,000	$10,000,000 to $25,000,000	$25,000,000 to $50,000,000	$50,000,000 to $100,000,000	$100,000,000 to $250,000,000	$250,000,000 or More
a) Total number of returns	1,665,477	46,446	914,575	335,741	169,847	93,468	74,420	12,559	9,820	3,886	2,080	1,435	1,200
b) Number of returns with net income	1,008,337	16,564	479,292	236,665	126,518	69,502	54,809	9,666	8,144	3,227	1,705	1,199	1,056
c) Percentage of returns with net income to total (b÷a)	60.5%	35.6	52.4%	70.5%	74.5%	74.4%	73.6%	77.0%	82.9%	82.8%	82.0%	83.6%	88.0%
d) Average net taxable income per return with income	71,776	31,217	3,233	11,241	22,964	43,259	127,899	304,603	443,618	951,985	1,829,433	4,681,362	34,444,500
e) Tax savings per average return from increasing surtax from $25,000 to $100,000	$ 12,162	1,616	-0-(1)	-0-(1)	-0-(1)	$ 4,747	$ 19,500	$ 19,500	$ 19,500	$19,500	$19,500	$19,500	$19,500
f) Total benefit per asset class (000 omitted; e x b)	$1,912,714	$26,764	-0-	-0-	-0-	$329,926	$1,068,776	$188,487	$158,808	$62,732	$33,248	$23,381	$20,592
g) Percentage of after tax income retained in the corporation		32.3%	77.5%	83.4%	83.9%	81.5%	80.2%	72.4%	62.6%	53.5%	43.1%	25.8%	3.7%
h) Amount of surtax savings retained in the corporation (000 omitted; f x g)	$1,425,258	$ 8,645	-0-(1)	-0-(1)	-0-(1)	$268,890	$ 857,158	$136,465	$ 99,414	$33,562	$14,330	$ 6,032	$ 762

(1) No benefit is reflected for these sizes of asset class because of the use of average number.
Any corporation in this size classification with taxable income in excess of 25,000 would benefit.

INTERNAL REVENUE CODE DISC PROVISIONS SHOULD BE RETAINED

HISTORY OF DISC

The DISC provisions were initially proposed by the Treasury Department, approved by the House Ways and Means Committee and approved by the House of Representatives as part of the Trade Act of 1970. However, the 91st Congress was adjourned before the Senate could complete action on the Bill. DISC was again proposed in August, 1971 by the Administration and was subsequently enacted, with modifications, as a part of the Revenue Act of 1971.

Secretary John Connally in 1971 testified that the enactment of DISC would:

(1) Provide a similar type of U. S. tax treatment for U. S. companies engaged in exporting as is available from manufacturing abroad through foreign subsidiaries:

(2) Create and preserve jobs in the U. S. through expansion of export sales, and

(3) Offset foreign laws which favor export production.

The Treasury Department offered testimony in September, 1971 that DISC would "result in an increase in annual export sales of $1.5 billion, which will mean more gross national product - more tax base in the U. S. and more tax revenues".

OPPOSITION TO DISC

Almost since the moment of its inception as law, the DISC provisions have been under a constant attack from opponents. The arguments most often stressed by the opponents of DISC are fivefold:

(1) The revenue losses to the Treasury have far exceeded the original estimates;

continued....

OPPOSITION TO DISC, (continued....)

(2) It can not be clearly demonstrated that DISC is encouraging export;

(3) The DISC provisions may be a violation of the General Agreement on Tariffs and Trade (GATT);

(4) Trade accounts of the U. S. have recently been in a surplus condition rather than in a deficit condition; and

(5) DISC has encouraged the export from the U. S. of some commodities which are in short supply in this country.

We agree that some products in short supply in the U. S. in the natural resource area in particular were being exported from this country. Congress has already acted effectively to solve this problem by providing in the Tax Reduction Act of 1975 for the elimination of DISC treatment on exports of certain natural resource products. This provision, along with the authority granted the President in Section 993 (c) (3) of the original provision, will effectively prevent the use of DISC to export products in short supply at the expense of the domestic market. Accordingly, this argument of opponents of DISC has been resolved and should no longer be justification for outright repeal of the DISC provisions.

We question the validity of the argument that DISC should be repealed because it may represent a violation of GATT. We do not believe that the U. S. is the only signer of the Agreement who might have export promotion policies which might be considered to be in violation of the terms of the Agreement. As a matter of fact, as was mentioned earlier, one of the purposes of enacting DISC in the first place was to offset some of the advantages provided by foreign tax laws to foreign industry certain of which undoubtedly could also be considered to be in violation of GATT. The U. S. would be giving up an important bargaining

continued....

OPPOSITION TO DISC, (continued....)

position if the DISC provisions would be unilaternally repealed without receiving concessions from other signers of the GATT.

A third argument set forth by the opponents of DISC is that it is no longer needed since the trade accounts of the U. S. are now showing a surplus. This argument is disturbing for two reasons. First, it seems to presume the attitude that DISC is something that should be turned on and off as economic circumstances change. This attitude, if it is in fact true, is not fair to business inasmuch as there is considerable expense and readjustment required of business when an economic mechanism is put into effect or taken away by Congress. Secondly, we believe the present trade surplus may well be a temporary one for the following reasons:

(1) In the first quarter of 1975, farm exports increased rather sharply;
(2) Oil imports have dropped sharply due to the Administration's increased import fee on foreign oil; and
(3) Demand for imported products has dropped due to the domestic recession.

In summary, we view the DISC provisions as a necessary part of the Internal Revenue Code, and not as an "on again, off again" measure controlled by temporary economic conditions.

The remaining arguments against DISC will be considered as we review the results of DISC for the short time for which information regarding the impact of DISC is available.

EFFECT OF FOREIGN COMPETITION

Like it or not, it is a fact of life that except in certain limited areas,

continued....

EFFECT OF FOREIGN COMPETITION, (continued....)

U. S. business operates from the same technological base as most of its foreign competition. Therefore, the policy of foreign governments in encouraging exports has a direct bearing on the competitive stature of U. S. business in the world market. In this regard, the March, 1975 International Economic Report of the President stated, "Foreign competitors, all with smaller domestic markets, have for some time devoted sizeable resources to foreign marketing programs. During the last 15 years, the U. S. has exported between 10% and 15% of the goods it produced, while major European countries have exported from 30% to 50%. The Report goes on to indicate that expenditures for export marketing and information services for 1973 by the governments of Canada, France, Japan, Italy and the United Kingdom averaged more than twice those proviced by the U. S.. Studies have indicated that foreign governments encourage exports in basically four ways:

(1) Through tax statutes by exempting, in whole or in part, export receipts from tax or by granting statutory tax incentives such as accelerated depreciation on export assets;
(2) By means of border adjustments through reimbursement of the Value Added Tax on exports;
(3) Help provided exporters by way of export financing, export insurance and practical assistance; and
(4) Direct cash subsidies or financing at favorable rates.

The incentives offered U. S. business as encouragement to export are rather meager in comparison to incentives offered to some foreign competitors. The basic incentive offered by the DISC is a temporary deferral of the tax on a portion of the income earned by the DISC, a far cry from direct cash subsidiaries received by certain foreign competitors.

RESULTS OF DISC

U. S. Department of Commerce figures indicate that exports have increased for $43 billion in 1971 to $97 billion in 1974. A key question is how much of this increase can be attributed to the DISC. Recently released Treasury Department and Commerce Department reports help give some insight into the answer.

The second Treasury Department report on the operation of the DISC program was released in April, 1975 and included the results of tax returns filed for tax years ending in fiscal 1973. The report indicates that 7,300 DISC elections have been filed as of February, 1975. The report indicated that 41% of U. S. exports in fiscal 1973 were DISC related and amounted to $21.9 billion for the period. DISC related exports for the period increased about 33% while all U. S. exports increased about 23%. The Treasury Department estimates that deferred or "lost" revenue because of DISC were $350 million in calendar year 1972, $640 million in calendar year 1973, $1.05 billion in calendar year 1974, and will be $1.3 billion in calendar year 1975.

The U. S. Department of Commerce in its review of the Treasury Department report has estimated that the amount of export growth attributable to the DISC incentive for the period covered by the Treasury report was $2.56 billion. Thus, the combination of the two reports indicates that the ratio of deferred revenue to export increase is about 7 to 1 ($2.56 billion ÷ $350 million). Applying this ratio to the Treasury Department's estimate of DISC deferred revenue for 1975 ($1.3 billion), we can expect exports to increase by approximately $7 billion in 1975 because of the DISC incentive. As a matter of fact, the Department of Commerce has indicated that because more companies are beginning to use the DISC the 1975 increase in exports will probably be in the neighborhood of $9 billion. Therefore, if the information gathered by these two Government Agencies is valid, one is led

continued....

RESULTS OF DISC, (continued....)

to the conclusion that the DISC is achieving the goal of increasing export sales which in turn leads to increased income tax revenue.

It is not correct for the opponents of DISC to dwell solely on the estimate of revenue deferred or "lost" as justification for the repeal of the DISC provisions. This deferral is only an initial effect of DISC. One must look to the effect of the DISC provisions from the standpoint of the increased tax revenues generated by the suppliers to the exporter, the increased taxes paid by the employees whose jobs depend on export business and the increased taxes paid by the economic activity resulting from the increased expenditures made by export employees. In other words, there is a multiplier effect which must be considered. In this regard, the U. S. Department of Commerce estimates that $1 billion of increased exports results in an annual increase in the Gross National Product (GNP) of $3 billion. As a result the above mentioned $7 billion to $9 billion expected increase in exports due to the DISC incentive will result in a $21 billion to $27 billion increase in GNP.

In addition, according to U. S. Department of Commerce estimates, each $1 billion of GNP produces Federal tax revenues of about $230 million. Hence, the projected $7 billion to $9 billion increase in exports from 1975 would (without consideration of the three-fold multiplier effect) produce increased Federal tax revenue of $1.6 billion to $2.1 billion as compared to the temporary deferral of tax revenue of $1.3 billion. Viewed in proper prospective then, we conclude that the DISC is a revenue-producer, not a revenue-loser.

From the standpoint of employment, private studies have estimated that each $1 billion gain in exports results in 60,000 to 70,000 more jobs. The Bureau of Labor Statistics has estimated that in 1973 the increase per $1 billion was 47,000 jobs. The same source reduced its estimate to 40,000 jobs per $1 billion for 1974

continued....

RESULTS OF DISC, (continued....)

because of the impact of inflation. Using the 40,000 job figure, the estimated $7 billion to $9 billion increase in GNP in 1975 because of the DISC incentive would result in a conservative estimate of between 180,000 and 360,000 more jobs.

It is interesting to note that, in testimony already presented to their Committee, the National Association of Manufacturers through a macroeconomic model projected that repeal of the DISC would result in a net decrease over a five year period in real fixed investment, manufacturing employment, total employment, real GNP and net Federal tax receipts.

We further question the validity of the argument often cited by opponents of the DISC that the deferred or "lost" revenue from the DISC incentive is much greater than originally anticipated as a basis for arguing for the repeal of the DISC provisions. Since the revenue loss is measured by the deferred tax revenue on income from export sales, one must conclude and the published statistics support the fact that export sales have been much higher than originally estimated. It would seem much valid for opponents of DISC to argue for the repeal of the DISC incentive if the deferred revenues were less than originally estimated.

Nor can we accept without comment the argument of opponents of the DISC that only the very large corporations have and will continue to benefit from the DISC incentive. Naturally the first taxpayers to take advantage of the DISC would be the corporations with substantial export business and with sophisticated tax advisers to assist in the interpretation of the complex DISC provisons. However, we are aware of an instance where a large corporation has terminated its DISC and aware of other situations where large corporations are contemplating the termination of the DISC largely because of the restrictions place on the use of the cash generated by the DISC in comparison to the companies' needs for use of the cash. In other

continued....

RESULTS OF DISC, (continued....)

words, many large corporations appear to be considering the decision to forfeit the tax savings provided by the DISC in order to get unrestricted use of the cash which they need in today's business climate. In brief, big business was the first to take advantage of the DISC incentive and they are also the first to reach the limit of the maximum benefit which can be achieved through the DISC tax saving as compared to the complex limitations imposed by the DISC tax provisions on the use of the cash generated by the DISC incentive. That point has been reached by some corporations and we believe that as time goes on the statistical information developed by the Treasury Department will indicate less use being made of the DISC by big business as a percentage of total businesses using the DISC.

IMPACT OF THE DISC ON COSE MEMBERS

So far we have presented statistics which have been prepared for the most part by various Government Agencies. Representatives of COSE in June, 1975 testified before the Senate Select Committee on Small Business on matters of tax reform, including the DISC. As part of that testimony we indicated that members of COSE and certain members of the Cleveland World Trade Association would be surveyed to determine, among other things, the impact of the DISC on the small businessman. The results of that survey clearly demonstrate that retention of the DISC provisions is critical to small business if it is to remain in the export market. First, the survey indicated that the small businessman is, in fact, a part of the U. S. export market. Of the businesses answering the survey, 29% had export sales. The dollar volume of exports ranged from a low of $2,000 to a high of $1 million plus with the majority in the $25,000 to $500,000 range.

Secondly, the attitude of the small businessman is aggressive in contemplating his role in the export market. An impressive 58% of the businesses responding to

continued....

IMPACT OF THE DISC ON COSE MEMBERS, (continued....)

the survey indicated that they believe that small business has a role in the export market. Furthermore, 67% of those who believed that small business has a role in the export market plan to actively seek to expand export sales.

Third, small business has been slow to respond to the DISC incentive. While 67% of the companies responding to the survey indicated that they were aware of the DISC provisions, only 13% of those companies responding who have export sales indicated that they were taking advantage of the DISC incentive. Of the twenty respondents who indicated they have export sales but have not used the DISC provisions, the following reasons were offered in explanation:

(1)	Insufficient export volume in comparison to costs to administer the DISC	60%
(2)	Not aware of provision	15%
(3)	Uncertain duration of law	5%
(4)	No reason given	20%
		100%

Finally, small business is awakening to the benefits offered by the DISC and the DISC benefits are often more vitally important to the small businessman trying to grow in the export market than they are to the large business which has already developed a mature export market. For example, it is common knowledge that foreign accounts are generally slow-paying accounts. It is not unusual for a U. S. exporters' accounts receivable on export sales to be outstanding two or three times longer than his domestic sales related receivables. The increased cash flow provided by the DISC incentive enables the small businessman to carry these slow-paying accounts which he could not afford to carry otherwise in today's money market. In addition, funds provided by the DISC incentive enable the small

continued....

IMPACT OF THE DISC ON COSE MEMBERS, (continued....)

businessman to make more frequent trips abroad to cultivate customer relations, enable the business to carry larger quantities of inventory in order to provide quicker deliveries and enable the business to increase its budgets in other key operating areas such as advertising. In the words of Mr. L. J. Davidson, President of Midwest America International, Inc. (a company whose export sales have increased from $300,000 in 1971 to $750,000 in 1974), the DISC has made it possible "for us to travel to the market areas two and three times per year; whereas one trip was usually it in the past. Our export travel budget is now 50% greater and the personal contacts are vitally necessary to maintain growth". The above cited problems are usually not a factor to the large, mature corporation with a sizeable overseas marketing force; however, to the small businessman, they are critical if he is to reamin in the export market, much less grow.

SUMMARY AND RECOMMENDATION

We, as representatives of small business, respectfully urge that the DISC incentive be allowed to remain in the tax statute. Small businessmen are, with increasing frequency, taking advantage of the DISC provisions and would be financially hurt if the provisions are repealed.

As an alternative recommendation, if the majority of the members of Congress believe the DISC incentive is too liberal, we would support the imposition of an upper limit on the amount of the deferred tax benefit which could be generated by the DISC incentive.

AMENDMENT OF ESTIMATED TAX OVERPAYMENT REGULATIONS

INTRODUCTION

Current provisions of the Internal Revenue Code (Sec. 6425) provide that a corporation may, after the close of its taxable year, file an application for an adjustment of an overpayment of estimated tax. Within 45 days from such an application, the IRS may credit the amount of the adjustment against any known liability and refund the remainder provided the amount of the remaining adjustment equals or exceeds 10% of the amount of tax liability estimated by the corporation and $500.

There is not, however, any present provision which would allow a "quick refund" for the overpayment of a specific estimated tax installment. Making the corporation wait until the close of its taxable year, does not permit the prompt refund of overpayments needed by corporations who find themselves facing a sharp reduction of income because of sudden business reversals. Therefore, we recommend that Section 6425 be amended to allow a corporate taxpayer ro file for a quick refund of overpaid estimated tax installments prior to the end of its taxable year. The 10% and $500 refund limitation provision of Section 6425 would still apply.

WHY REFUNDS ARE NEEDED

The value of such a provision can be well illustrated by the recent recessionary period. As business experiences reversals and sharp reductions in income, working capital becomes tighter and business concerns, particularly smaller companies, need to recover overpaid tax estimates just to meet day to day cash flow requirements. If the Treasury has nc proper claim against

WHY REFUNDS ARE NEEDED, continued

overpaid estimated taxes, there is no justifiable reason for holding the payments for the entire year before they are refunded. Allowing refunds of overpayments of specific estimated tax installments, will involve no loss or revenue to the Treasury since it will only speed the recovery of funds to which enterprises are already entitled.

We surveyed our membership to determine the frequency of overestimated tax payments and the use of the current quick refund provisions. Of the 78 responses, 16 or 20% indicated that their estimated tax payments were frequently in excess of their tax liability. Of this group, only 8 companies or 10% had made use of the current quick refund procedure. Out of the 78 responses, 28% indicated that their estimated tax payments were in excess of their tax liability. These figures indicate that a significant number of firms are making estimated payments that are in excess of their tax liability. A smaller but still substantial number are making use of the current quick refund procedures. We also asked what benefits would accrue to firms who could have quick refunds available before the end of the year. Of those who responded, the near unanimous statement was that it would provide a much needed improvement in cash flow at a time when business reversals are commonplace.

One survey response reflected upon the serious problem many smaller concerns have when it comes to estimating and paying income taxes:

> "As a construction contractor, it is almost impossible to accurately estimate taxable earnings. Overpayments are always possible and presently are lost for some time...(interim refunds of overpaid installments)...would obviously aid our cash flow."

Another respondent questioned why the Treasury was allowed to hold overpayments interest free when his company had to pay interest on underpaid taxes. The regretful answer is that there is no logical support for the Treasury position.

SUMMARY

These results support our argument that quick refunds should be available before the end of the year. If for no other reason that to ease the bind placed on businesses when they experience sharp reversals. Smaller business concerns have great difficulty in obtaining borrowed funds and usually pay the highest interest rates. Thus, an improved cash flow would greatly assist smaller enterprises in meeting economic downturns, thereby assuring their survival and future growth without any resultant lose of revenue to the treasury.

LIBERALIZATION OF DEDUCTIBILITY OF BUSINESS SEARCH EXPENSES

INTRODUCTION

Under current law, expenditures incurred in search of a prospective business or investment are deductible only when the transaction has actually been entered into and subsequently abandoned. Because there appears to be no justification for such a limit on deductibility, we advocate that expenses paid or incurred by an individual or corporation with respect to expenditures incurred in search of a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

If a taxpayer makes a good faith investigation of a business prospect which is clearly identifiable as such and incurs reasonable and necessary expenditures therein, then ordinary standards of equity and fairness should permit deduction of those expenses. The requirement of actually entering the transaction and conducting material activity in the business, places an arbitrary and unbusinesslike burden on those individuals interested in development of new economic opportunities.

SURVEY RESULTS

In support of our position we undertook as part of our survey of members of the Council of Smaller Enterprises to determine the extent and amount of such preliminary expenditures as well as the frequency that new investments fail to develop after such expenditures are incurred.

Of those questioned, 52 or 66% had undertaken some form of expenditure for the preliminary investigation of business opportunities. The expenditures undertaken ranged from the nominal amount of $50 to up to $50,000. The

SURVEY RESULTS, continued

typical types of expenditures included travel, appraisals, market surveys and legal and accounting fees. These survey results indicate that business opportunity investigations are widespread among smaller firms and can amount to substantial sums of money.

Also significant in support of the deductibility of search expenditures was the frequency that new investments fail to develop after these preliminary expenditures are incurred. Out of the 79 interviewees, 44 or 56% stated that preliminary search expenses of the type they have incurred, frequently fail to yield new business opportunities while only 4 or 5% felt that such expenditures seldom failed to yield no new investment and 31 or 39% expressed no opinion. The failure frequency of these expenses in yielding new investments indicates that it is not realistic to tie the deduction of such expenses to the acceptance or rejection of a potential business opportunity. Such a position is arbitrary and tends to discourage expansion, particularly in the capital-starved small business sector.

RECOMMENDATION

To encourage investigation of new economic opportunities, tax deductions should be permitted for preliminary expenses incurred while seeking out new opportunities. Any possible revenue loss would be more than outweighed by increased revenues from new businesses that result from such investigations. Promoting expansion investigations would also have a favorable impact on employment when it is considered that opportunities which result in the formation of new business concerns also produce new employment opportunities.

A deterrent to the investigation of growth opportunities would be removed by allowing a deduction for preliminary search expenses. Not only would an inequity be eliminated, but a desired increase in employment and business activity will result from expanding investigations of potential new business opportunities.

Mr. MAUER. Thank you, Mr. Chairman. My name is Bruno Mauer and I am president of the Independent Business Association of Wisconsin. I appreciate this opportunity to appear before this joint committee and I would also like to thank Senator Bentsen and their financial market committee for being here as well this morning.

The first four parts of my comments will be directed to what we consider myth-building. These four areas are: (1) Size standards that only recognize small and large corporations or businesses; (2) comparing corporate and individual wealth; (3) who really pays taxes; and (4) the need for capital versus industrial production capacity.

The second part of my comments will be directed to the one essential ingredient we desperately require—capital.

The first myth that confronts us in analyzing previous tax reform testimony is the definition of size standards. And don't be afraid please! I'm not going to get deeply involved into size standards here. We feel it is essential that our Government begin to recognize and understand that there are small, medium, and large businesses with different needs; and that the impact of Government policy has varied degrees of impact on these respective segments. We readily admit that we are not in a position to put sophisticated data together to provide all of the supportive data that may be needed or required; however, our good judgment, experience, and needs are all too loud and clear.

Former Assistant Secretary of the Treasury Hickman has stated that small business is a bewildering array of definitions, and we agree. This, however, does not negate the fact that there are distinct and many needy problems that call for understanding and help. Mr. Hickman also states that, "There is no real reason to lump all 'small business' together and no clear criteria for classifying them by size."

We do tend to agree in principle, but probably for different reasons. We feel there is strong justification for pulling out a segment of small business and calling it the independent or medium-sized growth-oriented corporate segment. This segment has many distinct needs and characteristics and calls for long-overdue recognition, especially in areas of capital requirements and capital formation. We are asking for and searching out for clear criteria for classification.

If we were to utilize the method to break out small business from large business as suggested by Mr. Hickman. He used a number of firms by size of employing using top 10 percent as large and then the lower 90 percent as small firms. I'm afraid we would all get whiplash from the extremes and vast disparity between ability and need. This size standard may be interesting, but certainly not very substantive to help solve serious problems that we all face today.

To more clearly define our objective, let's use the process of elimination. We can pull out partnerships, proprietorships, and subchapter S corporations because they, by their very selective nature, and for whatever reasons, have elected to use another avenue of business organization.

This leaves us with approximately 1,400,000 corporations. If we select the $25,000 net income level as the breakout point for smaller corporations, and also use the $1 million net income level and above to denote the larger corporations, we begin to establish a tax size standard that has purpose and meaning. Let me reiterate.

If we talk about 12 million business enterprises in the United States and we take out the partnerships, proprietorships, and subchapter S corporations, which amount to about 10,600,000, then that leaves us 1,400,000 corporations. If we pull out of that number the corporations with less than $25,000 net income, which is 1,250,000, this leaves us with about $150,000 corporations between $25,000 and the $1 million net income level. If we pull out those 5,000 corporations with more than $1 million net income, that leaves us approximately 145,000 independent business corporations that are independent medium-size corporations.

The argument may be made that this method of arriving at size is somewhat capricious and arbitrary; and yet, this is a rather large and significant business segment within which we see great needs arising.

We are talking about 145,000 taxable corporations that make up the bulk of the growth, job-oriented, independent business sector. This is the business that also requires large amounts of capital to perform its proper function in our economy; however, it does not have the equity markets available, nor does it have the funding ability of its big brother. It requires retained capital, and this requires proper tax consideration, We are not attempting to isolate specific corporate size groups and indicate that these are the good guys and these are the bad guys. Rather, we are attempting to react to the specific needs and problems of small independent business, because historically it has not been adequately represented. There are specialized problems based on size, and hopefully the Congress in its wisdom will continue to respond to these areas of concern. We are hopeful that we can be of substantial help.

The second myth that I would like to address is the statement often made that small, independent business is owned by persons of considerable wealth. This may or may not be true. There are probably all shapes and sizes of wealth involved in this area of small independent business. The key question should be: "Is this wealth, whatever or wherever, invested and creating a better and healthier society?"

Wealth of itself bears no consideration in determining the needs of corporate ownership. This line of reasoning is skirting the issue. If personal wealth is a problem area, then we should address the problem to the area of personal income, and not confuse it with corporate taxation and its respective needs, for capital and capital retention.

The third myth is profits, corporations, and capital. It has been said time and time again, that businesses do not pay taxes; people pay taxes, and in essence this is true. We could also say there are no profits; there are only costs, and the cost of using capital is called

profit. Somehow we have created a frame of mind in too many in our Nation today, that profit is synonymous with surplus. We prefer to compare profit with wages. As wages and salaries are payment to those who labor at a job, profits are the payment for those who risk their capital for the creation of new jobs, new ideas, and new ventures.

The corporation is just the predominate instrument or method we use as a means of putting the needed capital together in working form, so we can efficiently get the job accomplished. In the long run, all taxes to corporate business are passed along in the costs of the products or services that we provide. This fact is essential to remember if we are to adequately meet the future needs of our great Nation. The alternative is to pass the tax back to the owners and workers in the form of inadequate return for risk and inadequate compensation for work rendered. This form can survive for only a short period of time in a free society, for capital will move to areas of better return or lower risk and work will migrate to areas of greater avoidance of taxation. What is desperately needed or required is a better balance of tax burden among our people, and sufficient incentive to encourage productive investments.

The fourth myth that I would like to address is capital need versus industrial capacity. The argument is often raised that if industrial production is currently running at about 65–75 percent of capacity, then there is no need to invest additional capital. The question seems reasonable and yet does not face the real issue. We have to look at many other factors and ask some critical questions:

1. What is the shape and vintage of our capital equipment and buildings?
2. How competitive are we in world markets?
3. How do we compare our productive capital equipment with that of our competition?
4. How do we compare on labor content? With that of our competition? With that of other nations?
5. What is our investment in research and development?
6. What are we investing in machinery and equipment so we can continue to become more productive as a Nation?

The future is an unknown, but we must plan and even speculate. Look at just two, major recent events that have impacted and required untold billions of dollars in new capital, which in most cases, was not included in corporate long-range forecasts:

1. The OPEC decision and its emerging energy problems.
2. The EPA and its impact on pollution and environmental costs.

We could go on and attempt to cover the capital cost of OSHA, CPA, and others; however, that is not our attempt here today. Our point is made. The current level of industrial production is only one indicator of many that we could and should use for helping us to determine our need for future capital.

Hopefully, by lessening the impact and answering to the best of our ability many of the myths that frequently become obstacles to progress, we can spend the next few minutes on our needs—capital.

At this time I will not go into my comments that I did want to make on capital because I think that has been covered and we are short of time. I would like to say we did run a survey on corporations. We set up two representative exhibits. First is corporation A which from 1976 to 1980 has to survive under the $25,000 surtax exemption level. And we also set up corporation B, which is the identical corporation, however, on this one we gave them $100,000 surtax exemption starting in 1976 and running it through a test period up to 1980. I hope all of you will have a chance to look at these two sample corporations with the one under the $25,000 exemption and the other one under the $100,000 exemption. All other statistics in our exhibits are as close as we can possibly get it in the two exhibits shown. I hope you can see that the net effect in the area of job creation, capital formation, and so on, can take place and the net effect to the Government itself in the form of additional taxes as growth takes place down the road is very evident.

One last comment, gentlemen. I hope each and every one of you had a chance to read the current issue of Business Week magazine. It is on capital and captial formation. It is the finest document I have run across personally, and I hope I am very unbiased when I say that. It is an excellent article on capital and the crisis of capital. It is a beautiful job. They take many of these studies, for example, the Brookings Institution did studies. They take many of these types of studies that have been going on regarding the capital crisis and give a beautiful answer to the needs in that area. Thank you very much.

Senator NELSON. I read the article and it is very good.

Mr. MAUER. It is very good, Senator.

Senator BYRD. Mr. Chairman, for clarification, could I ask where are those two examples that you mentioned? Where can they be found?

Mr. MAUER. The two corporate samples, the $25,000 one and the $100,000 one? They should be in the testimony that we introduced.

Senator NELSON. Who has it in their testimony? Is it in somebody's printed text?

Mr. MAUER. Yes, it is in the printed text.

Senator BYRD. Whose?

Mr. MAUER. It would be under the Independent Business Association of Wisconsin.

Senator NELSON. You have submitted it for the record?

Mr. MAUER. Yes, it is submitted for the record.

Senator NELSON. All right, your entire statement will be printed in full in the record and those two are attached to it, I assume.

[The prepared statement of Mr. Mauer in full follows:]

Statement By

Bruno J. Mauer, President

Rickert Industrial Supply Co.

2942 N. 117 Street

Milwaukee, Wisconsin

President of

Independent Business Association of Wisconsin

Before

Senate Select Committee on

Small Business

Wednesday, September 24, 1975

Mr. Chairman and members of this Senate Committee, it is a privilege for me to appear before this committee to present the views and concerns of many Wisconsin independently owned and operated growing businesses.

The first four parts of my comments will be directed to what we consider myth building. These areas are:

1. Size standards that only recognize small and large.
2. Comparing corporate and individual wealth.
3. Who pays taxes.
4. The need for capital versus industrial production capacity.

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Former Assistant Secretary of the Treasury, Hickman has stated that small business is a bewildering array of definitions, and we agree. This, however, does not negate the fact that

there are distinct and many needy problems that call for understanding and help. Mr. Hickman also states that, "there is no real reason to lump all 'small business' together and no clear criteria for classif'ing them by size."

We again agree in principal, but probably for different reasons. We feel there is strong justification for pulling out a segment of small business and calling it the independent or medium-sized growth oriented corporate segment. This segment has many distinct needs and characteristics and calls for long overdue recognition, especially in areas of capital requirements and formation. We are asking for and searching out for clear criteria for classification.

If we were to utilize the method to break out small business from large business as suggested by Mr. Hickman, (number of firms by size of employment using top 10% as large, lower 90% as small firms), I'm afraid we would all get whiplash from the extremes, and vast disparity between ability and need. This size standard may be interesting, but certainly not very substantive to help solve serious problems.

To more clearly define our objective, let's use the process of elimination. We can pull out partnerships, proprietorships, and subchapter S corporations because they, by their very selective nature, and for whatever reasons, have elected to use another avenue of business organization.

In 1970 the following businesses were reported on income tax returns:

	Number (in millions)	Percent
Partnerships & proprietorships	10.33	86.0
Corporations	1.67	14.0
Subchapter S	.26	2.2
Other	1.41	11.8
Total	12.00	100.0

This leaves us with approximately 1,400,000 corporations. If we select the $25,000 net income level as the breakout point for smaller corporations, and also use the $1,000,000 net income level and above to denote the larger corporations, we begin to establish a tax size standard that has purpose and meaning.

	Number	Percent
Taxable corporations with income subject to normal and surtax rates ..	734,443	100.0
Corporations with $25,000 or less of income subject to normal and surtax rates	584,057	79.5
Corporations with over $25,000 of income subject to normal and surtax rates	150,386	20.5

Corporations with over $25,000 of net income taxed at normal and surtax rates	Number of Corporations
Over $25,000 under $50,000	64,339
$50,000 under $100,000	40,835
$100,000 under $250,000	26,681
$250,000 under $1,000,000	13,725
Over $1,000,000	4,806
Total	150,286

12,000,000	Business enterprises
- 10,600,000	Partnerships, Proprietorships & Subchapter S Corp.
1,400,000	Corporations
- 1,250,000	Corporations with less than $25,000 net income
150,000	Corporations
- 5,000	Corporations with more than $1,000,000 net income
145,000	Independent Business Corporations

The argument may be made that this method of arriving at size is somewhat capricious and arbitrary; and yet, this is a rather large and significant business segment within which we see great needs arising.

We are talking about 145,000 taxable corporations that make up the large bulk of the growth, job oriented, independent business sector. This is the business that also requires large amounts of capital to perform its proper function in our economy; however, it does not have the equity markets available, nor does it have the funding ability of its big brother. It requires retained capital, and this requires proper tax consideration. We are not attempting to isolate specific corporate size groups and indicate that these are the good guys and these are the bad guys. Rather, we are attempting to react to the specific needs and problems of small/independent business, because historically it has not been adequately represented. There are specialized problems based on size, and hopefully the Congress in its wisdom will continue to respond to these areas of concern. We are hopeful that we can be of substantial help.

62-209 O - 76 - 25

The second myth that we'd like to address ourselves to is the statement often made that small/independent business is owned by persons of considerable wealth. This may or may not be true. There are probably all shapes and sizes of wealth involved. The key question should be: is this wealth, whatever or wherever, invested and creating a better and healthier society?

Wealth of itself bears no consideration in determining the needs of corporate ownership. This line of reasoning is skirting the issue. If personal wealth is a problem area, then we should address the problem to the area of personal income, and not confuse it with corporate taxation and its respective needs.

The third myth is profits, corporations, and capital. It has been said time and time again, that businesses do not pay taxes; people pay taxes, and in essence this is true. We could also say there are no profits; there are only costs, and the cost of using capital is called profit. Somehow we have created a frame of mind in too many in our nation today, that profit is synonomous with surplus. We prefer to compare profit with wages. As wages and salaries are payment to those who labor at a job, profits are the payment for those who risk their capital for the creation of new jobs, new ideas, and new ventures.

The corporation is just the predominate instrument we use as a means of putting the needed capital together in working form, so we can efficiently get the job accomplished. In the long run, all taxes to corporate business are passed along in the

costs of the products or services provided. This fact is essential to remember if we are to adequately meet the future needs of our great nation. The alternative is to pass the tax back to the owners and workers in the form of inadequate return for risk and inadequate compensation for work rendered. This form can survive for only a short period of time in a free society, for capital will move to areas of better return or lower risk and work will migrate to areas of greater avoidance of taxation. What is desperately required is a better balance of tax burden among our people, and sufficient incentive to encourage productive investments.

The fourth myth we'd like to address ourselves to is capital need versus industrial capacity. The argument is often raised that if industrial production is currently running at about 65-75% of capacity, then there is no need to invest additional capital. The question seems reasonable and yet does not face the real issue. We have to look at many other factors and ask some critical questions:

1. What is the shape and vintage of our capital equipment and buildings?
2. How competitive are we in world markets?
3. How do we compare our productive capital equipment with that of our competition?
4. How do we compare on labor content? Our competition? Other nations?

5. What is our investment in research and development?

6. What are we investing in machinery and equipment so we can continue to become more productive?

The future is an unknown, but we must plan and even speculate. Look at just two, major recent events that have impacted and required untold billions of dollars in new capital, which in most cases, was not included in corporate long range capital forecasts:

1. The O.P.E.C. Decision and its emerging energy problems.
2. The E.P.A. and its impact on pollution and environmental costs.

We could go on and attempt to cover the capital cost of OSHA, CPA, and others; however, that is not our attempt here today. Our point is made. The current level of industrial production is only one indicator of many that we could and should use for helping us to determine our need for capital.

Hopefully, by lessening the impact and answering to the best of our ability many of the myths that frequently become obstacles to progress, we can spend the next few minutes on our needs - Capital!

We strongly urge Congress to take a real progressive stand for the capital retention and capital recovery requirements of business. For the segment of business we represent, we believe that the $100,000 surtax exemption is most critical and needed at this time. Others have well stated their respective stand for capital recovery, capital formation, and the need for all

businesses to be able to generate sufficient capital to survive. They have also stated our need for capital when compared to other industrialized nations, in such areas as:

1. Depreciation allowance and range
2. Investment tax credit
3. Integration of dividends for individuals

Our independent smaller business associations have presented testimony on several occasions in an attempt to identify the array of problems confronting so many of us. The predominate answer lies in this committee's area of concern - Taxation! ... and retained earnings are the essential ingredients to our future survival and growth.

We should remember that the very nature of the corporation is to absorb capital and grow as long as there is a demand or need for its products or services. The alternative is to decay and stagnate. If our nation and its people are going to continue to receive more and more from our productive capabilities in the form of benefits, services, and possessions, then we must continue to find new and better ways to produce economically and productively. All of this will require immense amounts of capital.

Big Business does not oppose us! Big Education does not understand us! Big Government is generally concerned over us! That leaves Big Labor. Labor has supported the $100,000 surtax exemption for business, and has also taken a very close look at job creation. This is one of their dominant areas of present concern. The small independent business sector is very job intensive; consequently, it should be of major concern to all

of us in these times of higher unemployment.

Mr. Chairman, Senators, we appreciate this opportunity to once again express our views before this distinguished, vital committee.

TO: Mr. Bruno Mauer, President
Independent Business Association of Wisconsin

SUBJECT: Report on Capital Retention
I.B.A.W. Federal Legislation Committee

DATE: September 15, 1975

Our committee report on capital retention is attached for your review and presentation. This report focuses on the $100,000 Surtax Exemption and capital recovery from investment in capital equipment.

Dean A. Treptow, V. Pres.

Federal Legislation
Independent Business Assoc. of Wis.

There is a growing concern today amongst economists, business men and government leaders, that this country will not have the capital necessary to support the economic growth that we will need to obtain reasonable levels of employment and the production of goods and services desired by the people of this country. There are detractors from this theory, who believe that our capital adequacy problems will not really become chronic, due largely to their belief in government's ability to control expenditures and increase revenues in the years ahead. The debate over capital adequacy that we are familiar with relates to the entire business segment of the U. S. economy.

Whichever side of that debate that you or I may find ourselves on, there is no doubt in my mind that a capital shortage will exist for small business and it will have a stifling effect upon small business if action is not taken in the very near term. The reasons for this are simple. I am sure you have heard many of them:

1. The small business man has virtually no access to the public equity or public debt markets such as they are today. I believe there is little doubt in anyone's mind that the only sources of capital growth for the small businessman is retained earnings from his own operation and short term debt that he can borrow from the banking system.

2. Recent double digit inflation caused the balance sheets of small business to balloon and increase to an already unattractive debt to equity ratio. Small business that wants to grow, will not be able to develop sufficient capital from retained earnings to maintain its present machinery and equipment and support the working capital requirements that growth and sales will require. There is a limit to how much money can be borrowed, a point at which any banker will refuse to increase the ratio of his money relative to the equity money of the owners.

The equity capital of the owners provides the cushion or shock absorber, to withstand the shocks of economic recessions. The lenders will require this equity capital to maintain a sufficient ratio to the level of sales of the company to withstand any reasonable expectation of shock within the economy, or unforeseen circumstances in the company's market. Once this point is reached in the mind of the lender, small business can look only to its retained earnings, and cannot expect to borrow additional funds.

Condition A and B will aid in making my point. These two exhibits, each comprised of a profit and loss statement, balance sheet and a funds statement for a manufacturing firm were prepared by one of our professional

members, a national accounting firm. The source of their data was from numerous, typical, medium sized manufacturing firms. They projected the operations of this company through 1980, based upon certain assumptions. Foremost among these assumptions was the desire to grow at the rate of 10%, 12%, 13%, 14%, 15% for each year, 1976 through 1980 respectively. For purposes of illustration, the gross profit margins and expense category were maintained at constant percentages of total sales. Interest rate for borrowings was assumed to be 12%. Ratios of receivables and inventory balances were also maintained at constant percentages to total sales. In support of the growth it was determined that it would be necessary to make an annual investment for each period of the forecast in the amount of $100,000 for machinery and equipment. This level of equipment investment is believed to be necessary to replace old equipment and increase capacity sufficient to support projected sales. Exhibit A is based on an assumption of the $25,000 surtax exemption that was in effect before the 1975 Tax Relief Act. Please note that with the sales increase percentages quoted earlier, sales will rise from $2,500,000 in the year 1975 to $4,562,804 by the year 1980. Using current averages for manufacturing companies of this type employment will rise from 42 production workers in 1975 to 77 production workers in 1980. This does not include any employees in sales or general administration. This company is typical in that it earns 6 to 8% on its equity annually. The illustrative company has profitable

operations, increasing its profits for the period of projection from $58,500.00 after taxes to $65,610.00 annually. The cash flow is positive, yet you will note on the balance sheet, during the period projected the company has been required to increase its short term debt position which must be assumed to have been borrowed from a bank, from $300,000 in 1975 to $932,396 in 1980. During this time the debt to equity ratio went from 1 to 1 which would be a healthy situation in 1975 to 1.8 to 1 in 1980. Using the $25,000 surtax exemption the effective tax rate for each year was approximately 40%.

The leverage of 1.8 to 1 achieved in the year 1980 is probably unrealistic. It is reasonable to assume that 1½ to 1 debt to equity ratio is nearing a maximum acceptable to most bankers. If the company were forced to adhere to this debt to equity ratio, growth would have to almost cease in the year 1978 with sales of $3,480,000. Many might ask, "What is the harm of this? The company is still profitable, the small business is probably closely held, the owner is still taking his salary and he is increasing his equity in the business." That obviously is a very narrow view as concerns the health of our economy. Any business that can compete in an open market today and can continue to increase it sales on a profitable basis while employing an increasing number of people, has to be an asset to our economy and to curtail further growth of a company of this type, simply for lack of capital,

has to cost this country dearly. We now begin to see the nature of the capital adequacy problem. Having attained the ceiling of debt to equity beyond which it cannot borrow further funds, the company has no choice but to compete less aggressively and almost certainly as a result of that, become less efficient and most likely will regress in the years ahead.

A more common alternative however, in the last decade, has been for a well managed company of this type to look outside of itself for a means to continue to grow. Being unable to tap public equity or public debt markets because of its size, there is only one choice available and that is to seek an acquisition with a much larger firm that can provide the capital and tap the public capital markets on behalf of this company. This has happened thousands of times in the last decade and the result of course, is the further concentration of business and a greater tendency toward oligopoly.

Exhibit A serves to illustrate the nature of the capital shortage problem. Now let us recommend a specific solution. Increase the surcharge exemption on Federal income taxes to $100,000. Exhibit B illustrates the impact of the $100,000 surcharge exemption on this particular business. All of the figures on the Statement of Income down through Operating Income are the same as those on Exhibit A. From there the differences occur as Interest Expense is reduced, Earnings before Tax are increased, Corporate Taxes are

decreased with a resultant increase in the Net Profit and Retained Earnings of the company. For the period projected through 1980, the company has attained a savings and interest expense of $24,361.00 and a Federal Tax savings of $74,652.00 for a total benefit in cash flow from the $100,000 surcharge exemption of $99,013.00. Bank borrowings have been reduced by $96,091.00. In the interest of using common standards for comparing the situation in Exhibit A with Exhibit B. lets assume that the lender still requires a debt to equity ratio of no greater than 1½ to 1. This company does not reach the 1½ to 1 debt to equity ratio until 1980, simply due to the increase in surtax exemption. It has been able to continue its ability to grow for two additional years. This additional growth has allowed the company to increase its employment from the 58 employees in 1978, the year in which Exhibit A company had to stop growing, to 77 employees in 1980. Now I have already mentioned that the impact of the increase in the surtax exemption cost the Federal Government $74,652.00 over the years 1976 through 1980. If we look at the total picture however, we find that this is not really the case. As we mentioned, in 1978 the company in Exhibit A had to stop growing with 58 employees. In 1979 the company in Exhibit B was able to employ 66 employees or an addition of 8 people. If we assume that these additional 8 people earned an annual income of $15,000.00, an income that can certainly be construed as very conservative in

today's economy, particularly in manufacturing companies, then the total additional payroll made possible by the tax exemption was $120,000. Now if we assume that each of these employees was in the 25% Federal Tax bracket, then this company has added $30,000 in personal Federal Income Taxes to the Federal Treasury. In the year 1980, employment has reached 77 employees, or an increase of 19 people over the 1978 base. In applying the assumptions of 19 people each at $15,000 per year, this company has paid out $285,000 more in payroll than the Exhibit A company. Again using the 25% personal Federal Tax bracket, the additional personal income taxes to the Federal Government in 1980 were $71,250.00. Thus, during just this two year period of 1979 and 1980 that this company was allowed to continue its growth due to the surtax exemption, it generated $101,250 in additional personal income taxes from the additional people that it employed, to give the government a profit of over $26,000 on its investment in the future of this company of nearly $75,000.

One has to ask the question, however, as to whether this investment was really worth it, inasmuch as this company can only survive for two more years before presumably it must be sold out to a larger conglomerate and ultimately the answer is the same - concentration of business. The answer is that the surtax exemption alone caused this company to continue at a very nice rate of growth for two years longer than it could otherwise have done. One or

two other model adjustmentsin the Federal tax codes could cause this company to be able to survive indefinitely into the future. One such change that we recommend, is accelerated capital recovery to shorten the period during which a company can depreciate its fixed assets. During the last decade, all businesses, large and small, have realized that the allowable reserve established for replacement of equipment as it wears out or becomes obsolete are inadequate due to inflation. The replacement of equipment, even if it is identicalin nature, costs far more than the depreciation reserves that were established under current depreciation guidelines. This company, with its growth oriented posture, is not only increasing its employment, but every year has been adding $100,000 of new machinery and equipment which much be assumed to create income, additional capital and greater employment within the companies from which it buys equipment. However, its depreciation allowance on its income statements never got close to the value of the equipment that it is acquiring. Adoption of the Canadian system, called the Capital Allowance System could permit depreciationin two years on machinery and equipment. The cash flow generated by this increased depreciation write-off would fund the growth of this company indefinitely into the future.

We are aware of the argument that there is no effective contribution to our economy by allowing small

certainly protect against any unreasonable abuses of the proposals that we have offered here.

In conclusion, the examples we have used today represent a typical manufacturing company. Certainly other types of small business, retailing, wholesaling or service organizations would have different financial structures and different tax impacts. In most cases, however, the principles remain the same. We do not have the resources to do exhaustive research to demonstrate our point conclusively. We are confident however, that based upon the research that we have done for various types of industries represented by small business, that our points will be reinforced. We urgently request the cooperation of Congress in recognizing the unique capital shortage problems of small business by increasing surtax exemptions to $100,000 and changing the depreciation guidelines to allow a more rapid writeoff of fixed assets. If you agree that small business is in fact a very desirable and essential element of the American economy, we need your cooperation now.

EXHIBIT A

$ 25.000 Surcharge

INDEPENDENT MANUFACTURING CORPORATION OF WISCONSIN

Forecast of Operations

STATEMENT OF INCOME

	1975	1976	1977	1978	1979	1980
TOTAL SALES	2,500,000	2,750,000	3,080,000	3,480,400	3,967,656	4.562.804
COST GOODS SOLD	1,589,000	1,732,500	1,940,400	2,192,652	2,499,623	2,874,567
GROSS MARGIN	911,000	1,017,500	1,139,600	1,287,748	1,468,033	1,688,237
SELLING EXPENSES	427,000	495,000	554,400	626,472	714,168	821,305
GENERAL EXPENSES	83,000	99,000	110,880	125,294	142,836	164,261
ADMINISTRATIVE EX	225,000	247,500	277,200	313,236	357,089	410,652
DEPRECIATION	40,000	45,000	55,000	65,000	70,000	75,000
OPERATING INC.	136,000	131,000	142,120	157,746	183,930	217,019
INTEREST	-36,000	-45,497	-60,965	-73,466	-87,399	-103,344
EARNINGS BEF. TAX	100,000	85,502	81,154	84,280	96,530	113,675
TAXES	41,500	34,541	32,454	33,954	39,834	48,063
NET PROFIT	58,500	50,961	48,700	50,325	56,696	65,610
ADDIT. TO R/E	58,500	50,961	48,700	50,325	56,696	65,610
NO. OF EMPLOYEES	42	46	52	58	66	77

62-209 O - 76 - 26

BALANCE SHEET

ASSETS

	1975	1976	1977	1978	1979	1980
CASH	10,000	10,000	10,000	10,000	10,000	10,000
TOTAL RECEIVABLES	480,000	687,500	770,000	870,100	991,914	1,140,701
TOTAL INVENTORY	650,000	708,835	794,074	897,497	1,023,360	1,177,080
OTHER CUR. ASSETS	5,000	10,500	11,160	11,961	12,935	14,126
CURRENT ASSETS	1,145,000	1,416,835	1,585,234	1,789,560	2,038,200	2,341,910
BUILDINGS	200,000	200,000	200,000	200,000	200,000	200,000
RES. FOR DEPREC.	5,000	10,000	15,000	20,000	25,000	30,000
MACHINERY & EQUIP.	250,000	350,000	450,000	550,000	650,000	750,000
RES. FOR DEPREC.	37,500	67,500	107,500	157,500	217,500	287,500
FURNITURE & FIXT.	50,000	50,000	50,000	50,000	50,000	50,000
RES. FOR DEPREC.	15,000	25,000	35,000	45,000	50,000	50,000
DEPRECIATED ASSETS	442,500	497,500	542,500	577,500	607,500	632,500
OTHER ASSETS	10,000	11,000	12,100	13,310	14,641	16,105
**TOTAL ASSETS	1,597,500	1,925,335	2,139,834	2,380,370	2,660,350	2,990,510

LIABILITIES AND EQUITY

	1975	1976	1977	1978	1979	1980
ACCOUNTS PAYABLE	419,000	494,303	553,682	625,729	713,405	820,495
SHORT TERM DEBT	300,000	458,294	557,791	666,642	790,011	932,396
FED. TAXES PAYABLE	21,125	8,635	8,113	8,488	9,958	12,016
OTHER ACCRUALS	49,708	104,708	111,308	119,316	129,061	140,964
CUR. LIABILITY	789,833	1,065,940	1,230,900	1,420,180	1,642,440	1,905,870
DEFERRED ITEMS	7,667	8,433	9,277	10,205	11,226	12,349
TOTAL LIABILITY	797,500	1,074,370	1,240,170	1,430,380	1,653,660	1,918,220
COMMON STOCK	400,000	400,000	400,000	400,000	400,000	400,000
RETAINED EARNINGS	400,000	450,961	499,662	549,987	606,683	672,294
TOTAL EQUITY	800,000	850,961	899,662	949,987	1,006,680	1,072,290
**TOTAL LIA. & EQTY.	1,597,500	1,925,330	2,139,834	2,380,370	2,660,350	2,990,510
DEBT:EQUITY	1:1	1,26:1	1,38:1	1,51:1	1.64:1	1.79:1
EFF. TAX RATE	41.5%	40.4%	40.0%	40.3%	41.3%	42.3%

FUNDS STATEMENT

Sources and Uses of Funds

	1976	1977	1978	1979	1980
SOURCES OF FUNDS					
NET INCOME	50,961	48,700	50,325	56,696	65,610
DEPRECIATION	45,000	55,000	65,000	70,000	75,000
CASH FLOW FROM OPERATIONS	95,961	103,700	115,325	126,696	140,610
DEFERRED ITEMS	766	843	928	1,021	1,123
***TOTAL SOURCES	96,727	104,543	116,253	127,717	141,733
USES OF FUNDS					
FIXED ASSETS	100,000	100,000	100,000	100,000	100,000
OTHER ASSETS	1,000	1,000	1,210	1,331	1,464
***TOTAL USES	101,000	101,100	101,210	101,331	101,464
NET CHANGE IN WORKING CAPITAL	-4,272	3,443	15,043	26,386	40,269
WORKING CAPITAL					
RECEIVABLES	207,500	82,500	100,100	121,814	148,787
INVENTORY	58,835	85,239	103,423	125,863	153,720
OTHER CUR. ASSETS	5,500	660	801	974	1,191
LESS CUR, LBTY	276,107	164,960	189,280	222,260	263,430
NET CHANGE IN WORKING CAPITAL	-4,272	3,439	15,044	26,391	40,268

EXHIBIT B

$100,000 Surcharge

INDEPENDENT MANUFACTURING CORP. OF WISCONSIN

Forecast of Operations

STATEMENT OF INCOME

	1975	1976	1977	1978	1979	1980
TOTAL SALES	2,500,000	2,750,000	3,080,000	3,480,400	3,967,656	4,562,804
COST GOODS SOLD	1,589,000	1,732,500	1,940,400	2,192,652	2,499,623	2,874,567
GROSS MARGIN	911,000	1,017,500	1,139,600	1,287,748	1,468,033	1,688,237
SELLING EXPENSES	427,000	495,000	554,400	626,472	714,178	821,305
GENERAL EXPENSES	83,000	99,000	110,880	125,294	142,836	164,261
ADMINISTRATIVE EX.	225,000	247,500	277,200	313,236	357,089	410,652
DEPRECIATION	40,000	45,000	55,000	65,000	70,000	75,000
OPERATING INC.	136,000	131,000	141,120	157,746	183,930	217,019
INTEREST	-36,000	-44,752	-58,458	-68,805	-80,236	-93,314
EARNINGS BEF-TAX	100,000	86,247	83,661	88,940	103,694	123,704
TAXES	22,000	18,974	18,405	19,566	23,849	33,400
NET PROFIT	78,000	67,273	65,255	69,373	79,844	90,304
ADDIT. TO R/E	78,000	67,273	65,255	69,373	79,844	90,304
NO. OF EMPLOYEES	42	46	52	58	66	77

BALANCE SHEET

ASSETS

	1975	1976	1977	1978	1979	1980
CASH	10,000	10,000	10,000	10,000	10,000	10,000
*TOTAL RECEIVABLES	480,000	687,500	770,000	870,100	991,914	1,140,701
*TOTAL INVENTORY	650,000	708,835	794,074	897,497	1,023,360	177,080
OTHER CUR. ASSETS	5,000	10,500	11,160	11,961	12,935	14,126
CURRENT ASSETS	1,145,000	1,416,835	1,585,234	1,789,560	2,038,200	2,341,910
BUILDINGS	200,000	200,000	200,000	200,000	200,000	200,000
RES. FOR DEPREC.	5,000	10,000	15,000	20,000	25,000	30,000
MACHINERY & EQUIP.	250,000	350,000	450,000	550,000	650,000	750,000
RES. FOR DEPREC.	37,500	67,500	107,500	157,500	217,500	287,500
FURNITURE & FIXT.	50,000	50,000	50,000	50,000	50,000	50,000
RES. FOR DEPREC.	15,000	25,000	35,000	45,000	50,000	50,000
DEPRECIATED ASSETS	442,500	497,500	542,500	577,500	607,500	632,500
OTHER ASSETS	10,000	11,000	12,100	13,310	14,641	16,105
**TOTAL ASSETS	1,597,500	1,925,335	2,139,834	2,380,370	2,660,350	2,990,510

LIABILITIES AND EQUITY

	1975	1976	1977	1978	1979	1980
ACCOUNTS PAYABLE	419,000	494,303	553,682	625,729	713,405	820,495
SHORT TERM DEBT	300,000	445,874	528,436	618,324	718,944	836,305
FED. TAXES PAYABLE	21,125	4,743	4,601	4,891	5,962	8,350
OTHER ACCRUALS	49,708	104,708	111,308	119,316	129,061	140,964
CUR. LIABILITY	789,833	1,049,630	1,198,030	1,368,260	1,567,370	1,806,110
DEFERRED ITEMS	7,667	8,433	9,277	10,205	11,226	12,349
TOTAL LIABILITY	797,500	1,058,060	1,207,300	1,378,470	1,578,600	1,818,460
COMMON STOCK	400,000	400,000	400,000	400,000	400,000	400,000
RETAINED EARNINGS	400,000	467,273	532,529	601,902	681,747	772,051
TOTAL EQUITY	800,000	867,273	932,529	1,001,900	1,081,750	1,172,050
**TOTAL LIA. & EQTY	1,597,500	1,925,330	2,139,830	2,380,370	2,660,350	2,990,510
DEBT:EQUITY	1:1					1.55:1
EFF. TAX RATE	22%				23%	27%

FUNDS STATEMENT

Sources and Uses of Funds

	1976	1977	1978	1979	1980
SOURCES OF FUNDS					
NET INCOME	67,273	65,255	69,373	79,844	90,304
DEPRECIATION	45,000	55,000	65,000	70,000	75,000
CASH FLOW FROM OPERATIONS	112,273	120,255	134,373	149,844	165,304
DEFERRED ITEMS	766	843	928	1,021	1,123
***TOTAL SOURCES	113,039	121,099	135,301	150,865	166,427
USES OF FUNDS					
FIXED ASSETS	100,000	100,000	100,000	100,000	100,000
OTHER ASSETS	1,000	1,100	1,210	1,331	1,464
***TOTAL USES	101,000	101,100	101,210	101,331	101,464
NET CHANGE IN WORKING CAPITAL	12,039	19,999	34,091	49,534	64,963
WORKING CAPITAL					
RECEIVABLES	207,500	82,500	100,100	121,814	148,787
INVENTORY	58,835	85,239	103,423	125,863	153,720
OTHER CUR. ASSETS	5,500	660	801	974	1,191
LESS CUR. LIABILITY	259,797	148,400	170,230	199,110	238,740
NET CHANGE IN WORKING CAPITAL	12,038	19,999	34,094	49,541	64,958

Senator NELSON. It is now about 4 minutes after 11 and this panel has been on 1 hour and 15 minutes. I wish we had more time, but we don't. We have one more panel. We will really have to quit by 12 or 12:15 today. We have a vote on the floor at 2. What do you wish to do about the points you made a few moments ago, Mr. Barnes. Are they in writing?

Mr. BARNES. Yes; they are in the written testimony.

Senator NELSON. Well, we will accept them for the printed record and we regret that we don't have more time to have you go into them. At the time we have hearings before the Finance Committee. I have no doubt that those representing small business, including some of you, will have an opportunity to appear. I have no doubt that Senator Long will accept more testimony specifically on those points at that time. We hate to cut anybody off, but we do have another panel. Under our time constraints, this is the best we can do. I appreciate very much your taking the time to come here this morning and I know that both of the committees do. I think you presented us with some very useful and valuable testimony for our deliberations on the tax reform legislation.

Our next panel will consist of Abraham Weiss, Assistant Secretary for Policy, Evaluation and Research, Department of Labor; Milton Stewart, president, National Small Business Association; and Robert Eisner, chairman, Department of Economics, Northwestern University. Dr. Pierre Rinfret, president, Rinfret-Boston Associates, Inc., was detained in New York and will not be able to attend this morning. His written statement will, however, be printed in full in the record.

PANEL PRESENTATION OF THE PANEL ON RELATIONSHIP OF TAXES TO EMPLOYMENT: ABRAHAM WEISS, ASSISTANT SECRETARY FOR POLICY, EVALUATION AND RESEARCH, U.S. DEPARTMENT OF LABOR, ACCOMPANIED BY DR. FRANK P. STAFFORD, SPECIAL ASSISTANT FOR ECONOMIC AFFAIRS, OFFICE OF POLICY, EVALUATION AND RESEARCH, U.S. DEPARTMENT OF LABOR; MILTON STEWART, PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION; ROBERT EISNER, CHAIRMAN, DEPARTMENT OF ECONOMICS, NORTHWESTERN UNIVERSITY

Senator NELSON. Gentlemen, would each of you now identify yourself for the reporter.

Mr. WEISS. I guess I will go first. I am Abraham Weiss and I am Assistant Secretary for Policy, Evaluation and Research, Department of Labor. I am accompanied by a colleague on my staff, Dr. Frank P. Stafford, who is Special Assistant for Economic Affairs in my office.

Senator NELSON. He may join you at the table if you wish.

Mr. EISNER. I am Robert Eisner, chairman, Department of Economics, Northwestern University.

Mr. STEWART. I am Milton Stewart, and I am president of the National Small Business Association.

Senator NELSON. If you would, gentlemen, your statements will all be printed in full in the record. You may present them however you desire. Will you start, Mr. Secretary?

Mr. WEISS. It is a pleasure to appear before you today to discuss payroll taxes and employment. At the request of a member of your staff, this topic was what was suggested to us, to discuss just this specific aspect with you today.

When employers pay wages to workers, these wages are subject to a variety of taxes and other charges. Since the overall level of such taxes has been growing rapidly and is projected to grow still further in the near future, it is important to address several questions pertaining to such taxes. What are the various elements of payroll taxes and how are they collected? What are the magnitudes of the yields from the different taxes? What are likely future trends in such taxes? What are the impacts of these taxes, and, particularly, what might be their influence on the employment of different types of labor in different sectors of the economy? Are there any reasonable approaches to reforming these payroll taxes that merit further exploration?

Clearly, this is a long list of questions, many of which are very difficult to answer. It is my hope that raising these questions will foster more systematic consideration and analysis of the effects of our current system of payroll taxes.

Current trends in payroll taxes are presented in table 1 which contains information from the budget of the U.S. Government for fiscal year 1975 and certain prior years. The items on which I wish to focus attention include various elements in old age, survivors, disability and health insurance (OASDHI), and unemployment insurance (UI) taxes. Whereas, in 1966 these elements comprised $24.5 billion in receipts, they comprised an estimated $86.9 billion in 1976. This means that over this period they have become the second largest source of tax revenue. That further growth is not an implausible forecast can be seen in table 2——

Senator NELSON. They went from where to where?

Mr. WEISS. From $24.5 billion in 1966 to $86.9 billion in 1976.

Senator NELSON. Then what is the difference between those two figures in constant 1966 dollars?

Mr. WEISS. We have not——

Mr. STAFFORD. I think it is probably about 70 percent.

Mr. WEISS. About 70 percent in constant dollars.

Senator NELSON. Seventy percent?

Mr. STAFFORD. An increase.

Senator NELSON. And if it were constant dollars, it would, instead of being $86 billion, it would be what? Do you have that?

Mr. STAFFORD. I can make a rough estimate. It would be maybe about 50 or 48. Almost close to double. We didn't do it in constant dollars.

Senator NELSON. If you would supply that for the record, I think that would be helpful.

[Subsequent information was received and follows:]

U.S. DEPARTMENT OF LABOR,
Washington, D.C., October 6, 1975.

Mr. HERBERT L. SPIRA,
Tax Counsel, Senate Committee on Small Business,
Old Senate Office Building, Washington, D.C.

DEAR HERB: During the course of my testimony on payroll taxes in relation to employment before the Senate Finance Committee on September 24, 1975, Chair-

man Nelson asked for information about the rise in social insurance taxes and contributions in constant dollar terms. Adjusting the total social insurance taxes and contributions by the Consumer Price Index, the level has risen by approximately 110% between 1965 and 1975. The corresponding rise in disposable personal income is approximately 40%.

I hope this responds to Senator Nelson's request.

Sincerely,

ABRAHAM WEISS,
Assistant Secretary for Policy, Evaluation and Research.

Senator BYRD. Could I ask a question, Mr. Chairman? How do the number of employees compare in those 2 years?

Mr. WEISS. The labor force has, of course, grown during that intervening period and that accounts in part for the increase between these time periods.

Mr. EISNER. If I might say, Mr. Chairman, I think the increase has been even larger if you take into account all the payroll taxes; that is, Federal, State, and local. And the increase is due in major part both due to increases in rates and increases in coverage. It was only due in minor proportion to the increase in employees and the price of inflation.

Senator NELSON. When you state payroll taxes, you are referring to what? Is it to unemployment?

Mr. EISNER. The total payroll taxes are taken to be about $100 billion actually.

Senator NELSON. Are you talking about unemployment insurance or are you talking about workmen's compensation or that sort of thing?

Mr. EISNER. Old age and survivors.

Senator NELSON. Do you have a payroll tax for that in the States?

Mr. WEISS. No, that is Federal.

Senator NELSON. You are talking about State payroll taxes? I was asking you to identify what you mean by——

Mr. EISNER. Mr. Chairman, I was simply working from the aggregate, but the total figures you get in the economic report and the budget figures will indicate payroll taxes in total, Senator, amounting now to something like the rate of $100 billion per year.

Senator NELSON. But including State payroll taxes?

Mr. EISNER. I presume the difference between the $80 billion and the $100 odd billion involves in large part unemployment insurance taxes going to the States.

Mr. WEISS. These data which I am citing are, of course, from the Federal budget.

Senator NELSON. And what are the items included in the Federal employment tax?

Mr. WEISS. They include, if you look at table 1, employment taxes and contributions which cover the following benefits: Old age and survivors insurance, disability insurance, hospital insurance, railroad retirement—and this is the railroad equivalent of OASI—as well as unemployment insurance. We have not included in these figures certain other contributions for insurance and retirement which are in the private sector primarily.

Mr. STAFFORD. If you look at just social security payments, which is fairly closely related to taxes because there is a very small trust

fund, between 1965 and 1975 real—56 percent. So that the taxes rose in real terms about that amount too, with an upward adjustment for a somewhat larger labor force.

Mr. WEISS. It is clear from table 2 that the rates are currently scheduled to rise during the next 10 years by close to 8 percent.

The second most important element in the payroll tax system is unemployment insurance taxes. In fiscal year 1975, unemployment insurance outlays totaled $12.8 billion. For fiscal year 1976, outlays are estimated at $15.7 billion. When these outlays are compared to the receipts—(see table 1)—it is clear that the State trust funds must be slowly replenished over future years either with increased tax rates or increased tax base. The administration has recommended an increase in the tax base for the Federal unemployment tax and the States may well follow suit. The third element in the category of payroll taxes which I will mention just briefly is workers' compensation. Although I will not review the recent empirical studies on workers' compensation, I do mention it here since it operates in a fashion comparable to OASDHI and UI, although it is State run and not a tax in the same sense as the other two.

All three elements of payroll taxes mentioned above have similar general features. Of particular significance is that all use the same tax base—namely, wages and salaries. OASDHI applies a constant percentage tax rate up to a taxable maximum; workers' compensation premiums are generally based on a given percentage per $100 of payroll. In the case of OASDHI, the current proportional tax is 11.7 percent paid in equal parts by the employer and the employee on the employee's earnings, up to a taxable maximum of $14,100. Each year the taxable maximum or wage base is increased by a formula tied to the Consumer Price Index.

The unemployment insurance system is somewhat more difficult to summarize because the tax rate paid by employers varies across firms since the different States apply experience rating systems which make the rate for any given firm vary as a function of the firm's past record with respect to layoffs and within a zone defined by a minimum and a maximum rate. Suffice it to say that 2 percent might be considered a representative rate for unemployment insurance. The Federal Unemployment Tax Act sets a maximum annual labor earnings subject to Federal tax of $4,200. Many States have adopted the maximum, but others have set their own. As a matter of fact, 15 States have higher taxable wage bases above the $4,200.

The details of workers' compensation are still more difficult to summarize very concisely. The premium payments are made to private insurance carriers, large firms can self-insure, and workers' compensation premium rates may vary for different employee groups within a given firm. Nevertheless, the general structure is fairly comparable to that of OASHDI and UI payments. See Wayne Vroman, "The Incidence of Compensation Insurance Premium Payments," in supplemental studies for the National Commission on State Workman's Compensation Laws, Washington, D.C., 1973, pages 241 to 270. In recent years there has been a tendency for these compensation premiums to be effectively a constant proportion of wages and salaries as the tax base, the ceiling, has risen. If we take 1.5 percent as a representative rate of "tax" and I use quotes, for workers' compensation, then a typical worker might be one whose wage payments are

subject to a combined tax rate of about 15 percent. Of course, part of these taxes are paid by the employer and part are paid for by the employee—equal shares in the OASDHI case; but this still means that over the range when earnings are below all three maximum annual earnings levels, or the wage base, a tax of 15 cents is added to each dollar paid in wages and salaries. This is above and beyond any Federal income taxes which might be also paid.

Let us turn our attention to OASDHI and UI payroll taxes alone and consider their possible impact on the worker and the employer. The economic analysis of these taxes turns heavily on the conceptual distinction between the tax payment and tax incidence; that is, who bears the burden. In the OASDHI case, both the worker and firm pay an equal percent of the tax, but the economist is always more concerned with the incidence of the tax which is the much more difficult question of who actually bears the tax. Empirical work which would command a consensus on who bears the payroll taxes—workers or firms or consumers—does not exist. However, there are some general implications which flow from the nature of the payroll taxes outlined above and on which most economists would be in agreement.

Since payroll taxes are levied on earnings up to a maximum taxable ceilings level, beyond these ceilings the marginal tax rate is zero. Accordingly, where employees bear the incidence of the tax, we would expect workers to endeavor to reduce the impact of the tax by working longer hours per year, including overtime hours. Working part time would be a disadvantage since less of the annual earnings—perhaps none—would be beyond the taxable ceiling. Generally, there may be incentives to substitute hours per worker for more workers in any production process. Employers might also have an incentive to hire more highly paid skilled workers and perhaps, more subtly, workers might have an incentive to become more skilled; that is, higher paid, in order partially to avoid the marginal tax burden, since the higher their annual earnings are above the taxable earnings ceiling, the less is the proportional payroll tax bite.

Another likely outcome, reinforced by various tax advantages afforded capital through such provisions as the investment tax credit—to appreciate this possibility it can be noted that in 1976 the "tax expenditure" or estimated Federal revenue foregone by this provision was $8.8 billion. See "Estimates of Federal Tax Expenditures, Committee on Finance," U.S. Government Printing Office, July 8, 1975, page 9—is that firms will have incentives to substitute capital for labor as well as to substitute skilled labor for less skilled labor. Generally, apart from discrimination and cost of living differences, we mean lower wage workers. This substitution will be reduced to the extent that workers bear the payroll tax and if their labor supply is inelastic with respect to wages. If, as seems likely, such responses do in fact occur, the result may be employment difficulties for certain groups of labor and certain industry sectors such as retailing. That is, sectors which utilize entry level, part-time and lower wage workers are likely to be unfavorably impacted by the current system of payroll taxes. The resulting impact on employment, particularly for youths and minorities and associated on-the-job training losses, may have undesirable consequences. Growing out of such a less efficient allocation of resources would be a reduction in real GNP.

Payroll taxes also have labor supply implications which one might consider, especially in the context of the existing transfer payment system and effective tax rates. For example, what is the effect of taxes on the "take home" pay of a low wage worker who receives some benefits from, for example, the food stamp program? If he earns an extra dollar from the labor market, that is, from working, his food stamp benefits would be reduced by about 30 cents under current food stamp rules. Combining this with increased Federal and State income taxes of even 5 cents, plus payment by the worker and his employer of relevant payroll taxes, implies a marginal benefit reduction or tax rate across all programs of about 50 percent—30+5+15. If other elements in the income transfer system are added, this 50 percent figure can go even higher. Many economists are concerned over these effects insofar as they may create work disincentives.

In light of the rapid growth in payroll taxes, and the possible adverse impacts of such taxes on lower wage workers and the sectors which are most likely to employ them, consideration might be given to a series of steps. First, empirical analysis of the impacts of the rapid growth in payroll taxes should be undertaken. That is, what evidence do we have of the general effects outlined above? Can we quantify these effects? Can we learn from exploratory case studies?

Second, research should be done on the likely future requirements of the OASDHI, UI, and other systems in which financing is payroll based. Projected changes in the demographic structure of the United States may place the OASDHI system under substantial pressure. This is because when the large cohort of the "baby boom" years moves into retirement ages, it will be supported by the relatively small cohort implied by today's dramatically lower birth rates. OASDHI payroll tax rates obviously will be reviewed in this context. Future UI system requirements turn on decisions which will have to be made about the maximum duration of coverage, extensions of eligibility and the like. Decisions on these components of the UI program will probably involve adjustments in the tax rate and/or tax base.

Third, tax reform of various types merits consideration. Employment tax credits and personal wage subsidies merit examination beyond that given them in existing public policy and social science literature. Another area could be the possibility of making adjustments in the tax rate or tax base. This could provide the same tax yield, but it would spread out the source of the tax by reaching into higher-wage groups. We could also do more research on financing these expenditure areas by what some have termed more neutral taxes; that is, taxes which do not create major incentives to use one type of labor or capital over another. Such a "neutral" tax could be more closely approximated by a "value added" tax or even a general income tax. It should, however, be noted that public finance economists do not necessarily agree on the general desirability of value-added taxes.

Yet the problem is not even so simple as that. If one views the various payroll taxes as insurance charges for likely future services or benefits to be rendered (old age, and unemployment income, medical and disability payments, et cetera), then one can argue that the current tax system is not as questionable as our previous discussion might suggest. In essence, payroll taxes can be conceived as insurance premiums for specified benefits based on actuarial expectations. Features such as experience rating in unemployment insurance, along

with greater proportionate payments for workers who are more likely to receive benefits from the system during periods of unemployment, introduce price-like elements, and premium components, wherein benefit payments are related to likely use. Currently, OASDHI payments are disproportionately larger for lower wage workers, but so are the future claims of lower wage workers disproportionately larger. The policy dilemma appears to be that the current system could discourage employment of low-wage and part-time workers, yet simple abandonment of the current system for a system financed purely out of general revenues would reduce, perhaps even cut, the tie between payments and expected benefits in these areas.

If we remove the present system, which is analogous to an insurance premium as a result of which you get some benefits, if you remove that nexus and say that we should finance these out of general revenue, you may be cutting the tie between what you pay in and what you get out, the premium and the benefit. There also is another psychological factor involved. I believe that workers don't mind paying for the social security benefits because they know their financial input will derive them a benefit proportional to their contribution, to their taxes. If you have, however, social security benefits financed out of general revenues, I think two consequences might occur: One is since the employee and the employer do not contribute to this benefit, pressures to increase these benefits for those who would be the recipient of such benefits might occur.

Senator NELSON. I think you ought to change the word from "might" to "will."

Mr. WEISS. I have been trained to be cautious, Mr. Chairman.

Senator NELSON. Because when the original law was designed, there was an argument at that time for, I think it was, one-third General Treasury, one-third employer, and one-third employee. That argument still goes on. I can see some merit to it in the sense that there are changes in the economy over which a retired person has no control, such as increases in prices as a result of inflation. But if all the benefits came out of the General Treasury, you would go right through the roof on benefits, because what would be the restraint?

Mr. WEISS. And let me add——

Senator NELSON. I think that would happen, anyway.

Mr. WEISS. I was going to add the reverse of that coin, Senator. If it would come out of general revenues, I think the general body politic might be extremely reluctant for that and they would transmit their views to their elected representatives.

Senator NELSON. Reluctant?

Mr. WEISS. To increasing benefits. In other words, this could be a countervailing force. And I believe in countries abroad where a system similar to social security is financed out of general revenues, I believe there the benefits tend to be significantly lower because there is no direct relationship between employee and employer contributions and the benefit schedule. In other words, the body politic feels it is coming out of its pockets.

We consider, for example, cost of living increases as meriting an increase in social security benefits because in large part, though not completely, these benefits are provided for and are financed by contributions from those directly affected, from those who would be recipients, namely, partly employees and partly employers. So you have countervailing forces, I think——

Senator BYRD. Would you yield at this moment? As I get it then, the social security recipient would have to compete for the General Treasury money with all the other agencies and departments and all the other groups who are interested in the General Treasury?

Mr. WEISS. Your statement is very valid, sir. It is not a clear-cut picture. I am saying there are really two opposing forces. I don't know which would prevail if the system were to go to general revenue. I do want to make clear that I am not urging or supporting that system either.

Senator HASKELL. If it were to general revenue, then the tax would be more equitable. Even though you said you had no studies, I think it is fairly obvious a lower income taxpayer pays a greater percentage of his income into this and if it were switched to general revenue and was a graduated income tax, it would be fairer, wouldn't it?

Mr. WEISS. To the extent income is progressive.

Senator BROCK. But not to the extent of benefits derived from the payment?

Mr. WEISS. No; to the extent that there would be, for example, minimum social security benefits that might be counterbalanced by that segment of his income tax, which presumably would be allocated to that benefit.

Mr. STAFFORD. I guess the question is whether you want to stick with some elements of this quid pro quo relationship.

Mr. WEISS. Yes; premium versus benefits.

Mr. STAFFORD. That seems to encourage some wider spread support of the system. I think the point about countries where they go to general revenue financing is that maybe in the short run there would be this "let's add on more benefits and take it out of the general revenues," but it seems when you look at other countries when they have gone to that route after a period of time, there has been a general reduction in the level of benefits flowing through the social security system.

Senator BROCK. I think the problem some of us are concerned about the general revenue approach is if you go to general revenues, then it becomes the older people who are receiving against everybody else and they might suffer as a consequence in the long term. I do think if we want general revenue, we should add to the funding in the short term. But I do think you don't want to create a caste differential between the two groups. It would be particularly disadvantageous for those who are receiving benefits over the long term.

Senator HASKELL. Because they don't have a strong lobby?

Senator BROCK. They have a pretty strong lobby. I wouldn't underestimate the lobby itself.

Senator HASKELL. Then why?

Senator BROCK. I'm saying at this time under these circumstances they are not competing with any other lobby. If you change the circumstances, you would force competition because there is a limit to the total budget.

Senator NELSON. And don't forget there is a budget deficit.

Senator HASKELL. There is no limit to the budget.

Senator NELSON. Yes; everybody supports the deficit for their own benefits. Well, anyway, that is an interesting suggestion.

Mr. WEISS. We are just trying to say there is some kind of loose relationship between their premium and their benefits, which, in our

view, admittedly on cursory analysis, would appear to be severed or sundered if these benefits were financed from general revenue. That is the only point I am trying to make.

Just to conclude briefly, we have been discussing some potential implications of payroll taxes on employment. Nevertheless, as a matter of equity and economics, in the interests of providing countercyclical stabilizers, various administrations have initiated and strengthened the income support programs financed by payroll taxes. As in all legislation, the desirability of the goals to be achieved has been weighed against potential costs.

Cognizant of these factors, this administration has put forth a proposal to strengthen the unemployment insurance system. Secretary of Labor Dunlop has proposed such a program, which would be expanded to cover workers in industries not presently covered—such as agriculture, domestic service workers, and certain State and local government employment—improve benefit adequacy, and modify triggers for the permanent extended benefits program. The proposal also incorporates financing charges. In addition, a national study commission would be established to lay out alternatives and to make recommendations for further improvements in the system. This proposal is currently being marked up by the Unemployment Insurance Subcommittee of the House Ways and Means Committee and should be before the Senate Finance Committee in the near future.

Senator NELSON. Thank you very much.

[The prepared statement of Mr. Weiss in full follows:]

STATEMENT BY ABRAHAM WEISS, ASSISTANT SECRETARY FOR POLICY, EVALUATION AND RESEARCH, U.S. DEPARTMENT OF LABOR

Messrs. Chairmen and members of the committees: It is a pleasure to appear before you today to discuss payroll taxes and employment.

I. INTRODUCTION

When employers pay wages to workers, these wages are subject to a variety of taxes and other charges. Since the overall level of such taxes has been growing rapidly and is projected to grow still further in the near future, it is important to address several questions pertaining to such taxes. What are the various elements of payroll taxes and how are they collected? What are the magnitudes of the yields from the different taxes? What are likely future trends in such taxes? What are the impacts of these taxes, and, particularly, what might be their influence on the employment of different types of labor in different sectors of the economy? Are there any reasonable approaches to reforming these payroll taxes that merit further exploration?

Clearly this is a long list of questions, many of which are very difficult to answer. It is my hope that raising these questions will foster more systematic consideration and analysis of the effects of our current system of payroll taxes.

II. PAYROLL TAXES—THE VARIOUS COMPONENTS AND THEIR RECENT GROWTH

Current trends in payroll taxes are presented in Table 1 which contains information from the Budget of the United States Government for Fiscal Year 1976 and recent years. The items on which I wish to focus attention include various elements in Old Age, Survivors, Disability and Health Insurance (OASDHI), and unemployment insurance (UI) taxes. Whereas, in 1966 these elements comprised $24.5 billion in receipts, they comprised an estimated $86.9 billion in 1976. This means that over this period they have become the second largest source of tax revenue. That further growth is not an implausible forecast can be seen in Table 2, which lists current and scheduled rates of tax in the OASDHI system.

It is clear from Table 2 that the rates are currently scheduled to rise during the next 10 years by close to 8 percent.

TABLE 1.—BUDGET RECEIPTS BY SOURCE, 1966–76

[In millions of dollars]

Source	Actual									Estimate	
	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Individual income taxes	55,446	61,526	68,726	87,249	90,412	86,230	94,737	103,246	118,952	117,700	106,300
Corporation income taxes	30,073	33,971	28,665	36,678	32,829	26,785	26,166	36,153	38,620	38,500	47,700
Social insurance taxes and contributions (trust funds):											
Employment taxes and contributions:											
Old age and survivors insurance	17,556	22,197	22,265	25,484	29,396	31,354	35,132	40,703	47,778	54,779	58,276
Disability insurance	1,530	2,204	2,651	3,469	4,063	4,490	4,775	5,381	6,147	7,196	7,662
Hospital insurance	893	2,645	3,493	4,398	4,755	4,874	5,205	7,603	10,556	11,167	11,975
Railroad retirement	683	776	814	885	919	980	1,008	1,198	1,411	1,546	1,642
Total employment taxes and contributions	20,662	27,823	29,224	34,236	39,133	41,699	46,120	54,876	65,892	74,688	79,555
Unemployment insurance	3,777	3,659	3,346	3,328	3,464	3,674	4,357	6,051	6,837	7,154	7,382
Contributions for other insurance and retirement:											
Supplementary medical insurance		647	698	903	936	1,253	1,340	1,427	1,704	1,868	1,977
Employees' retirement—employee contributions	1,111	1,201	1,334	1,426	1,735	1,916	2,058	2,146	2,302	2,468	2,576
Other retirement contributions	18	19	20	24	29	37	39	41	45	47	50
Total contributions for other insurance and retirement	1,129	1,867	2,052	2,353	2,701	3,205	3,437	3,614	4,051	4,383	4,603
Total social insurance taxes and contributions	25,567	33,349	34,622	39,918	45,298	48,578	53,914	64,542	76,780	86,225	91,550

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Excise taxes:											
Federal funds:											
Alcohol	3,720	3,980	4,198	4,482	4,610	4,696	5,004	5,040	5,248	5,281	5,393
Tobacco	2,066	2,077	2,121	2,136	2,083	2,205	2,205	2,274	2,435	2,303	2,260
Other [1]	3,358	3,221	3,380	3,640	3,600	2,297	2,522	2,522	2,060	5,584	17,513
Total Federal excise taxes	9,145	9,278	9,700	10,585	10,352	10,510	9,506	9,836	9,743	13,168	25,166
Trust funds:											
Highway	3,917	4,441	4,379	4,637	5,354	5,542	5,322	5,665	6,260	5,839	5,972
Airport and airway						563	649	758	840	940	1,007
Total trust excise taxes	3,917	4,411	4,379	4,637	5,354	6,104	5,971	6,424	7,100	6,779	6,979
Total excise taxes	13,062	13,719	14,079	15,222	15,705	16,614	15,477	16,250	16,844	19,947	32,145
Estate and gift taxes	3,066	2,978	3,051	3,491	3,644	3,735	5,436	4,917	5,035	4,800	4,600
Customs duties	1,767	1,901	2,038	2,319	2,430	2,591	3,287	3,188	3,334	3,910	4,300
Miscellaneous receipts:											
Deposit of earnings by Federal Reserve System	1,713	1,805	2,091	2,662	3,266	3,533	3,252	3,495	4,845	5,700	6,100
Other miscellaneous receipts [2]	162	303	400	247	158	325	381	426	524	1,968	4,825
Total miscellaneous receipts	1,875	2,108	2,491	2,908	3,424	3,858	3,633	3,921	5,369	7,668	10,925
Total budget receipts	130,856	149,552	153,671	187,784	193,743	188,392	208,649	232,225	264,932	278,750	297,520
MEMORANDUM											
Federal funds	101,427	111,835	114,726	143,321	143,158	133,785	148,846	161,357	181,219	185,966	199,278
Trust funds	32,997	42,935	44,716	52,009	59,362	66,193	72,959	92,193	104,846	118,681	126,510
Interfund transactions	−3,568	−5,218	−5,771	−7,547	−8,778	−11,586	−13,156	−21,325	−21,133	−25,807	−28,268

[1] Includes proposed excise tax on domestic crude oil and natural gas of $3,000,000,000 in 1975 and $15,200,000,000 in 1976.

[2] Includes both Federal funds and trust funds. Includes import fees on crude oil and petroleum products of $1,380,000,000 in 1975 and $3,847,000,000 in 1976.

Source: "The Budget of the United States Government," 1976, U.S. Government Printing Office, 1975, p. 358–59.

TABLE 2.—OASDHI TAX RATES 1975-85

	Old age and survivors (percent)	Disability	Health	Total by individual	Total (employer matches employee contribution)
1975-77	4.375	0.575	0.9	5.85	11.7
1978-80	4.350	.600	1.1	6.05	12.1
1981-85	4.30	.65	1.35	6.30	12.6

The second most important element in the payroll tax system is unemployment insurance taxes. In FY 1975, unemployment insurance outlays totaled $12.8 billion. For FY 1976, outlays are estimated at $15.7 billion. When these outlays are compared to the receipts (see Table 1) it is clear that the State trust funds must be slowly replenished over future years either with increased tax rates or increased tax base. The Administration has recommended an increase in the tax base for the Federal unemployment tax and the States may well follow suit. The third element in the category of "payroll taxes" which I will mention just briefly is workers' compensation. Although I will not review the recent empirical studies on workers' compensation, I do mention it here since it operates in a fashion comparable to OASDHI and UI (although it is State run and not a tax in the same sense as the other two).

III. THE GENERAL FEATURES OF PAYROLL TAXES

All three elements of payroll taxes mentioned above have similar general features. Of particular significance is that all use the same tax base—namely, wages and salaries. OASDHI applies a constant percentage tax rate up to a taxable maximum; workers' compensation premiums are generally based on a given percentage per $100 of payroll. In the case of OASDHI the current proportional tax is 11.7 percent paid in equal parts by the employer and the employee on the employee's earnings, up to a taxable maximum of $14,100. Each year the taxable maximum or wage base is increased by a formula tied to the Consumer Price Index.

The unemployment insurance system is somewhat more difficult to summarize because the tax rate paid by employers varies across firms since the different States apply experience rating systems which make the rate for any given firm vary as a function of the firm's past record with respect to layoffs and within a zone defined by a minimum and a maximum rate. Suffice it to say that 2 percent might be considered a representative rate for unemployment insurance. The Federal Unemployment Tax Act sets a maximum annual labor earnings subject to Federal tax of $4,200. Many States have adopted the maximum but others have set their own.

The details of workers' compensation are still more difficult to summarize very concisely. The premium payments are made to private insurance carriers, large firms can self-insure, and workers' compensation premium rates may vary for different employee groups within a given firm. Nevertheless, the general structure is fairly comparable to that of OASDHI and UI payments.[1] If we take 1.5 percent as a representative rate of "tax" for workers' compensation then a typical worker might be one whose wage payments are subject to a combined tax rate of about 15 percent. Of course, part of these taxes are paid for by the employer and part are paid for by the employee (equal shares in the OASDHI case); but this still means that over the range when earnings are below all three maximum annual earnings levels, a tax of 15 cents is added to each dollar paid in wages and salaries. This is above and beyond any Federal income taxes which might be paid.

IV. POSSIBLE EFFECTS OF PAYROLL TAXES

Let us turn our attention to OASDHI and UI payroll taxes alone and consider their possible impact on the worker and the employer. The economic analysis of these taxes turns heavily on the conceptual distinction between the tax payment and tax incidence. In the OASDHI case both the worker and firm pay an equal percent of the tax, but the economist is always more concerned with the incidence

[1] See Wayne Vroman, "The Incidence of Compensation Insurance Premium Payments," in "Supplemental Studies for the National Commission on State Workmen's Compensation Laws," Washington, D.C., 1973, pp. 241-270. In recent years there has been a tendency for these compensation premiums to be effectively a constant proportion of wages and salaries as the tax base (ceiling) has risen.

of the tax which is the much more difficult question of who actually bears the tax. Empirical work which would command a consensus on who bears the payroll taxes—workers or firms or consumers—does not exist. However, there are some general implications which flow from the nature of the payroll taxes outlined above and on which most economists would be in agreement.

Since payroll taxes are levied on earnings up to a maximum taxable ceilings level, beyond these ceilings the marginal tax rate is zero. Accordingly, where employees bear the incidence of the tax, we would expect workers to endeavor to reduce the impact of the tax by working longer hours per year, including overtime hours. Working part-time would be a disadvantage since less of the annual earnings (perhaps none) would be beyond the taxable ceiling. Generally, there may be incentives to substitute hours per worker for more workers in any production process. Employers might also have an incentive to hire more highly paid (skilled) workers and perhaps, more subtly, workers might have an incentive to become more skilled in order partially to avoid the marginal tax burden, since the higher their annual earnings are above the taxable earnings ceiling, the less is the proportional payroll tax "bite."

Another likely outcome, reinforced by various tax advantages afforded capital through such provisions as the investment tax credit[2] is that firms will have incentives to substitute capital for labor as well as to substitute skilled labor for less skilled labor.[3] If, as seems likely, such responses occur, the result may be employment difficulties for certain groups of labor and certain industry sectors such as retailing. That is, sectors which utilize entry level, part-time and lower wage workers are likely to be unfavorably impacted by the current system of payroll taxes. The resulting impact on employment, particularly for youths and minorities and associated on-the-job training losses may have undesirable consequences. Growing out of such a less efficient allocation of resources would be a reduction in real GNP.

Payroll taxes also have labor supply implications which one might consider, especially in the context of the existing transfer payment system and effective tax rates. For example, what is the effect of taxes on the "take-home" pay of a low wage worker who receives some benefits from, for example, the Food Stamp program? If he earns an extra dollar from the labor market, his Food Stamp benefits would be reduced by about 30 cents under current Food Stamp rules. Combining this with increased Federal (and State) income taxes of even 5 cents, plus payment by the worker and his employer of relevant payroll taxes implies a marginal benefit reduction (tax) rate across all programs of about 50 percent (30+5+15). If other elements in the income transfer system are added, this 50 percent figure can go higher. Many economists are concerned over these effects insofar as they may create work disincentives.

V. ALTERNATIVES TO THE CURRENT PAYROLL TAX

In light of the rapid growth in payroll taxes, and the possible adverse impacts of such taxes on lower wage workers and the sectors which are most likely to employ them, consideration might be given to a series of steps. First, empirical analysis of the impacts of the rapid growth in payroll taxes should be undertaken. That is, what evidence do we have of the general effects outlined above? Can we quantify these effects? Can we learn from exploratory case studies?

Second, research should be done on the likely future requirements of the OASDHI, UI and other systems in which financing is payroll based. Projected changes in the demographic structure of the U.S. may place the OASDHI system under substantial pressure. This is because when the large cohort of the "baby boom" years moves into retirement ages it will be supported by the relatively small cohort implied by today's dramatically lower birth rates. OASDHI payroll tax rates obviously will be reviewed in this context. Future UI system requirements turn on decisions which will have to be made about the maximum duration of coverage, extensions of eligibility and the like. Decisions on these components of the UI program will probably involve adjustments in the tax rate and/or tax base.

Third, tax reform of various types merits consideration. Employment tax credits and personal wage subsidies merit examination beyond that given them in existing public policy and social science literature. Another area could be the possibil-

[2] To appreciate this possibility it can be noted that in 1976 the "tax expenditure" or estimated Federal revenue foregone by this provision was $8.8 billion. See "Estimates of Federal Tax Expenditures," Committee on Finance, U.S. Government Printing Office, July 8, 1975, p. 9.

[3] Generally, apart from discrimination and cost of living differences, we mean lower wage workers. This substitution will be reduced to the extent that workers bear the payroll tax and if their labor supply is inelastic with respect to wages.

ity of making adjustments in the tax rate or tax base. This could provide the same tax yield but it would spread out the source of the tax by reaching into higher wage groups. We could also do more research on financing these expenditure areas by what some have termed more neutral taxes; that is, taxes which do not create major incentives to use one type of labor or capital over another. Such a "neutral" tax could be more closely approximated by a "value-added" tax or even a general income tax. It should, however, be noted that public finance economists do not necessarily agree on the general desirability of "value-added" taxes.

Yet the problem is not even so simple as this. If one views the various payroll taxes as insurance charges for likely future services or benefits to be rendered (old age, and unemployment income, medical and disability payments, etc.) then one can argue that the current tax system is not as questionable as our previous discussion might suggest. In essence, payroll taxes can be conceived as insurance premiums for specified benefits based on actuarial expectations. Features such as experience rating in unemployment insurance along with greater proportionate payments for workers who are more likely to receive benefits from the system during periods of unemployment introduce price-like elements wherein benefit payment is related to likely use. Currently, OASDHI payments are disproportionately larger for lower wage workers but so are the future claims of lower wage workers disproportionately larger. The policy dilemma appears to be that the current system could discourage employment of low wage and part-time workers, yet simple abandonment of the current system for a system financed purely out of general revenues would reduce the tie between payments and expected benefits in these areas.

We have been discussing some potential implications of payroll taxes on employment. Nevertheless, as a matter of equity and economics, in the interests of providing countercyclical stabilizers, various Administrations have both initiated and strengthened the income support programs financed by payroll taxes. As in all legislation, the desirability of the goals to be achieved has been weighed against potential costs.

Cognizant of these factors, this Administration has put forth a proposal to strengthen the unemployment insurance system. Secretary of Labor Dunlop has proposed such a program, which would be expanded to cover workers in industries not presently covered (such as agriculture, domestic service workers, and State and local government employment), improve benefit adequacy, and modify triggers for the permanent extended benefits program. The proposal also incorporates financing changes. In addition, a national study commission would be established to lay out alternatives and to make recommendations for further improvements in the system. This proposal is currently being marked up by the Unemployment Insurance Subcommittee of the House Ways and Means Committee and should be before the Senate Finance Committee in the near future.

Average taxes paid by individuals[1]		Estimated revenue loss by use of 50 percent job creation credit	Percent distribution of job credit by income level		Estimated loss of revenue 1st yr for 100,000 jobs	Estimated 1st yr repayment in taxes
Income class	Average tax paid		Average salary	Percent of population		
Under $5,000				16.6		
$5,000 to $6,000	$410	$2,750	$2,750	5	$13,750,000	$2,050,000
$6,000 to $7,000	537	3,250	3,250	5.2	16,900,000	2,792,450
$7,000 to $8,000	665	3,750				
$8,000 to $9,000	795	4,250	4,250	16.8	71,400,000	13,288,800
$9,000 to $10,000	912	4,750				
$10,000 to $11,000	1,060	5,250				
$11,000 to $12,000	1,180	5,750				
$12,000 to $13,000	1,322	6,250	6,250	26.1	163,125,000	34,937,460
$13,000 to $14,000	1,480	6,750				
$14,000 to $15,000	1,651	7,250				
$15,000 to $20,000	2,151	7,750	8,250	23.0	189,750,000	72,795,000
$20,000 to $25,000	3,180	8,750				
$25,000 to $30,000	4,342	13,750	16,875	7.3	123,875,000	41,266,900
$30,000 to $50,000	7,065	20,000				
Total					578,860,000	192,205,610
Gain[2]					1,600,000,000	
Gain, deducting job crea- credit					1,021,200,000	

[1] IRS data 1973.

[2] For every 1,000,000 jobs gained, the Government gains $16,000,000,000 in revenue—$2,000,000,000 in unemployment insurance payments and $14,000,000,000 in taxes. (100,000 jobs would increase revenues $1,600,000,000 to the Federal Government.)

Source: Senate and House Budget Committees. Congressional Budget Office, "Inflation and Unemployment: A Report on the Economy," June 30, 1975.

Senator NELSON. Dr. Eisner.

Mr. EISNER. Yes; I was delighted to listen to Mr. Weiss' excellent presentation and summary of a great deal of valuable information. I had a proposal, which is now in the record, a proposal for a job development credit, a tax credit for investment in human capital, which I prepared in response to Senator Javits request when I appeared before the committee in June.

Senator NELSON. That is in the printed record?

Mr. EISNER. That is now in the printed record on pages 121 to 131. I would like to pick a few highlights from that proposal and tie it into Mr. Weiss' remarks and perhaps a few of the closing remarks of the panel earlier this morning.

You hear a great deal of talk about capital shortages. I was, I must say, a bit amused to hear your last witness this morning referring to the Business Week article, which is a rather mammoth piece entitled "The Capital Crisis: A 4.5 Trillion Dollar America." I am amused because the article quotes me, I suppose as one of the dissidents, indicating the view that the capital shortage never exists, and they do suggest that that view should be taken more seriously. I will perhaps not burden you by reading Business Week's quotation of my remarks, but I would like to argue that the whole drive you hear on behalf of expanded investment in physical capital contrasts sharply with the real needs of the economy and the real needs of small business, in particular.

The payroll tax constitutes a direct tax on employment. I don't think we can emphasize sufficiently how greatly it has increased. I am rather surprised economists have not paid more attention to its role as a contributor to inflation. Obviously, most business costs have to get passed on in the long run. Payroll taxes get passed on very clearly in any kind of competitive situation in the short run.

We all know that labor costs are what we call in economics "prime" and "variable costs". If labor costs go up, a businessman has little alternative in a competitive situation but to pass this increase in costs on and particularly when the increase in costs is pervasive throughout the economy.

You have a situation now where there is an 11.7 percent social security tax on payrolls, up to $14,100, per covered employee. Now that tax has increased very markedly, as was pointed out, in the last few number of years.

I might add that while I appreciate the concern of responsible legislators for having some kind of a tie between taxes and benefits, I believe Mr. Weiss will bear me out, as he suggested in his remarks, that the tie is a fairly loose one at the present. The benefits bear only a rough resemblance to the taxes paid. There are all kinds of inequities in this regard: Inequities with women as the secondary earners in the family and inequities in the case of youth. This relates in considerable part to the fact, too often forgotten, that a dollar now is not a dollar 30 or 40 years from now. And to ask a kid of 17 or 18 or 19 to contribute now to a pension he may get if he lives that long, 40 or 50 years from now, is asking him to make a much larger contribution than you ask of a person who has been in the labor force all his life, is 50 or 55 or 60 years of age, and is contributing towards a pension he will be receiving in the near future.

Now, the whole problem of youth, I think, is one that has to be tackled and faced very directly.

We have major unemployment problems and we have particularly major unemployment problems among youth. I happen to be one who argues over and over again—and I am afraid despite our belief in free enterprise, these views I will express are more honored in the breech—I have argued that we should not interfere in the economy blindly. We are too full of all kinds of schemes to help this business or that business or control one business or another. This does not mean that I am against all intervention, but intervention should be on a principled basis when there is really some justification for it, when you can see the economy is not functioning properly, when you can see that there is some reason for the Government to intervene.

The whole case for subsidizing business plant and equipment with equipment tax credits, accelerated depreciation, appealing as it may seem and supported as it has been by legislators of both parties and powerful as the lobbies for it have been, has no real economic justification, unless you happen to believe that the free enterprise system is a myth. If you believe businessmen don't know what is profitable, don't know when they should get new machinery, don't know when they should build a new plant, and the Government has to say "you wouldn't do this by yourself, but you will do it because we give you a 10-percent credit," then you are saying there is something wrong with the whole allocation of capital in our markets and our capital system is not really functioning. I really, in the main, would reject that proposition.

I would say, however, there are market interferences now through the payroll tax which discourage investment in human capital. This investment in human capital is the investment in the training of our youth and getting them to know how to work, which will mean that in 10 or 20 or 50 years, instead of mugging, instead of going into the numbers rackets, instead of picking people's pockets, they will realize they can earn a better living and have a better life by working at a job. This is very important. It is very important to avoid the massive unemployment we have had in youth.

You may ask, if I say this, "Why do I not expect the private enterprise system will take care of it by itself?" Well, here, economic analysis indicates there really is a defect in the system. It is a defect in the system which I would not correct by abolishing the system, but it is a very real defect, which relates to the fact that we are not a slave economy. If we were a slave economy, if you could own human labor the way you could own a piece of equipment or a building, it would pay a private employer to take a slave and say: "I am going to hire you. I will train you. I will teach you the job until eventually you pay off."

However, with our system today, it does not usually pay a private employer to take a kid, who has had no job experience, who is unreliable as far as he knows and has no references, and to give him a job and train him so he becomes a long-term productive member of the society. The reason for that is simply that in a free society, in a free economy, this worker may work for this one employer for 6 months or a year or he may work part time, or he may go somewhere else. The benefits to the individual employer, therefore, is considerably less than the benefit to society.

So I think there is a case for intervention of some kind through subsidized training, through public employment, through a CCC, to do anything you want to try to get the people into that job and get them so that they can work.

Senator HASKELL. What about the British experience, the British Industrial Training Act, whereby each industry is required to train their own employees? I suppose they do it on an industry basis, so that if an employee moves within that industry, they haven't lost anything. I suppose they think there will be a swap between other industries so that they won't really lose anything in the long run.

Mr. EISNER. I must be honest, Senator, I am not familiar with the details of that, so I had better not try to comment on it.

Senator HASKELL. Well, in principle?

Mr. EISNER. In principle?

Senator HASKELL. Is that somewhat the argument that you are making that it isn't worth it? Of course, it wouldn't be worth it for an individual if he is isolated, but if everybody had to do it, would it?

Mr. EISNER. Well, there are various proposals that could come to grips with this problem and that might be one of them. I just have some general concern that so many of the regulations in the British economy seem to have interfered more than they helped.

The proposal, therefore, that I am making here, and which is in the record now, is a relatively modest one. I hardly argue that it will meet the entire problem of teenage unemployment or of people who don't go into the labor force, but it would, at least, correct a situation in which Government is aggravating the problem with these payroll taxes. That proposal was that the payroll taxes, the whole 11.7 percent, be taken over out of General Treasury funds for those under 22 years of age up to, let us say, a maximum of $14,100 for a lifetime, which is the current maximum subject to payroll taxes in a single year.

Senator NELSON. I didn't understand that. You say the payroll tax would be taken over by the General Treasury for people——

Mr. EISNER. Under 22.

Senator NELSON. And?

Mr. EISNER. And the particular suggestion I made, the particular thought—although obviously there are other thoughts that could work, too—would be that this subsidy, this payment out of the General Treasury revenue would be limited for each employee to, at this point, $14,100. The notion of limiting it is——

Senator NELSON. You mean a total of $14,100 that would be paid from the General Treasury?

Mr. EISNER. No, I am sorry. I perhaps misspoke. I meant the taxes on the $14,100. So that; for example, if a youth has a job for $6,000 a year, either part time or full time, and he earns $6,000 one year and he earns $6,000 the next year and he earns $6,000 the third year, then in the third year, after he has earned $2,100 he will no longer be an eligible employee.

Senator NELSON. Once he has earned a total of $14,100?

Mr. EISNER. That is right.

Senator NELSON. Then the employer picks it up?

Mr. EISNER. Then the employer would pick up his share and the employee would again have money taken out for his share.

Senator NELSON. Why wouldn't that be an incentive to the employer to get rid of the guy when he reaches the ceiling and start again with another?

Mr. EISNER. I think it would probably not be an incentive to get rid of him, because by that time the employee would have had sufficient experience that he should certainly be worth the 11.7 difference. And you needn't have that cutoff. I was looking for ways to get the maximum impact with a minimum loss.

Senator NELSON. What if it is a job that requires no training—just an ordinary job on an assembly line, a no-skill labor job—then wouldn't there be an inducement to get rid of him?

Mr. EISNER. I am sorry?

Senator NELSON. There would be some inducement to get rid of him, if the job was a no-skilled job.

Mr. EISNER. Well, conceivably, but my view is there is a great cost in getting information on people and you don't get rid of an employee if he is working successfully.

Senator NELSON. You think that if he is a good employee, they would want to keep him?

Mr. EISNER. I would think he would stay and again he would have the experience and references.

Senator NELSON. Well, it is an interesting idea.

Mr. STAFFORD. One comment. There may be some more incentive in the case where the job is what is called "general human capital" and not specific. So, if it was an entry level job, and not a specific job, then you might have more of these turnover problems. It is just a comment, a reflection.

Senator NELSON. I don't know whether it is good or bad, but there are all kinds of businesses like, let's say, the summer resort business. There they hire a whole lot of young people for the summer and then when they move out, they hire a whole lot of young people for the next summer. You also have some resorts where you find retirees, who are very good employees, and they only want a part-time job. So they work 4 months and that gives them something to do and they have some extra income——

Senator BROCK. I think you are missing one point, though, and that is in my bill, and that is that it requires the job to be held for a full year. The reason for that is that even with a low-skilled job, there is a cost to the employer beyond——

Senator NELSON. Oh, I didn't realize it was 1 year.

Senator BROCK. Yes; because most employers will tell you it takes about 6 months, even with a low-skilled job, to get the person up to where he is earning what he is being paid, even at the minimum wage. So, the employer has a lot more invested than the 11.7 percent.

Mr. EISNER. I can see the argument for the year requirement. I would also suggest, Senator Brock, it might have some drawbacks in terms of it discouraging the hiring of people as summer, part-time workers. That may well be important.

Senator BROCK. I understand that.

Mr. EISNER. There are difficulties in perfectly targeting anything.

Senator BROCK. You might reduce the rate of incentive for a shorter time, that is, you might have half the benefits of that if they were employed for 4 months or more. But, I think the Senator's

point is absolutely valid, that unless you have some sort of minimum time requirement, you are going to get into this real problem. I know some manufacturers, unfortunately, who would take advantage of this.

Mr. EISNER. I would like to add that some proposal of this type need not be restricted to youth. It might be extended to all new entrants into the labor force, regardless of age. I think, though, that there is some advantage to concentrating on youth where you have a payoff from job experience over a whole lifetime. But the point that should be stressed is that this is really particularly advantageous to small business, which tends to be labor intensive. I don't mean to be critical, necessarily, of people who have been on the earlier panel or others that I hear speak on these subjects, but I am always amazed to the extent to which small businesses will become sort of lobbyists for interests which are essentially interests of much larger businesses. I have in mind particularly the stress upon looking for tax advantages for acquisition of physical capital, because we all know it is the largest businesses, and for good reason, that are most capital intensive and that get the greatest benefit from equipment credits and accelerated depreciation.

Now, surely, the smaller businesses get some benefit, but considering the fact that taxes have to be paid by somebody, it seems to me very reasonable to think that kind of incentive costs the small business in the long run more than it gives, because the benefits to the big business, which is capital intensive, are greater.

On the other hand, if you want to help small businesses because you feel that a competitive economy requires it, a way to help it would be to have benefits which are more tailored to their needs. Benefits along the lines of reducing payroll taxes, and particularly for the young labor force, which small businesses frequently find themselves hiring, would be of proportionately greater value to them.

I have, of course, a good bit in the statement on the record, but I think in view of the time, I'd better let others proceed. You may question me further, if you will.

Senator NELSON. Thank you. We may have a little bit more later on this subject.

Go ahead, Mr. Stewart.

Mr. STEWART. Mr. Chairman, it is always a pleasure to be here. Our association has made a proposal, which we call the job creation tax credit. It was before the Senate Finance Committee last March, and was made as part of a discussion of a series of tax measures, which we thought small businesses needed at the moment.

We were, frankly, very surprised by the response. Editorials appeared all over the country. We heard from many of our members and from nonmembers and from small businesses and small business people in general, who liked the principle we enunciated. That principle went something like this. We said that the Federal Government should provide a tax credit for up to two newly created jobs in any company for the first year of employment, with a maximum of 50 percent of the cost of wages of the one or two new jobs.

Next, to pick up on some things Dr. Eisner said. We began to think along these lines because of the very tilt and distortion that the investment credit and other indirect measures, alleged to produce

employment, create in the economy. We have gone from a point 30 years ago where we undertook a commitment to full employment. We have argued three alternative ways of doing it through five recessions now. Some people still believe you can leave it all to the free market. We do not. Some people think that what you ought to do to create employment is to expand the Government payroll. We do not. Some people think that indirect tax measures, which, in our view, almost invariably wind up distorting the economy further in the direction of big business, will help. Again, we dissent from that.

So, we came to our proposal, really, on the basis of both trial and error and thought about alternatives, of a nonexpert kind. Let me emphasize that.

It turned out that what we were talking about was viewed by economists as a "wage credit." We found ourselves involved in discussions of many matters which we do not consider pertinent to the problem before the Congress, which is how to put people back to work at minimum costs, with minimum inflation and with minimum distortion in the economy.

Now, in that regard, I am going to offer, for the record, a letter to the New York Times of April 1, 1975, from a man named Edwin Furey. It begins:

> Let me tell you what it is like for one guy to be 52 years old and jobless in America, in 1975. As a recently fired middle-management executive of the division of one of America's top private companies, I have sent out over 150 résumés.

It is a rather moving letter. I have tried, since I became president of my association, tried to maintain some perspective about objectives. We come to the Congress often, and we come here for lots of kinds of tax relief for small business. I have tried, since this letter appeared, to read it every day to maintain my perspective. So far as I am concerned, I am as concerned about young people and people in the ghetto as anyone. But in or out of the ghetto, there are 8 million unemployed people out there, and I don't think this is a tolerable country so long as that continues without remedial action being taken by the Congress.

Let me just make five quick points:

First, job creating tax legislation should be the highest priority measure for the Congress;

Second, what evidence we have—and I am going to give you some—persuades us that the proposal which we have made will work, will work quickly and will work relatively inexpensively;

Third, we urge you to make a start with any measure, whether ours or someone else's, that seems to you to be prudent in terms of costs;

Fourth, whatever you do, we suggest that you accompany it with very specific budgetary provisions and mandate controlled experiments about how it works, just to meet the kinds of considerations that I have had expressed to me about the proposal that we have made; considerations made which may be important to economists, but I must tell you are not important to the unemployed or small businessman;

Fifth, we would much prefer to see this experiment conducted with general revenue income rather than employment taxes. Employment taxes are a severe problem for small business.

The Congress and the President must, sooner or later, face up to the fact that employment taxes are among the most regressive taxes in the country. They burden small business unduly. I have served as special counsel to the Governor of a State, I know how merit rebate formulas work in unemployment insurance and I am sure the Chairman does, too. By and large, unemployment insurance taxes are heavily tilted against small business. At some point we have to face all of those issues. I submit respectfully, that to try to deal with employment incentives within a framework of dealing with inequities or improprieties or difficulties of employment taxation, is to mix oranges and apples. It makes your legislative road unduly difficult.

Let's decide how much it is worth for us to provide small business with an incentive, a tax incentive that will work. I say that, not because small business wants this as a handout. It wants it because it is surrounded by unemployed people. It wants to do more for them.

I came to visit Senator Brock one day with a young man who is the leader of an outfit called Sons of Bosses. His family was in the candy business. He explained to us that he would be happy to hire another man, that he had actually been looking for a skilled worker or someone who could be trained. But he had to wait until his payroll or sales level permitted it. He said, as you may remember, Senator, that he was about 30 percent to the point where he could hire this man. Every good small businessman runs his business one man short. That is how he knows he is being prudent.

All our proposal is intended to do is to take him over the bridge with a Federal "tax forebearance" investment of a temporary kind in 50 percent of the wage cost. We wanted it to be as simple and self-executing as possible. We did not want it to become involved in either tax theory or economic theory; hopeless as that is in this town.

We had many kinds of responses—all of them favorable. One of my favorites is from a former Cabinet officer:

> I confess to you my unfamiliarity with this proposal. The newspaper clips explained this, at least, in part. S. 2007, which is now introduced by Senator Thurmond and Senator Garn, is apparently hot stuff in Decatur, Campbell, Biloxi, Yoursville, and Waco, but hasn't had much attention in elite land (he means Washington). I also admit my inability to see the bugs in this idea. I still can't. There are obvious possibilities of abuse of the credit, but it would seem to me this could be fairly easily met. Why has this been given so little attention? I will try it out on some of my favorate skeptics and let you know.

This is from a man who ran a Cabinet department deeply concerned with this problem. As material to us as this kind of response are answer to approximately 10,000 inquiries to small businessmen around the country, and we have the first 1,200 back, and we think they are even more important. Three out of four of them urge you to adopt our proposal. Of those, 65 percent (or 50 percent) of all of them say unequivocally that they will hire one or two people if the Congress and the President can agree to give them this contribution to initial wage costs.

We have computed the job creation consequences of this on the most conservative basis we can. We hope the President and Congress will get out of the conventional ruts of analysis and quit belaboring one another with both vetos and overriding or not overriding votes. We hope they will try to come together on a new approach. We think

the one we made will create, and quickly, 1,250,000 more jobs, with a minimum of cost and a minimum of inflationary impact. If you put a man on the Government payroll, that is an added hole in the deficit of 100 percent. We are proposing at least to cut it to 50 percent.

But, let small business take that 50 percent as a credit.

Senator BROCK. May I interrupt you? The thing I like about it is if it doesn't create 1,250,000 jobs, it doesn't cost us.

Mr. STEWART. No cost.

Senator BROCK. It only costs if it works and then again the cost is returned to us, so we get the money back. That is the beauty of it. And that is greatly different from any of our Federal direct grant programs, where it doesn't matter whether we get any results or not. Excuse me.

Mr. STEWART. No; it was my pleasure, Senator.

Let me try to conclude in this way. There is no doubt in my mind this country wants job creating action. It wants it now and it wants it without inflation, if possible. We do not claim to have all the answers, or even a foolproof partial answer, but it is at least as good as any other answer we have seen. Swift action by Congress and the President for even a limited experiment is urgently needed. There are 50 ways we can limit the applicability of the credit. You can set up controlled experiments to satisfy the economists to see whether the small business would hire anybody without this or not. You can match two sets of six cities one way and six cities another. I am reminded that in 1970, the Administration had promised to conduct some experimentation along these lines, which somehow or another got scratched, leaving the field again free for all of us to speculate about.

As far as we are concerned, the situation is too serious to wait for perfectionist economists or other theoreticians to be satisfied. We think you can find out just by talking to your own small business constituents, as we have, that these jobs will not be created without this credit.

But, we can't prove it unless the Federal Government tries it.

We think this program will lead to more permanent and satisfying jobs than straight public employment.

But we can't prove it, unless the Federal Government tries it. We think this program will create jobs at less cost and with less inflation than any other, for small business would be paying half the cost of each new job, and small business is less able and less likely to pass on any increased cost then either big government or big business.

But we can't prove it unless the Federal Government tries it.

We believe there will be no more cheating with this program than there is with tax payments generally.

But, we cannot prove it unless the Federal Government tries it.

We believe this program can be run without significant new personnel, or another blizzard of Federal paper.

But, we cannot prove it unless the Federal Government tries it.

We believe that this program can become a useful, flexible response to unemployment of a kind we badly need.

But we cannot prove it unless the Federal Government tries it.

We will support any version of the general point of view we are expressing here. We invite you to check our judgments, however, with your own small business constituents.

I have one last point about employment taxes. We have looked into the experience of the Government with the WIN program, which offered a 20-percent credit. It did not work and it did not work for a variety of reasons. One of the reasons we are satisfied is, because the incentive was simply not there. If you offer a small businessman a 15-percent credit and explain to him what you are going to have to take off your employment tax and what you are going to have to take off your Federal income tax, he is going to think it is going to cost him at least 15 percent more to get this thing done. It is too complicated. It gets him involved in social security and unemployment taxes.

In and of itself, the 15 percent, in my opinion, is not high enough. And I am as scrupulous about the Federal Government as the guy who spent 3 years in the Bureau of the Budget in this town can be. I don't like to see you expend this kind of money. We have our own estimates of what the Federal recoupment will be, and we think it will be substantial and rapid. But the judgment about that is not for us to make; it is for the Congressional Budget Office and OMB, and all those people. The judgment for us to make, based upon what we know about small business and what it is prepared to do, is to tell you that if you provide enough of an incentive, it will do a significant job for you.

When I appeared before the Senate Finance Committee on this subject, I offered this caution, which is an old rural phrase: "Don't try to trade a biscuit for a barrel of flour." That is what you are doing when you come to the small businessman and offer him a 15-percent credit, and ask him to take on a new employee he is going to have to train.

Thank you very much.

Senator NELSON. Thank you. Did you do any analysis?[1] You said about 1,250,000 was your estimate of people who could be hired in the program. That is probably about a cost of $5 billion a year?

Mr. STEWART. Yes, sir.

Senator NELSON. And then you calculate benefits from sums that would otherwise have been paid out and in taxes paid by those newly employed, and what do you come up with?

Mr. STEWART. Let me read you what my colleagues, Messrs. Liebenson and Longenway, have given me, for they are much smarter about this than I am.

The removal of 1.25 million individuals from the unemployment rolls would relieve the Federal Government from paying benefits for unemployment compensation, food stamps, and medicaid amounting to over $4 billion a year.

Senator NELSON. That would be assuming that all you removed were, in fact, receiving this, but you would have all kinds of variables, like high school graduates at 18 and——

Mr. STEWART. Exactly. In addition, the Treasury would receive $17.5 in income, social security, and unemployment compensation taxes.

Senator NELSON. How could they do that, if the cost of the program to the Federal Government is $5 billion and the cost of the employer-employee is $5 billion, then how do you get 17?

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[1] Requested material not available at time of going to press.

Mr. STEWART. I don't think that is intended to be a net figure. Let me go through with this, Senator, and then we will come back to it, because we will try to satisfy your questions.

The potential gain to the Treasury is just over $21 billion, and must be measured against the possible loss of revenue of only $5 billion, the cost of the job credit legislation. What I think we are saying is if you take the Congressional Budget Office's estimate about the cost to the Federal revenue of unemployment, and if you put 1.25 million people to work, as I recall it, their estimate is 1.6 billion for every 100,000 jobs. I think that is their figure. We will submit this table for the record. Senator Thurmond put it in the Congressional Record when he introduced the bill.

If you deduct the cost of $5 billion from the revenue, which is not lost by not having 1.25 million people unemployed, we end up with a net saving of $17.5 billion. The problem is it will come back to you in about 2 or 3 years. So, you will have a $5 billion deficit out-of-pocket. None of us appreciates the prospect of that. At the same time, in an almost $400 billion Federal budget, in terms of a priority of where you give up and where you don't give up, it seemed to us this $5 billion is imminently worth risking.

Senator NELSON. Supposing it was decided to authorize the executive branch to administer such a program on a pilot program basis in *x* number of places. Would you get any real feedback from other competing small business making the same product and competing in the same market with one of them in one city 10 miles away and another in another. What if the pilot was in Minneapolis?

Mr. STEWART. You surely would, Mr. Chairman, if you did it that way. On the other hand, you might do it by taking five cities, which had unusually high unemployment, matched with an unusually high incidence of concentrated industry, and you would deal with it that way, on the theory that they needed the diversification support, as well as the unemployment support more than in other cities. You could match them with five cities and take samples of businessmen from both places and find out how many hires took place with this credit in sample group city A and without it in sample group city B. I am sure these Government gentlemen can design controlled experiments better than I can. It has been 25 years since I tried.

But, it can be done, and it can be done on an objective basis that will not upset small business people or be discriminatory. Let me say for the record I would much prefer to see you do it nationally and do your research within the framework of a nationwide program.

But, if the Congress doesn't feel like going that far, by all means let's have a controlled experiment as quickly as possible.

Senator NELSON. Do you want to pursue that question?

Senator BROCK. Yes. We had, as you know, a long conversation. I was much impressed with the argument and I thoroughly agree with it and am a champion of it, particularly since it doesn't cost us anything if it doesn't work. I am a great believer in pilot-testing and, in fact, in most of the legislation I have introduced, I have included it, but in this instance I am not in favor of it, because I think you have an absolutely urgent problem with 9 million people out of work.

I think we are not using the free enterprise system today to solve the problem and I think that is where the strength of our economy is. We are using the Government and the Government cannot solve unemployment.

So, I am with you. My problem is, frankly, a political one. I just didn't believe, and still do question, whether or not we can get a 50-percent tax credit. I think taking Professor Eisner's suggestion, and I think Mr. Weiss indicated at least an interesting concept, too, of calculating the exact tax it is, based on a small business, as the result of unemployment, will give us a double advantage.

No. 1, and it may not be enough of a credit and I grant you that, but this bill of mine does eliminate the tax on employment that comes through social security, medicare, unemployment compensation, and the rest. And that is not out of line, frankly, with the investment tax credit that we give corporate enterprise on a larger basis. So again, there is a certain amount of equity here. I am not sure what percentage is going to be necessary to do the job. However, I do think that 15 percent would be a hell of a start.

I have one disagreement with you, and that is the limit of two. My bill would allow you to go up to seven. I would question if you had it unlimited, because then GM has the investment tax credit, the employment tax credit, and a few more small businesses, therefore, are going to go out of business, because they can't compete.

But, I limited it to seven new employees, and I think that is a little more logical just because seven new employees hardly constitutes any benefit to a major corporation, but it makes a whale of a difference to that little guy that is trying to compete.

Mr. Eisner. I have a fact or two, both in relation to what I have suggested, as well as what Mr. Stewart has suggested. If it did not seem politically dangerous because of the rather popular prejudice that there must be some contribution into a fund of social security, I think one could relieve small businesses generally of a good bit of paperwork by not going through the whole operation of a Treasury appropriation of the amount equal to payroll taxes. Just tell every employer he simply doesn't have to file, he doesn't have to turn anything in, and he doesn't have to withhold anything, for whatever employees are eligible.

Senator Brock. The problem is that, even though the small businessman is being already killed with paperwork, but he is already doing it for the social security report for his existing employees, so to add new ones incrementally is not a terrible burden.

Mr. Eisner. Well, it may well be, but I was thinking more in terms of the proposal for the credit for those under 22. If you could tell the employer, just hire someone under 22 and you don't have to start withholding for him for payroll and the like, I think that would help. The one thing I don't quite follow, and I profess I don't have the text before me on Mr. Stewart's proposal, is the matter of how you can avoid having employers pick employees from elsewhere; that is, what will discourage an employee from quitting a job in one place and then getting a job from another employer who will be happy to add him, even perhaps at a considerably higher wage, recognizing that 50 percent will be subsidized. I confess I don't know the details of the proposal. I presume it is possible to work something out to take care of that.

I would suggest, if you come down to legislation drafting, you have to be very careful you don't kid yourself and you don't encourage the employer, in effect, to hire somebody who has been encouraged to quit somewhere else.

Senator BROCK. I might say, again in my bill we had a minimum unemployed period. If you are unemployed for a week, you would not qualify. I required either 90 days or 30 days.

Mr. EISNER. I would question even whether 90 days would work. There is a good bit of a problem on that. Again, we shouldn't be sectarian.

Senator BROCK. I think we can deal with that. I think the point is well taken. This is to create new jobs, and it certainly is not to encourage people to pirate employees from each other. I think that may be one of the dangers to going to 50 percent; 15 percent doesn't give you that much of a motivation, but 50 percent might.

But, again, the thing I think we've got to keep in mind is the cost effectiveness of this kind of an approach. Now, I don't know that I understood Mr. Stewart's statement about $17 billion in new revenue to the Government——

Mr. STEWART. I am not under oath.

Senator BROCK. Pardon?

Mr. STEWART. I don't think I am under oath.

Senator BROCK. Well, I think I can prove that 1 million new workers would add $17 billion to the gross national product. I think I can certainly demonstrate that, but I can't prove we can get $17 billion, unless we get a 100-percent tax, to the Federal Government. I can prove, I think, that this bill of mine will be, within 12 months, returning $3 for every $1 we invest in it. I think I can demonstrate that, at the 15-percent level.

Senator NELSON. At 15 percent?

Senator BROCK. Yes, it is a tax credit of up to 15 percent on the workers' pay. Because if you add unemployment compensation, medicare, and so on, it comes to 14.9 percent. So, that is the figure in my bill.

But, I think I can document that, that is what we are going to have.

And a good percentage of these people are not drawing unemployment compensation, and are not drawing welfare, and I recognize that. But, Dr. Eisner, I would not limit this to just the teenage group. My bill applies 14.9 percent to new entrants and that would mean a woman of maybe 35 years of age who had maybe never worked. She could get this, too.

If the person had a skill, then I would reduce the level just to the 11.7 percent that social security requires.

But, in either case, I think you can fairly quickly demonstrate that within 12 months, and certainly no more than 18, the Federal Government would have a net increase in its revenues as the result of this tax expenditure that we have discussed.

Mr. EISNER. I do think, Senator, there is a lot of merit in your bill in extending it beyond youth. I focused on youth as perhaps the most important.

Senator BROCK. That is certainly a big problem.

Mr. EISNER. But, women, and particularly those who have been out of the labor force, they would benefit considerably and the economy would benefit from encouraging people to employ them.

Mr. STEWART. Senator, if I may just conclude with what I want to say about your bill? There is nothing magical about our 50-percent figure or about our $20,000 maximum figure. They may be too high.

Senator BROCK. I want to say I would vote for your bill, if it came up. Don't worry about it.

Mr. STEWART. We got to those numbers, really, based on the WIN experience with 20 percent, which seemed, clearly, not to be enough. Now, it may be enough in the general labor population and perhaps it was not there that was particularly troublesome——

Senator BROCK. The Department of Labor killed the WIN program with its own regulations. You and I both know that.

Mr. STEWART. I will not disagree.

Senator BROCK. I think it was so damn close to deliberate that I am not sure why they did it.

Mr. STEWART. On that point, Senator, what we are talking about will work with the simple use of W-2 forms. I don't know of any businessman who is going to play games with the IRS over the kind of money that is involved here and run the risk of criminal penalty.

As a last point, let me just suggest that if the percentages seem too high, one kind of controlled experiment to run would be to take three samples; take cities where you have 9 percent or more unemployed and take cities where you have 6 percent unemployed, and then take cities where you are under 5 percent. Try the 50 percent in one group of cities, and the 15 percent in the other and nothing in the third. Establish an eligibility standard. Then put your survey people to work comparing the conduct of small businessmen and see whether they hire people anyway, or cheat or do all the other things that worry you so much, because I don't think they will, frankly. They are too busy trying to make a living.

Senator NELSON. Well, thank you very much. Gentlemen, this testimony has been a very valuable contribution to our record today. We appreciate your taking all this time to come.

The hearings will be open tomorrow in the same room at the same time.

[Whereupon, at 12:30 p.m., the committees recessed, to reconvene at 9:30 a.m. Thursday, September 25, 1975.]

[The prepared statement of Dr. Rinfret in full follows:]

62-209 O - 76 - 28

RINFRET

Economic and Financial Intelligence

Statement by

DR. PIERRE A. RINFRET, PRESIDENT

RINFRET-BOSTON ASSOCIATES, INC.,

NEW YORK, NEW YORK

Before the

UNITED STATES SENATE SELECT COMMITTEE ON SMALL BUSINESS

September 24, 1975

Employment and economic growth are primary concerns of the U.S. economy today. But the startling and too-little known fact is that small businesses and individual entrepreneurs are the largest source of jobs in our economy.

- Nearly half -- 48 percent -- of all businesses in the United States had between one and three employees in 1972, the year of most recently available U.S. Census data.
- A staggering 99 percent of all businesses in the U.S. consisted of firms with less than 250 employees.
- These small businesses employed fully 64 percent of the private work force.

But by every economic measurement, the entrepreneurial sector is in a state of material decline.

As one indication, in 1945, at the beginning of the postwar era, individual proprietors' income accounted for about 17 percent of U.S. national income. Since then, individual proprietor income has been collapsing relative to the total. In 1974 it accounted for only 9 percent of national income. Thus, during the past 30 years individual proprietors have lost almost 50 percent of their relative share of national income.

During the 1973–75 recession, small incorporated manufacturers suffered even greater and relatively more severe losses than large corporations did. According to the *Quarterly Financial Report* of the Federal Trade Commission, the following occurred during the first three months of 1975:

- Manufacturing corporations with assets of less than $1 million suffered a 48.9 percent decline in after-tax income, compared with the same period in 1974.
- By contrast, manufacturers with assets of $1 billion or more suffered a 28.5 percent loss for the period.

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(Continued on Page 2)

This poor profit performance means that small businesses will have great difficulty in adding to the stock of their productive capital. This means they will have great difficulty in sustaining, let alone expanding, the level of their economic activities and employment.

Obviously, capital formation is the single most critical problem facing small as well as larger businesses in this country today.

This Committee can help stimulate U.S. economic activity and employment by recommending changes in the tax law to reduce the tax burden on small business, whether it is operated by an individual entrepreneur, partnership or corporate entity.

I therefore recommend that this Committee consider the following measures:

- A 7 percent tax credit to small businesses for hiring new employees.
- A 20 percent investment tax credit for new plant and equipment expenditures by businesses with less than 250 employees. This is double the present investment tax credit rate.
- A permanent reduction in the tax rate imposed on the first $25,000 of income earned by small corporations.
- Permit small businesses to retain accumulated earnings on a tax-free basis so they can build the capital reserves needed to grow and to survive adverse economic conditions. At present, any business that accumulates after-tax earnings of more than $100,000 is subject to further taxation on these accumulated earnings, subject to the applicable Internal Revenue Code adjustments.

SMALL BUSINESS TAX REFORM

THURSDAY, SEPTEMBER 25, 1975

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
AND THE SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The committees met, pursuant to notice, at 9:45 a.m., in room 2221, Dirksen Senate Office Building, Senators Gaylord Nelson (chairman of the Select Committee on Small Business), and Lloyd Bentsen (chairman of the Subcommittee on Financial Markets of the Committee on Finance) presiding.

Present: Senators Nelson, Bentsen, Mondale, Packwood, and Hansen.

Also present: William B. Cherkasky, staff director, Senate Small Business Committee; Herbert L. Spira, tax counsel to the Senate Small Business Committee; Judah C. Sommer, minority counsel, Senate Small Business Committee; David Allen, office of Senator Bentsen; Phillip Kawior, office of Senator Brock; and George Pritts, minority staff, Senate Finance Committee.

Senator PACKWOOD. We will call the meeting to order.

Senator Mondale, I apologize for the late start. I know you have to run to another committee, but I appreciate your taking the time to come here initially. We will start with you.

Senator MONDALE. Thank you, Mr. Chairman. Jared How, a friend of mine and one of the business leaders of our State of Minnesota will be testifying on the next panel. I wanted to introduce him at this time, although he will be testifying in the next panel. Mr. How is the publisher of the Mankato Free Press, one of our outstanding daily newspapers, and was a witness at an earlier hearing before the Senate Committee on Small Business in Minneapolis where we heard from farmers, accountants, attorneys, and businessmen concerning the plight of the present estate tax law. His testimony was so impressive that the staff felt he ought to be part of this panel, today, as we hear from leaders from around the country as to what changes should be made.

And I wanted to introduce Jared because I think his testimony has a special dimension. Because he raises the question of the independence of communications outlets, and the connection between those outlets and the local community. His is a locally owned business, and it is one which performs responsibly for the citizens who are known by its owners. The profits and the leadership remain in the local community. He will testify as to the impact of the present laws; how they relate to the trend toward increasing numbers of remote

corporations buying up such newspapers. On the basis of his testimony and that of others, I have introduced legislation this week, S. 2394, the Estate Tax Relief for Farmers and Small Business Act, which is now before the Senate Finance Committee.

No. 1, my bill raises the exemption from $60,000 to $150,000. That is not enough, but if you look at the financial implications of even a higher rise, it is hard to know how we can expect to get a higher exemption in this kind of tight budget situation. Second, it changes the standard for the long-term payout, the 10-year payout, from undue hardship simply to hardship. And I would hope we could establish a record that this would include hardship attendant upon a family or heirs trying to keep a business or farm in the family; in other words, to spread the years over which an estate tax can be paid. It also returns the interest rate imposed upon that long-term payoff back to 4 percent where it was a year ago. Today it is 9 percent. This high rate may cause forced sales, and I think that is one thing devoutly to be avoided.

The bill also would value farm estates for farm purposes.

We have a great many farms that are nestled up to growing suburban communities and urban communities around the country. If you value those estates for other purposes—like real estate development, shopping centers, housing and the rest—they would carry a per acre value far in excess of anything they could bring for farming purposes. Yet it ought to be one of the objectives of our country to keep land in agriculture and to permit family farmers to pass those farms on to their heirs. And this is becoming an increasing problem. Incidentally, I think this is a good conservation measure because it would keep more of this land from being wastefully gouged up in what is called urban sprawl.

In any event, no person in Minnesota has, I think, provided more leadership in this issue than Jared How and I want to introduce him and also express my appreciation for his leadership.

Senator PACKWOOD. My first receptionist was from Mankato when I started here in 1969, a girl from Mankato, and she was the most delightful receptionist we have had ever since.

Senator NELSON. She moved over there from Wisconsin.

Senator MONDALE. Well, people wondered why you performed so spectacularly when you first got down here.

Senator PACKWOOD. I hope I haven't gone downhill since. Does your bill also then increase on the marital deduction, increase that to $300,000?

Senator MONDALE. No, and one of the questions we should consider—and I think one of the most hopeful things about these hearings is that it includes Finance as well as Small Business and three of us, of course, are members of the Finance Committee—one of the questions we should look at is how you deal with the marital share problem. Of course, all of it has to be looked at in terms of the budget. If you raise the exemption to $180,000, which is what I want to do, I think it is something like $3 billion or $3.5 billion. And with a deficit of $65 or $70 billion, whatever it is, it is not likely you are going to get that kind of progress in this session. So I tried to put something in that I thought we might manage.

Senator PACKWOOD. I may want to join you with that bill as a cosponsor on it if you don't mind.

Senator MONDALE. Yes, I will send a copy over because I think it is a useful measure. Thank you very much.

Senator PACKWOOD. Thank you.

Senator NELSON. Our first scheduled witness this morning is Bruce G. Fielding, secretary, board of directors of the National Federation of Independent Business, and member, Commission on Federal Paperwork, accompanied by David Voight.

If you would identify yourself for the reporter, we would have the record kept straight.

[The prepared statements of Senators Nelson and Bentsen, in full, follow:]

STATEMENT OF HON. GAYLORD NELSON, A U.S. SENATOR FROM THE STATE OF WISCONSIN

This morning's session concludes the current three days of hearings on small business tax reform and constitutes the 6th day of the Select Committee's hearings on this subject in cooperation with the Financial Markets Subcommittee of the Senate Finance Committee.

In these hearings, as well as the three days held in February in connection with the emergency Tax Reduction Act of 1975, and a day of testimony in Minnesota in August on estate taxes, we have become even more aware of the diversity of size and type of enterprises among the small- and medium-sized business communities. This is the variety that imparts dynamism, creativity and competition to the economy. It constitutes a great force for prosperity, if it can function under a wise government policy in taxation and other areas.

The efforts of the small business witnesses and their organizations researching and presenting their case have been extensive and considerable. It has been pleasant and rewarding to work with Senator Bentsen and his Subcommittee in this endeavor.

We are hopeful that the Treasury Department will give us its views at a later date, and we may receive further testimony on the questions in other hearings which are being planned by the Small Business Committee this year.

Our committees are working together to try to assemble the facts and figures and to develop findings and recommendations for responsible tax reform measures which will provide meaningful assistance to the broad spectrum of the small- and medium-sized independent business segments of our nation. We have already begun to develop and introduce legislation on particular facets of the tax system and are working toward the development of a comprehensive omnibus small business bill during this 94th Congress.

STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM THE STATE OF TEXAS

Today we will begin the third of a three day set of hearings by the Senate Financial Markets Subcommittee which I chair and the Senate Small Business Committee which is chaired by Senator Nelson. The subject of these hearings is the financial problems which presently confront our small businesses.

During the past two days representatives of business as well as tax and economic experts have testified on capital formation and the relationship of taxes to employment. Today we will hear testimony regarding estate and inheritance taxes.

Our small businesses need help. And it is well worth our while to remember that, as we help them, we will be helping our entire economic situation.

Small business has played an indispensible role in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. Small business, in many ways, is the essence of our country's promise. It is the small businessman who provides jobs for about one-half of our private work force. The survival of small business across our Nation is vital to healthy competition in our economy.

Our Nation's small businessmen have been facing a particularly difficult time during these periods of recession, inflation and energy shortages. Their costs have gone up. Demand for their products and services has generally declined. As a consequence, many smaller firms are faced with a serious profit squeeze.

The statistics show that from 1948 to 1972 the number of self-employed businessmen in this country has shrunk from 10.7 million to 7.1 million, even though the work force has grown from 60 million to 86 million. In 1960 small and medium sized manufacturing corporations held 50 percent of this country's manufacturing assets and 41 percent of the profits. But by 1972 this had declined to 30 percent of the assets and only 28 percent of the profits.

Part of the reason for the decline in the number of small businesses is the substantial competitive tax advantage enjoyed by the large corporations.

In 1974 a Congressional study of 143 corporations found an average tax rate of 23.6 percent compared to a tax payment level for all corporations of about 33.4 percent.

During these hearings we are taking a close look at possible tax reforms and how we can best help small businessmen use our tax system to their benefit. As things stand now, our tax laws and incentives are so complex that often only large corporations with specially trained lawyers can take advantage of them.

Observations from the testimony here will enable us to develop sound proposals that will be responsive to the plight of our small businesses.

STATEMENT OF BRUCE G. FIELDING, CPA, SECRETARY, BOARD OF DIRECTORS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, AND MEMBER, COMMISSION ON FEDERAL PAPERWORK, ACCOMPANIED BY DAVID VOIGHT, LEGISLATIVE REPRESENTATIVE

Mr. VOIGHT. Thank you. I am David Voight, legislative representative for the National Federation of Independent Business which is the largest small business membership organization in this country. Mr. Mike McKevitt, our Washington counsel, had hoped to be here today to introduce Mr. Fielding, but was unavoidably detained and asked me to fill in.

We would like to thank the Senate Select Committee on Small Business and the Subcommittee on Financial Markets of the Senate Finance Committee very much for holding these hearings. Very clearly, if the subjects of tax reform and pension reform are not the No. 1 problems affecting small business today, they are certainly among the most pressing. We are very grateful for the opportunity to present our views and testimony today. Mr. Bruce Fielding is a highly qualified small businessman. He is secretary of NFIB and a member of the board of directors of NFIB. In addition, he is president of his own highly regarded CPA firm and a member of the Internal Revenue Service Small Business Advisory Committee. As you mentioned, he is also a member on the Commission on Federal Paperwork.

Mr. FIELDING. Thank you. Before I start my official testimony, I would like to congratulate Senator Nelson on recently being elected San Jose State's No. 1 graduate of all time. My son is an alumnus there and I wish to congratulate you. Maybe you weren't aware that you were elected to that.

Senator NELSON. Be sure to get that in the record.

Mr. FIELDING. The National Federation of Independent Business' proposals are along the lines of proposals which we hope will motivate millions of small businessmen to take advantage of tax proposals in order to increase their productivity and encourage them to increase

employment. These motivations we have put in three categories: Incentives, equalization, and simplification.

Our incentives are designed specifically for small business. Primarily in the past these incentives have been designed for large business, but these are specifically for small business.

However, I want to refer to equalization first. Unincorporated businesses should have the same tax privileges as incorporated businesses. I think as a prime example of that I would just like to show you, Senators, a volume of paperwork. This is what it took to incorporate a physician. This amount of paperwork amounted to $2,000 in legal fees. The only reason he incorporated was to take advantage of the more liberal pension benefits allowed a corporation and denied to a small businesssman. That is what we mean by equalization.

Next simplification. The present reporting requirements in many of our tax laws and particularly in the area of retirement plans are unrealistic in the costs they impose upon the small businessman. The result is a negative incentive. We are finding that many small businessmen are dropping their retirement plans just because of the complication and the costly reporting requirements.

As part of my testimony I would like to present in detail the National Federation of Independent Business' tax and pension reform proposals for 1975. They are attached to the testimony which you have before you.

I would now like briefly to go through some of the high points of these proposals rather than going into great detail. Our first proposal, which we think is very innovative, is to allow the taxpayer an optional tax basis of reporting income. We would propose that all individuals or corporations, whose inventories are less than $200,000, have the privilege of reporting this taxable income on a cash basis and thereby avoiding the taxation of paper profits.

We would like also to propose a graduated investment credit starting at 20 percent of the first $5,000 tangible personal property purchased scaled down to 10 percent on everything over $10,000. We presently have a 10-percent credit as an incentive to purchase capital goods. I have talked to many of my clients and the 3-percent increase is not a stimulant. Seven percent the previous year and 3 percent this year is not a stimulant. We feel a graduated credit starting at 20 percent of the first $5,000 is where we find most of our small business people. They purchase items in the $5,000 category. This would be a very strong stimulant.

I talked to one of our clients, who is a very large distributor of forklifts and they distribute a volume of approximately $4 million a year, and I said: "Dick, what is wrong with your sales this year? Aren't you using the investment credit as a tool?" And he said, "We tried, but the 3 percent doesn't motivate people to buy." This I think is a significant point. That is why we are talking about 20 percent.

I also asked him what other problems have they encountered and why the investment credit is not working. And he said one of their largest buyers, who buys over a half a million dollars of forklifts from them in a given year, has purchased absolutely nothing this year. This buyer is the largest supermarket chain in the country. They said that they bought all their goods in 1974 because they thought the investment credit was going out in 1975. This kicking

the investment credit around gets very confusing in planning for the small businessman and even for the large businessman.

We also propose a graduated first-year depreciation with a 100-percent writeoff of the first $5,000 worth of goods purchased, scaled down to 20-percent writeoff on the purchases between $10,000 and $15,000 of tangible personal property.

We also propose a graduated corporate tax rate beginning at 10 percent of the first $10,000 of tangible income scaled up to 50 percent of all taxable income over $500,000.

We also have another very innovative proposal, which is a tax on unincorporated business income at corporate rates on 70 percent of the income of an unincorporated business. This is where we are getting into the area of equalization. We are saying let's treat them all alike.

Retirement plans for unincorporated businesses should be governed by the same laws and regulations as incorporated businesses. Again, we would like them to be treated alike. Small businesses are not different whether incorporated or unincorporated. They have the same problems. They should have the same rules.

We also feel that payroll tax deposit requirements are very unrealistic and impose undue penalties on small businesses and we have proposed the easing of these requirements for deposits. We also believe that the small business should be exempt from the more costly reporting requirements that are imposed upon them under the new Retirement Act of 1974.

We also propose, under the area of simplification, that the Government sponsor retirement prototype plans of reporting packages to small businesses to encourage them to come up with their plans, which is a plan that they can adopt realistically without a great deal of cost.

If I may give you an example of what might happen under our proposals for a graduated investment credit and a 100 percent writeoff of equipment after the first $5,000 worth of equipment is purchased. Take an individual who buys a vehicle which costs $5,000—and this is in the area where most of our people are purchasing—the graduated investment credit and the 100 percent writeoff under our proposal would save him $2,800 in taxes which would be over half the cost of the vehicle. Now if that isn't a stimulant, I don't know what else we could do to stimulate people. It is a tremendous saving for small business. It doesn't hurt large business, but it is a real stimulation there for the small businessman.

Our next proposal that we would like to make is not in our detailed program that we have outlined, but it is a proposal that we think is long overdue. We think we ought to do something more drastic or more realistic as an incentive to hire people. Why not an investment credit for people? We have investment credits for equipment. Why not investment credit for people? At the present time the estimate is that unemployment benefits for this year will be $20 billion. What we have now is a rather incongruous situation. We have developed an investment credit for equipment. This encourages large businesses to buy automated equipment. The present 10 percent investment credit has quite an impact upon their tax saving. So they buy automated equipment. We are encouraging them to buy automated equipment which then puts people out of jobs. On one hand we are

encouraging them to buy equipment and on the other the result is people are being put out of jobs. The only way I think we can overcome this situation is an investment credit in people.

We propose that it should be a graduated investment credit starting at 35 percent of the total wages paid a new employee, an added employee, scaled down to 20 percent for all employees added to the staff for that year. And it is not a difficult thing to determine. It doesn't take a lot of reports and it doesn't take a lot of complicated law. The information is already on the quarterly 941's that the employer files. The investment credit in people could be applied against the payroll taxes set forth on the quarterly returns without any additional paperwork. All we need is one more line on that report.

I think that what I might say, because I am on the paperwork commission and I think in terms of reports in anything that we try to develop, that I have proposed in the paperwork commission that we recommend to Congress that the future drafts of all bills must also contain drafts of all reporting requirements. I think Senator Bentsen tried something along that line before.

Senator BENTSEN. Senator Nelson and I introduced something like that yesterday.

Mr. FIELDING. This is a must. I think it would discourage a tremendous number of bills. I don't think they would ever get passed if people had to see the amount of paperwork that they created. When we come up with a proposal, as we are presenting here today, the very first thing we do is start with a report. We don't start with the law and how we think the law is going to be changed. We develop the report and from that report then we develop the law. That is the way we should approach these. That is why I say that our thoughts on investment credit on people lead us to conclude this would be very simple. We'd need just one more line on that 941. That is all we need because the numbers and dollars are on that. We don't need any more.

Senator BENTSEN. On your investment credit on people, I just introduced a piece of legislation on investment tax credit on people. My proposal is that they be given credit for the additional people they hire beyond their base period of 1973 and 1974.

Mr. FIELDING. Yes.

Senator BENTSEN. So you don't get some kind of a ripoff there. In that kind of situation the maximum would be 10 percent up to $8,000 a year. My feeling is that that would add all the way from 200,000 to 1 million more people on the payrolls. A provision is in there that they have to be hiring people that have been unemployed for some minimum period of time. That would be much cheaper than public service jobs, which costs us about $8,000 a year now.

Mr. FIELDING. No question about that.

Senator BENTSEN. And it would be the least disrupting to the economic process because those people we would hope, what with the economy recovering or if it did, they would be kept on and they would not be going into a public service job and then being pulled out to try to get them back into private enterprise.

Mr. FIELDING. If I may make one comment on this 10 percent, the reason we said 35 and then scaled down to 20 percent is that it costs you 10 percent in payroll taxes alone to hire a new employee.

Senator BENTSEN. Yes; but you are going to be hiring some. And what you are doing is trying to add some additional incentive to do it.

Mr. FIELDING. What can happen though is that rather than encouraging them to hire more employees, because it does cost them 10 percent, then it would encourage them to pay overtime.

Senator BENTSEN. Well you have that tradeoff anyway.

Mr. FIELDING. Well that is our reason for a higher percentage.

Senator BENTSEN. I'm trying to moderate that tradeoff and put another incentive in there that will overweigh that kind of tradeoff.

Mr. FIELDING. Yes.

Senator BENTSEN. But I don't argue with that point.

Mr. FIELDING. No; I'm just trying to give you the reason for our figures.

Senator BENTSEN. What yours does is cost more. It is just a question of the cost involved.

Mr. FIELDING. Of course we should effect a tremendous saving in unemployment benefits.

Senator BENTSEN. Absolutely. In fact I would guess on mine you would probably save as much as you would find it costing you because every 1-percent increase in unemployment adds $2 billion to $3 billion in unemployment compensation in this country.

Mr. FIELDING. Yes; plus the sociological effects of more employment, which has tremendous ramifications.

Senator BENTSEN. Well I am delighted to have someone who has such judgment and perception and articulation appear before us this morning.

Mr. FIELDING. Thank you. The next area that we would like to discuss is the need for pension reform. The present law, which was enacted in 1975 and is known as the Employment Retirement Income Security Act of 1974, was designed to protect the employees of big business. It did not take into consideration the effect it was going to have on the small businessman and the employees of the small businessman. I'm a practicing public accountant and we prepared a study of 10 clients for whom we prepared all of these reports last year that were required under the old act. Our cost ranged from $64 for participating employee to a high of $747 per participating employee with an average of $300 per participating employee under the old law. We are not an expensive firm and we are not a large firm, but under the old law $300 per employee was the average cost we incurred. This is based on an actual study of our costs. We have attached that to our testimony.

Senator NELSON. I didn't get it clear in my mind. What was the cost under the old law prior to the new?

Mr. FIELDING. It ranged from $64 per participating employee to $747 per participating employee.

Senator NELSON. Under the old law?

Mr. FIELDING. Yes; with an average of $300.

Senator BENTSEN. You are referring to the pension reporting forms?

Mr. FIELDING. Various forms are required like the 4848, the 4849, the 990B, the accounting to each individual employee, and the accounting to the employer.

Senator PACKWOOD. When you say "number of participants" that means the number of people in the plan?

Mr. FIELDING. Right.

Senator PACKWOOD. So your $747 one was for just one participant?

Mr. FIELDING. Just one participant. Of course, the more participants you have in the plan, the cost goes down. The average small businessman has 13 employees. So we are talking about a very costly plan that averages about $300 per participant.

Senator NELSON. What is the cost under the new?

Mr. FIELDING. Well we estimate the cost under the new plan will be a minimum of $143 per participating employee to a high of $1,400.

Senator PACKWOOD. Is that an annual cost?

Mr. FIELDING. That is an annual cost. And half the plans we assume will be at least $700 per participant. According to the figures we have, that is equal to 5 percent of the net assets of the plan. This is what has happened to us. These are actual figures. Of course, it is great business for an accounting firm, but you are not doing anything productive for your clients.

Senator BENTSEN. Do you think this is the Retirement Act of 1974 for actuaries and accountants and lawyers?

Mr. FIELDING. That is exactly what it is.

Senator BENTSEN. I don't agree with you that some of us weren't really concerned about the very thing you propose because many of us were. We kept trying to say what we were trying to draw was not an ideal plan, but some minimum standards so small companies wouldn't be dissolving their plans and going out of the pension field. Senator Nelson and I again have introduced legislation mandating the departments to simplify the returns and the reporting procedures for companies that have 100 or less participants in a pension plan.

Mr. FIELDING. Well that is excellent.

Senator BENTSEN. We are very deeply concerned over what you are saying. We were concerned then. In the report and in the legislation we talk about simplifying it, but we don't mandate it. But this legislation Senator Nelson and I introduced does mandate the simplification.

Mr. FIELDING. I hope the guidelines and suggestions presented in our detailed statement that accompanies my testimony will be helpful in that matter because we have specific suggestions that could go a long way.

Let me, if I may, divert just a moment and just tell you about our Gulliver's travels in trying to get recognition of our ideas. To simplify this, we submitted our ideas to the general counsel of the Pension Guarantee Corp. and got no response. We submitted our proposals to the assistant commissioner of the Internal Revenue Service who had been newly appointed to handle retirement plans, and got no response. We submitted these proposals to Congressman Vanik, who is chairman of the Oversight Committee, and we got a thank you. We submitted these proposals to a meeting at the White House last month with the Deputy Assistant Secretary of the Treasury, and his comment was these are very interesting. So here we are today and we know you are going to hear us.

Senator NELSON. Even under any plan, $300 is too much money to be putting into the personnel management of the plan.

Mr. FIELDING. Yes, Senator, it is.

Senator NELSON. I haven't looked at this submission you have on

pension reform proposals, but if you could have your ideal and maintain proper supervision and integrity of the plan and so forth, and you could draft it yourself, how far down do you suppose you could reduce the costs of administering the plan?

Mr. FIELDING. I think one of our suggestions is that the Internal Revenue Service sponsor or promote, if you use that term, or encourage the use of prototype plans and reporting packages so that we don't have all of this expense of setting up plans. This is where a lot of expense comes in, in just the formation of the plan, and that is not even taken into consideration in the $300. We propose reporting packages that could be sponsored by the IRS and could cut down tremendously on the costs of reporting. Consolidated annual reports would be another step in that direction. Now we have to make a report to IRS and we have to make a report to the Department of Labor and each report is required at a different date. They all contain basically the same information so we are suggesting consolidating the reports. We are also suggesting exemption from certified annual reports; that is, a certified annual report requiring the certification of an actuary every 3 years and also an annual certification of a certified public accountant. We don't even want to audit these plans because our necks are way out. We have to certify that there have been no prohibited transactions, which means we have to look at every transaction. It is costly. We don't want to be involved and we don't feel that it is realistic for the small business person to have to meet these requirements. That is where your tremendous costs come from.

Senator BENTSEN. Let's go on the other side though. What about the safeguards you have to have where you would have problems of prohibitive transactions. How would you have knowledge of that? What is your protection?

Mr. FIELDING. Well, of course, in our incentive area we are suggesting the loosening, I might say, the softening of the prohibited transactions rules. They are too restrictive as they are now set forth.

Senator BENTSEN. Do you have specifics on that?

Mr. FIELDING. Yes.

Senator BENTSEN. How about the fiduciary role and the responsibility there and the liabilities involved? Do you feel that—you see, I have a concern that you are going to see this kind of situation developed. You are going to see those liabilities so stringent that you are going to see the administration, where they keep the plans, passed to some of the very largest financial institutions in this country and you are going to see an overconcentration of the administration in just the very large financial institutions. Does that concern you or does it not?

Mr. FIELDING. Yes that concerns us. We also have another recommendation in the area of equalization under the Keogh Plan and that is that the individual be allowed to act as their own trustee. We feel by doing that, you reduce the administrative costs and you reduce this concentration and you get a much more effective control and management of the plan. I don't think we should enter into any drafting of tax laws where we assume the individual is not going to be an honest individual. As we have seen, most of our clients are forthright, honest,

and are trying their best to comply with these complicated rules and these complicated reports don't make them any more honest.

Senator NELSON. Go ahead, please.

Mr. FIELDING. One further area I would like to cover is to discuss just briefly the following. At the last meeting in June, the National Federation of Independent Business offered our services to help the committee conduct a survey among the members of the small business community in determining if they can derive some very current raw data. Working in cooperation with Herb Spira, we have developed a survey which is presently going to be released to various members and which we think is going to provide a very sound basis for determining the needs of small business for tax reform. This survey is going to go to wholesalers, manufacturers, retailers, the construction industry, the service industry, to members of the National Federation of Independent Business, and members of the Regional Small Business Organizations. We are all going to be working together on this. I think these results are going to be very significant and very revealing to your committee and will be very helpful in determining some of the directions we are going to be going in the future. We do hope to have these results back to you by the end of November.

I would just like to say in summary that it is a privilege to be here again. I hope that our testimony has helped in the formation of the concept that small business must be motivated and must have tax relief and reform that is designed specifically with the small or independent businessman in mind because his needs are not quite the same as large business needs. We all know that we have to do something. I just hope that the results of our hearings in February and the results of our hearings in June and the results of our hearings today—and I know they come out in a nice booklet form—but I hope they just don't end up on the library shelf. Thank you.

[The prepared statement of Mr. Fielding in full follows:]

STATEMENT OF BRUCE G. FIELDING
DIRECTOR & SECRETARY-NATIONAL FEDERATION
OF INDEPENDENT BUSINESS
PARTNER BRUCE G. FIELDING & CO.
CERTIFIED PUBLIC ACCOUNTANTS
1043 STIERLIN RD.
MOUNTAIN VIEW, CA.
MEMBER OF COMMISSION ON FEDERAL PAPERWORK
MEMBER OF I.R.S. SMALL BUSINESS ADVISORY COMMITTEE

Before: Select Committee on Small Business and the Subcommittee on Financial Markets, Committee on Finance United States Senate.

Date: September 25, 1975

The National Federation of Independent Business has developed on behalf of its more than 428,000 members Tax and Pension Reform Proposals which would motivate the millions of small businesses to increase their productivity and to increase employment. These reforms can be categorized as follows:

1. Incentives
2. Equalization
3. Simplification

Small business needs incentives which are designed specifically to motivate small business, not incentives which have been designed primarily with big business in mind.

Unincorporated businesses should have tax advantages which are similar to those now available to incorporated businesses.

Lastly, there is a continuing need for the simplification of our tax structure. The present reporting requirements which plague the small business person are a depressant and can result in "negative" motiviation. For example, this negative motivation is causing many small businesses to terminate their employee retirement plans.

I would like to present to the Committee, the National Federation of Independent Business's "Tax and Pension Reform Proposals for 1975".

The most significant of our proposals in the area of tax reform are as follows:

1. Optional cash basis of accounting for the taxable income of all small business whose inventories are less than $200,000.
2. Graduated investment credit ranging from 20% credit on the first $5,000 of capital goods purchased in a year to a 10% credit on purchases over $10,000.

3. Graduated first year depreciation ranging from 100% write-off on the first $5,000 of capital goods purchased in a year to a 20% write-off on purchases between $10,000 and $15,000.

4. Graduated corporate tax rates ranging from 10% to 50% on income of $500,000 or more.

5. Deferred tax credit for unincorporated businesses which would allow them to be taxed at corporate rates on 70% of their net business income.

6. Payroll tax deposit requirements would be eased for all small businesses.

7. Establish a permanent committee on tax and pension simplification for small business.

An example of how our proposals might motivate a small business person would be the purchase of a vehicle for $5,000. This could result in a tax-savings of approximately $2,800 for an individual in the 39% tax bracket. This saving is over one-half of the cost of the vehicle and would provide a real incentive for the small-business person to acquire more capital goods.

In addition to the proposals which we have presented to you in detail, we would like to suggest that consideration should be given to a tax-incentive which would motivate the small business person to hire more employees. Why not an investment credit for people?

We would like to propose a graduated tax credit based on an increase of employees over a base period, ranging from 35% of the wages of one new employee to 20% of the wages of all new employees. There would also be recapture penalties if the work force decreases.

Our Pension Reform Proposals, which we have submitted in detail, emphasize the need for immediate relief of small business from the unrealistic compliance requirements. The Employees Retirement Income Security Act of 1974, better known a "ERISA", is a prime example of a law that is geared to protect employees of big business. This very costly protection process is having a negative incentive on small business.

Our accounting firm recently prepared a study on the actual cost to small business of retirement plan compliance. This study was based on our charges last year for filing the various reports required under the old law and our estimate of costs under ERISA. I would like to present this report for the record.

Our costs last year ranged from $64 to $747 per participating employee. We estimate that under ERISA, the costs will range from $143 to $1,427 per participant with more than half of the plans spending over $700. This cost is 5% of the average net asset value of our clients trust funds.

While the National Federation of Independent Business's "Tax and Pension Reform Proposals" are specifically designed for small business, they will also be beneficial to big business, with the possible exception of "Graduated Corporate Tax Rates". However, the emphasis is "Incentives, Equalization, and Simplification" for the millions of small businesses.

At your committee hearing in June, 1975, we offered the survey facilities of the National Federation of Independent Business to assist your Committee in getting current raw tax data from small business. Presently, the available tax data is three to four years old. Working in cooperation with Mr. Herb Spira, we have developed a questionnaire which will provide your Committee with the most up-to-date information available. This data should provide a statistically sound basis for determining the needs of small business for tax reform. The survey will be circularized among manufacturers, wholesalers, construction industry, service industry, retailers, and members of the National Federation of Independent Business and regional small business organizations. Our goal is to have the results of this survey available for your Committee in November.

Your Committee is to be congratulated for allowing us to pursue this media for gathering current tax data. This is the first time that a survey such as this one, has ever been undertaken.

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COST OF ADMINISTERING PENSION PLANS OF TEN SMALL CORPORATIONS

We recently completed a study of the costs incurred by ten small corporate clients of ours on administering their pension plans during the past year and, also, our estimate of the costs they will incur during the next year under ERISA. (See attached schedule.)

The administrative costs incurred by these plans during the past year was already high in relation to the earnings on the net assets of the plans an the taxable income of the employers. However, the costs under ERISA will be substantially greater:

1. Many plans will be spending all of their earnings on administrative expenses and some plans will have costs substantially in excess of plan earnings.

2. More than half of the ~~plans will~~ be spending over $700 per participant on administrative costs and some plans will be spending twice this amount.

3. Administrative costs will be equal to more than 3% of the taxable income of most employers and up to 11% for some employers.

These costs are a very heavy burden on small independent businesses and will probably cause many to terminate their existing plans or postpone indefinitely the creation of new plans.

COST OF ADMINISTERING PENSION PLANS
OF TEN SMALL CORPORATIONS

PLAN #	NUMBER OF PARTICIPANTS (1)	NET ASSETS PLAN (2)	EMPLOYER'S TAXABLE INCOME (3)	ANNUAL COST BEFORE ERISA				ESTIMATED ANNUAL COST AFTER ERISA			
				TOTAL COST (4)	COST AS % OF NET ASSETS (5)	COST PER PARTICIPANT (6)	COST AS % OF COLUMN 3 (7)	TOTAL COST (8)	COST AS % OF NET ASSETS (9)	COST PER PARTICIPANT (10)	COST AS % OF COLUMN 3 (11)
1	30	$208,397	$ 43,021	$1,912	0.9%	$ 64	4.4%	$4,302	2.1%	$ 143	10.0%
2	20	288,902	140,890	3,069	1.1	153	2.2	4,055	1.4	203	2.9
3	19	278,557	116,058	2,679	1.0	141	2.3	3,938	1.4	207	3.4
4	4	139,110	105,885	1,473	1.1	368	1.4	2,266	1.6	567	2.1
5	2	98,270	17,701	782	0.8	391	4.4	1,931	2.0	966	10.9
6	2	59,431	50,234	559	0.9	280	1.1	1,737	2.9	869	3.5
7	2	25,498	35,839	723	2.8	362	2.0	1,506	5.9	753	4.2
8	2	24,062	31,181	334	1.4	167	1.0	1,495	6.2	748	4.8
9	1	23,591	20,272	747	3.2	747	3.7	1,427	6.0	1,427	7.0
10	1	8,400	11,251	455	5.4	455	4.0	1,313	15.6	1,313	11.7

Note: Costs include actual trustee fees where a bank is trustee or estimated trustee fees of 1/2% of net assets (minimum $250) where an officer of the employer acts as trustee.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
1975 TAX REFORM PROPOSALS

INTRODUCTION

Many of the 400,000 members of the National Federation of Independent Business and the millions of other small independent businesses could be motivated to increase their productivity by re-structuring tax incentives, equalizing the treatment of unincorporated businesses with incorporated businesses, and simplifying reporting requirements.

This report was prepared by the National Federation of Independent Business with the objective of indicating the areas of tax reform which would be most beneficial to small independent businesses.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

1975 TAX REFORM PROPOSALS

INCENTIVES: Pages 1-7

I. Optional Cash Basis of Accounting.
II. Graduated Investment Credit.
III. Graduated First Year Depreciation.
IV. Graduated Corporate Income Tax Rates.
V. Estate Taxes.
VI. Retirement Income Credit
VII. Investment Income Exclusion.
VIII. Indexing the Tax Structure.

EQUALIZATION: Pages 8-11

I. Deferred Tax Credit for Unincorporated Businesses.
II. Net Operating Loss Carry-overs.
III. Maximum Individual Tax Rates.
IV. Organization Expenses of Partnerships.

SIMPLIFICATION: Pages 12-14

I. Payroll Tax Deposits.
II. Sub-Chapter S Corporation.
III. Effective Dates.
IV. Committee on Tax Simplification for Small Business.

INCENTIVES

I. Optional Cash Basis

A. Present Structure

If inventories are an income determining factor, a business must determine its taxable income on the "accrual" basis. Accounts receivable are included in income, accounts payable are treated as expenses, and the increase in inventory during the year is excluded from cost of sales.

B. Proposed Structure

1. Grant every business with an ending inventory of less than $200,000, the option to determine its taxable income on a "cash" basis. Accounts receivable would not be included in income, accounts payable would not be treated as expenses, and the increase in inventory would be included in the Cost of Sales.
2. For a presently existing business using the accrual basis, the conversion would produce a loss, which would be amortized in equal amounts over a 10 year period.
3. The maximum ending inventory of $200,000 would be indexed to the cost-of-living.
4. A taxpayer would lose this "cash" option when its ending inventory exceeded the maximum for two consecutive taxable years.
5. If a taxpayer voluntarily converts or is required to convert to an "accrual" basis, any income created by the conversion would be amortized over a ten-year period. If there exists any unamortized loss, from a previous conversion to a cash basis, the taxpayer would continue its amortization of such loss.
6. Any taxpayer, who takes this "cash" option, and later converts to an accrual basis, would not be permitted to reconvert to the "cash" basis until its inventory was less than the maximum for two consecutive years.

C. Supporting Arguments

There are two basic ingredients which are necessary for the success of all small businesses. They are good management and sufficient working capital. A small business cannot survive without both of these. The government can enhance the working capital of small business by not taxing its "paper profits". By allowing businesses with inventories of less than $200,000 to be taxed on a "cash" basis, an average of $3 billion dollars per year will be retained. This will enable small businesses to enjoy a more stable growth pattern until they reach the point where they will be able to obtain their necessary working capital in the stock market.

D. Estimated Revenue Loss First Year (Assuming all eligible taxpayers convert)

1. Excluding Accounts Receivable from Income	$102.2 billion
2. Including Ending Inventory in Cost of Sales	61.2 billion
3. Excluding Accounts Payable from Expense	(61.3) billion
4. Net Decline in Taxable Income-First Year	$102.1 billion
5. Amortization (1/10th)	$10.21 billion
6. Estimated Loss (30% X $10.21 billion)	$3.06 billion

II. Graduated Investment Tax Credit

A. Present Structure

1. A percentage of the cost of acquisition of capital business goods and manufacturing facilities is allowed as a credit against the purchasers tax liability:

Property with a useful life of:	
(1) less than 3 years	0.0%
(2) 3 years but less than 5 years	3 1/3%
(3) 5 years but less than 7 years	6 2/3%
(4) 7 years and over	10%

2. This credit applies to all entities whether it is a sole proprietor, partnership, sub-chapter S corporation, or a regular corporation.
3. The credit is limited with respect to the purchase of used equipment to the first $100,000 of used equipment purchased in a year.
4. The credit, in a given year, cannot exceed the taxpayer's total income tax liability for that year. Any excess may be carried back and/or forward to other taxable years.
5. If the taxpayer disposes of the item for which there has been an allowable tax credit before the end of its useful life, the government recaptures all or a portion of that investment credit.

B. Proposed Structure

1. Percentage of the cost:
   (a) Property with a useful life of less than 3 years, the credit would be 0.0%.
   (b) Property with a useful life of at least 3 years:
      (1) 20% of the cost ranging from $0 to $4,999
      (2) 15% of the cost ranging from $5,000 to $9,999
      (3) (i) 10% of the cost ranging in excess of $9,999 if the property has a useful life of 7 years or more.
      (3) (ii) 6 2/3% of the cost in excess of $9,999 if the property has a useful life of less than 7 years but 5 years or more.
      (3) (iii) 3 1/3% of the cost in excess of $9,999 if the property has a useful life of less than 5 years but at least 3 years.
2. There would be no limitation with respect to used equipment.
3. If the credit exceeded the taxpayer's income tax liability, the difference would be refunded.
4. If the taxpayer disposes of the property before it has been held for the expected useful life, the government would recapture all or part of the previously allowed credit the same as it is under the present law.

C. Supporting Arguments

1. Graduated rates with emphasis on purchases under $5,000 would help small businesses overcome the problem of raising working capital and accelerate their decision to purchase autos and other capital goods.
2. Allowing a full credit on all equipment purchases totalling less than $10,000, and having a useful life of at least three years, will encourage the more current replacement of equipment. Accordingly, if equipment is to be replaced over a shorter life-span, then there should not be a limitation on the investment credit applicable to used equipment. Trade-ins are a vital element of the capital goods industry and used property is purchased more often by small businesses than large corporations.

D. Estimated Revenue Loss

1. Based on a 1974 NFIB survey which developed a financial profile of its members and assuming that there are approximately 10,000,000 tax-paying businesses in the United States, the following revenue loss statistics can be developed:
   (a) 56% made no purchases in 1973=5.6 million businesses-no revenue loss.
   (b) 25% purchased less than $10,000=2.5 million businesses-estimated revenue loss $667 per business=1.7 billion dollars.
   (c) 19% purchased more than $10,000, revenue loss $750 per business=1.4 billion dollars.
   (d) Total estimated revenue loss 3.1 billion dollars.

III. Graduated First Year Depreciation

A. Present Structure

1. An additional amount of depreciation is allowed in the year of purchase on all depreciable property having a useful life of at least six years. The additional depreciation is limited to 20% of the cost of the first $10,000 of property purchased during the year. This limitation applied to all business entities. However, individuals filing a joint return are allowed a $20,000 limitation. The remaining cost of the assets are reduced by the additional first year depreciation before calculating the normal depreciation for the year.

B. Proposed Structure

1. Additional first year depreciation of:
   (a) 100% of the cost of first $5,000 of depreciable property
   (b) 25% of the cost of second $5,000 of depreciable property, and
   (c) 20% of the third $5,000 of depreciable property. (In the case of a joint return the 20% would apply to the next $10,000 instead of $5,000.)
2. No requirement that the depreciable assets have useful lives of at least six years.
3. No adjustment to depreciable basis of assets for the additional first year depreciation for purposes of computing annual depreciation.

C. Supporting Arguments

1. An increase in the first year depreciation allowance would help small businesses to overcome the problem of raising working capital and accelerate their decision to purchase capital goods.

D. Estimated Revenue Loss

1. Based on the assumption that 4.4 million business taxpayers will each purchase depreciable property in excess of $5,000, the estimated revenue loss is 4.5 billion dollars.
2. However, there will be a gain in revenue in subsequent years because of the decreased annual depreciation attributable to the basis of the asset having been reduced by the 100% first year depreciation. The average annual gain would be approximately 750 million dollars.

IV. Graduated Corporate Income Tax Rates

A. Present Structure

20% of the first $25,000 of taxable income, 22% on the next $25,000, and 48% on all income in excess of $50,000.

B. Proposed Structure

1.

Taxable Income	Rate
$0 to $9,999	10%
10,000 to 19,999	$1,000 + 15% of excess over $10,000
20,000 to 29,999	$2,500 + 20% of excess over $20,000
30,000 to 39,999	$4,500 + 25% of excess over $30,000
40,000 to 49,999	$7,000 + 30% of excess over $40,000
50,000 to 59,999	$10,000 + 35% of excess over $50,000
60,000 to 69,999	$13,500 + 40% of excess over $60,000
70,000 to 499,999	$17,500 + 45% of excess over $70,000
500,000 and over	$211,000 + 50% of excess over $500,000

2. Proposed rates would apply for 1976 and subsequent years.

C. Supporting Arguments

1. The income which a small corporation retains (income less taxes on income) is vital to its continued existence. Increasing this retained income through realistic tax relief will enable these corporations to have sufficient working capital to remain in business and acquire more capital goods to insure a healthly existence. Based on the 1970 income statistics, the comparative schedule disclosed the fact that 600,000 (82%) of the corporations paying income taxes that year had taxable income of less than $30,000. In todays economy the present two-tiered tax structure is inequitable when it is applied to the small corporation.
2. A graduated corporate income tax would bring corporate taxation more into accordance with the principle of the ability to pay, which has long been in effect for individual income taxes.

D. Estimated Revenue Loss

1. Based on 1970 corporate income statistics, there would be no revenue loss. (See attached comparative schedule.)

V. Estate Taxes

A. Present Structure

1. An exemption of $60,000 is deductible from the gross estate in determining the taxable estate.
2. Estate tax rates are as follows:

Taxable Estate	Tax Rate
$0- 5,000	3%
5,000- 10,000	7
10,000- 20,000	11
20,000- 30,000	14
30,000- 40,000	18
40,000- 50,000	22
50,000- 60,000	25
60,000- 100,000	28
100,000- 250,000	30
250,000- 500,000	32
500,000- 750,000	35
750,000-1,000,000	37

B. Proposed Structure

1. The $60,000 estate tax exemption should be increased to $180,000.
2. Estate tax rates should be as follows:

Taxable Estate	Tax Rate
$0- 50,000	5%
50,000- 100,000	10
100,000- 150,000	15
150,000- 200,000	20
200,000- 400,000	25
400,000- 600,000	30
600,000-1,000,000	35

C. Supporting Arguments

1. Many small independent businesses now have to be sold, liquidated, or merged to pay the substantial amounts of estate tax due on the death of the owner.
2. Inflation since 1954, when the present estate tax exemption and tax rates were established, has pushed small estates into much higher tax brackets. The present estate tax rates rise rapidly from zero to 28% for estates up to $100,000 and then more slowly to 37% for estates up to $1,000,000. The proposed rates would reduce this heavy burden on smaller estates.
3. The present estate taxes discourage personal motivation and productivity of the owner of the small independent business.

VI. Retirement Income Credit

A. Present Structure

1. The retirement income credit allows a tax credit on up to $1,524 of an individual's retirement income at a rate of 15%. The maximum credit is $228. A husband and wife who file a joint tax return can elect to take a credit based on their combined retirement income. The election excludes, in effect, $2,286 of retirement income and the maximum tax credit is $342.
2. If a taxpayer received any Social Security benefits, the above amounts of $1,524 and $2,286 are reduced by the benefits received.

B. Proposed Structure

The above amounts of $1,524 and $2,286 should be increased to $4,572 and $6,858, so that more taxpayers who receive Social Security benefits will be eligible for a retirement income credit.

C. Supporting Arguments

1. Taxpayers with Social Security benefits of $1,524 if single, or $2,286 if filing jointly, do not qualify for any retirement income credit. The recent increases in Social Security benefits have resulted in many taxpayers having benefits in excess of these limitations and therefore becoming ineligible for the retirement income credit.
2. An increase in the amounts of $1,524 and $2,286 would be an incentive for taxpayers, who have not yet retired, to save and provide funds for their retirement instead of being totally dependent upon the Social Security system.
3. Social security taxes are now three times what they were in 1962 when the $1,524 and $2,286 figures were established.

D. Estimated Revenue Loss

Information to estimate the effect on the government's revenue is not readily available.

VII. Investment Income Exclusion

A. Present Structure

1. Dividends received, less a $100 exclusion, are included in the taxable income of individuals.
2. Interest income is taxable .
3. 100% of short-term capital gains and 50% of long-term capital gains are included in taxable income.

B. Proposed Structure

Income from dividends, interest on savings accounts and the taxable portion of capital gains should be reduced by an exclusion of $1,000.

C. Supporting Arguments

1. Additional capital would be available for the expansion of industry and the financing of housing.
2. Millions of individuals would be encouraged to invest in common stocks and savings accounts instead of spending all their income.
3. The present trend of corporations raising capital by issuing bonds instead of common stocks would be discouraged.

VIII. Indexing the Tax Structure

A. Present Structure

Tax brackets, standard deductions, low income allowances, individual exemptions, corporate surtax exemptions and other fixed amounts remain unchanged until revised by Congress.

B. Proposed Structure

1. Tax brackets and other amounts mentioned above should be indexed to the cost-of-living.
2. Indexing would be done no more than once each year.
3. No change would be made until the cost-of-living index had increased by more than 10% since the date of the last change.

C. Supporting Arguments

Indexing would prevent taxpayers from having to pay an ever increasing proportion of their income in taxes due to inflation automatically pushing them into higher tax brackets each year even though real income remains unchanged.

EQUALIZATION

I. Deferred Tax Credit for Unincorporated Businesses

A. Present Structure

1. Corporations are taxed on their income at 20% on the first $25,000, 22% on the next $25,000, and 48% on the remainder.
2. The business income of a sole-proprietor or partnership is taxed at more than 20% in most cases. A married individual pays more than 20% on taxable income in excess of $8,000 and an unmarried individual pays more than 20% on taxable income in excess of $4,000.

B. Proposed Structure

1. Allow an unincorporated business the option of computing its tax liability on a portion of its business income, as set forth on Line 13, Schedule SE, Form 1040, at the same rates as are presently applicable to corporations.
2. The unincorporated business income would be eligible for the alternative tax computation as follows:
   (a) Taxable income less an exclusion of 70% of the self-employment income (but not to exceed the taxable income) would be subject to individual income tax rates.
   (b) The amount excluded in (a), above, would then be taxed at the prevailing corporate income tax rates.
   (c) The difference between the tax liability incurred without the alternative tax rate and the liability incurred using the alternative tax rate would become a deferred tax liability. The deferred tax liability would be paid over a 10-year period or upon termination of the business, whichever occurs the earliest.
   (d) Example:
      1. Married taxpayer, 2 dependents and itemized deductions of $3,000.
      2. Income from business (Schedule C) $35,000.
      3. Other non-business income of $1,000.
      4. Tax liability without alternative tax computation, $7,880.
      5. Alternative tax computation:

(a) Taxable Income	$30,000	
(b) 70% X 35,000	$24,500	
(c) Adjusted taxable income	$ 5,500	
(d) Tax (individual rates) on $5,500	$ 905	
(e) Tax (corporate rates) on $24,500	$ 4,900	
(f) Total Alternative Tax (d&e)		$5,805
6. Deferred Tax Liability (line 4-5(f))		$2,075

3. Another approach would be to simply allow a tax credit of 7% of the taxable business income, with a maximum credit of $10,000 per year. The tax credit would be recaptured 10% per year for 10 years or upon termination of the business, whichever occurs the earliest.

C. Supporting Arguments

1. The relatively low corporate tax brackets, and other tax advantages enjoyed only by corporations, encourage many businesses to incorporate even though from a practical operational viewpoint they can be conducted more effectively without incorporation.
2. The proposed tax deferral on the taxable business income of unincorporated businesses would help businesses to finance the ever increasing cost of inventories and other assets.

D. Estimated Revenue Loss

As the proposed tax credit would be completely recaptured the government's revenues would be unchanged over the long-term.

II. Net Operating Loss Carry-Overs

A. Present Structure

1. The carry-overs of net operating losses by a corporation are applied directly against income whereas an individual loses the benefit of his personal itemized deductions and exemptions.
2. A net operating loss may be carried back to each of the 3 preceding years, and carried over to each of the 5 following years.

B. Proposed Structure

1. The requirement that personal exemptions and nonbusiness deductions be added to taxable income in computing the net operating loss of an individual should be eliminated.
2. An individual or corporation should be allowed to carry-back a net operating loss to each of the 3 preceding years, and then carry-over to the following years without time limitation.

C. Supporting Arguments

1. The present method of applying net operating losses favors corporations over individuals and is one of the reasons why businesses decide to incorporate even though it is more efficient from an operational viewpoint to remain unincorporated.
2. Operating losses incurred in the early years of a business enterprise may be so large, and later profits so small, that they cannot be recovered in the limited carry-forward period now permitted.

D. Estimated Revenue Loss

This proposal would result in some loss of revenue but the amount is unlikely to be significant.

III. Maximum Tax Rates

A. Present Structure

1. The top tax rate applicable to an individual's earned income is limited to 50%.
2. A taxpayer engaged in a business where both services and capital are material income-producing factors may treat not more than 30% of his share of the net profits as earned income.

B. Proposed Structure

1. The top tax rate applicable to an individual's earned income should be limited to the maximum rate applicable to corporations.
2. A taxpayer engaged in a business where both services and capital are material income-producing factors should be able to treat all of his share of the net profits as earned income.

C. Supporting Arguments

1. The top tax rate applicable to a corporation's income is now 48%.
2. None of the corporation's income is now taxed at more than 48%, even if capital is a material income-producing factor.
3. Taxing an individual's income at higher rates than a corporation's income is inequitable and results in many businesses deciding to incorporate even though they could be conducted more efficiently unincorporated.

D. Estimated Revenue Loss

These changes would not result in a substantial revenue loss.

IV. Organization Expenses of Partnerships

A. Present Structure

Partnerships are not allowed to amortize their organization expenses although the amortization of a corporation's organization expenses is permitted.

B. Proposed Structure

The option to amortize organization expense should be extended to partnerships.

C. Supporting Arguments

Permitting corporations to amortize their organization expenses while prohibiting it for partnerships discriminates against the unincorporated business. This is one of the reasons why businesses decide to incorporate even though it is more efficient from an operational viewpoint to remain unincorporated.

D. Estimated Revenue Loss

The government's revenue would be delayed but unchanged. Under the present law, the unamortized organizational expenses may be deducted upon liquidation of the partnership.

62-209 O - 76 - 30

SIMPLIFICATION

I. Payroll Tax Deposits

- A. Present Structure

1. Payroll taxes of $200 or more, but less than $2,000, per month must be deposited within 15 days after the end of the month.
2. Payroll taxes of $2,000 or more in any quarter-monthly period must be deposited within 3 banking days after the end of the quarter-monthly period. (I.R.S. has proposed to increase this period to 7 banking days.)

B. Proposed Structure

1. The limit for monthly deposits should be raised from $200 to $600.
2. The limit for quarter-monthly deposits should be raised from $2,000 to $6,000.

C. Supporting Arguments

1. Present depository requirements are unrealistic in view of accelerating payroll taxes. When the requirements for the present monthly deposits ($200 and $2,000) was initiated in 1972 the payroll taxes were considerably less than they are today. Social security taxes has increased 76% from 10.4% of $9,000 of wages in 1972 to 11.7% of $14,100 of wages in 1975. Social security taxes are now three times what they were in 1966 when the depository limits were $150 and $4,000.
2. Requiring less frequent deposits will ease the heavy paperwork burden on the small business with limited clerical staff.
3. It is the small employer, whose payroll tax deposits are subject to different limits each month, that are penalized for failure to make timely deposits.

D. Estimated Revenue Loss

There would be no revenue loss to the government.

II. Sub-Chapter S Corporations

A. Present Structure

1. A corporation with 10 or fewer stockholders and complying with a number of other eligibility requirements may elect to be taxed under Sub-Chapter S.
2. Under Sub-Chapter S, a corporation is taxed in a manner which bears some similarity to the method of taxing partnerships.

B. Proposed Structure

1. All corporations with 20 or fewer stockholders should be allowed to elect to be taxed exactly like a partnership.
2. The only requirement for this election should be a statement filed by the corporation with its tax return for the year of election and signed by an officer of the corporation to the effect that there are 20 or fewer stockholders and that the stockholders at a duly constituted meeting decided to be taxed as a partnership.
3. After a corporation has made this election, it should not be allowed to revoke it for 5 years without the permission of the Treasury Department.

C. Supporting Arguments

1. The extremely detailed procedures for complying with Sub-Chapter S and the many tax pitfalls which may be encountered by a Sub-Chapter S corporation, make an election to be taxed under these provisions rather dangerous for the average small business.
2. Eliminating Sub-Chapter S and allowing small corporations to be taxed exactly like partnerships would be a substantial simplification of the tax law.

D. Estimated Revenue Loss

The tax revenues would be unchanged.

III. Effective Dates

A. Present Structure

The effective dates of changes in the tax laws are fixed when the laws are passed by Congress.

B. Proposed Structure

1. The effective dates of changes in those tax laws, which impose different operating or reporting requirements, should not be earlier than 1 year after the final regulations are issued by the Treasury Department.
2. The effective dates of such changes as a reduction in the tax rates, could be effective immediately, or even retro-actively.

C. Supporting Arguments

Taxpayers have great difficulty in complying with changes in tax laws imposing different operating or reporting requirements before detailed regulations are finalized.

IV. Committee on Tax Simplification for Small Business

A. Present Structure

1. Tax laws are often written with the medium and large business in mind. The point of views of small businesses and their compliance problems resulting from their limited administrative staffs may be overlooked.
2. Changes in circumstances over a period of years result in many sections of the tax laws becoming inapplicable.
3. Tax laws and the interpretations issued by the Treasury Department are not reviewed to determine whether their application is within the intent of Congress.

B. Proposed Structure

1. A permanent standing committee of the Federal Government should be established for the purpose of devoting continued attention to the simplification of the tax laws, regulations, and other publications relating to the taxation of small businesses.
2. The committee should appoint a small business tax analyst with the responsibility for looking at tax problems primarily from the viewpoint of small businesses rather than the Government's interest in raising revenue.

C. Supporting Arguments

1. The committee would provide a forum for regular contact between the various Federal agencies concerned, the businesses affected, and the Congress.
2. The development of tax laws and regulations, their revision in accordance with changing circumstances, and the review of their application, would not overlook the viewpoint of the small businesses.

COMPARISON OF ESTIMATED DIFFERENCE BETWEEN EXISTING CORPORATE INCOME TAX RATES AND THE NFIB PROPOSALS (BASED ON 1970 INCOME)

TAXABLE INCOME ($)	NFIB PROPOSED RATES (%) (a)	NO. OF CORPS (000) (b)	EXISTING RATES (%) (c)	AVERAGE TAXABLE INCOME ($-000) (d)	AVERAGE ANNUAL TAX EXISTING ($) (e)	AVERAGE ANNUAL TAX PROPOSED ($) (f)	AVERAGE ANNUAL SAVINGS ($) (g)=(e-f)	GOV'T GAIN (LOSS) ($-000,000) (h)=(gxb)	% REDUCTION OF ANNUAL TAX LIAB (i)=(g-e)
$0-9,999	10%	393	20%	$ 3	$ 600	$ 300	$ 300	$(118)	50.0%
$10,000-19,999	15	121	20	14	2,800	1,600	1,200	(145)	42.9
$20,000-29,999	20	86	20/22	25	5,500	3,500	2,000	(172)	36.4
$30,000-39,999	25	30	22	34	6,980	5,500	1,480	(44)	21.2
$40,000-49,999	30	18	22	45	9,400	8,500	900	(16)	9.6
$50,000-59,999	35	13	48	56	13,380	12,100	1,280	(16)	9.6
$60,000-69,999	40	9.5	48	64	17,220	15,100	2,120	(20)	12.3
$70,000-79,999	45	7.3	48	74	22,020	19,300	2,220	(20)	12.4
$80,000-89,999	45	6.0	48	85	27,300	24,250	3,050	(18)	11.2
$90,000-99,999	45	4.6	48	95	32,100	28,750	3,350	(15)	10.4
$100,000-149,999	45	15.0	48	119	43,620	39,550	4,070	(61)	9.3
$150,000-199,999	45	7.6	48	172	69,060	63,400	5,660	(43)	8.2
$200,000-249,999	45	4.4	48	224	94,020	86,800	7,220	(32)	7.7
$250,000-499,999	45	9.2	48	348	153,540	142,600	10,940	(101)	7.1
$500,000-999,999	50	4.6	48	687	316,260	304,500	11,760	(54)	3.7
Over $1,000,000	50	4.8	48	10,338	4,948,740	5,130,000	(181,260)	870	(3.7)
Totals		734.0						5	

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
PENSION REFORM PROPOSALS

INTRODUCTION

The new reporting and administrative requirements of the Pension Reform Act of 1974 have greatly increased the cost of creating and operating pension and profit-sharing plans. This burden is very heavy for small independent businesses which do not have large clerical staffs.

This report was developed by the National Federation of Independent Business with the objective of indicating the areas in which simplification of the present requirements would be most beneficial to small independent businesses.

The survey of members who attended the pension seminars held by the National Federation of Independent Business at its Washington National Conference in June 1975 indicated overwhelming support of these proposals.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

PENSION REFORM PROPOSALS-1975

INCENTIVES: Pages 1-4

I. Individual Retirement Accounts
II. Limitation on Profit Sharing Contributions
III. Target Benefit Plans
IV. Prohibited Transactions
V. Taxation of Participants When Plan Inadvertently Disqualified
VI. Estate Tax Exclusion

EQUALIZATION: Pages 5-6

I. Same Rules for All Types of Entities
II. Keogh Plan Trustees

SIMPLIFICATION: Pages 7-12

I. Prototype Plan and Reporting Package
II. Consolidated Annual Reports
III. Exemptions from Certified Annual Reports
IV. Effective Dates
V. Reduce Discretion of Internal Revenue Service
VI. Committee on Pension Simplification for Small Business

SURVEY RESULTS: Page 13

INCENTIVES

I. Individual Retirement Accounts

A. Present Structure

1. An employee is not allowed to make a contribution to an individual retirement account if he is covered by his employer's plan. This is so, even if the employer is unable to make a contribution.
2. The maximum contribution is 15% of wages up to $10,000.

B. Proposed Structure

1. An employee who is covered by his employer's plan should be allowed to make a contribution to an individual retirement account of 8% of wages.
2. The maximum contribution should be 15% (or 8% for an employee covered by his employer's plan) of wages up to $20,000 for individuals under 40 years of age. The percentage should be increased for individuals over 40 years of age by 1% for each year in excess of 40 years, up to a maximum 40% at age 65.

C. Supporting Arguments

1. An employee is prohibited from making a contribution to an individual retirement account if his employer includes him in his plan but is unable to make adequate contributions.
2. Increasing the contribution base from $10,000 to $20,000 would be a substantial encouragement to middle-income individuals to provide sufficient funds for their retirement.
3. The contribution rate of 15% is adequate for younger individuals but does not provide adequate funds for retirement for anyone nearing retirement age.

II. Limitation on Profit Sharing Contribution

A. Present Structure

The contribution to a profit-sharing plan is limited to 15% of participant's compensation.

B. Proposed Structure

1. Limitation should continue to be 15% of compensation for participants who are age 40 or under.
2. Limitation for participants who are over age 40 should be on a sliding scale. It should be 15% plus 2% for each year over age 40, up to a maximum of 65% at age 65.

C. Supporting Arguments

1. The 15% limitation prevents a profit-sharing plan from providing adequate retirement benefits for older employees.
2. Adequate pensions could be provided for older employees without the paperwork problems of a pension plan.

3. Employers would be able to set-up plans to provide adequate pensions for older employees without an obligation to make contributions in years in which insufficient profits are available or the requirement to fund investment losses of the plan

III. Target Benefit Plans

A. Present Structure

1. The contribution to a target benefit plan is limited to 25% of compensation.
2. The contribution to a defined benefit plan is limited to the amount necessary to fund a pension equal to 100% of compensation.

B. Proposed Structure

The contribution to a target benefit plan should be limited to the estimated amount necessary to fund a pension equal to 100% of compensation.

C. Supporting Arguments

1. The 25% limitation on target benefit plans deters a business from providing adequate pensions for its older employees.
2. Adequate pensions could be provided for employees with less administrative expenses than a defined benefit plan. One of the savings would be the elimination of the cost of obtaining an [illegible]uary's certificate.
[illegible]he requirement under defined benefit plans to fund investment [illegible]sses deters many employers from setting up a retirement plan which provides its older employees with adequate pensions.

IV. Prohibited Transactions

A. Present Structure

1. Pension plan may invest up to 10% of its assets in the employer's securities or real property.
2. Profit-sharing plan may invest all of its assets in the employer's securities or real property.
3. An employer's securities (other than stock) must be "marketable" and an employer's real property must be a substantial number of parcels which are dispersed geographically.

B. Proposed Structure

1. Pension or profit-sharing plans should be allowed to invest up to 50% of their assets in loans to the employer, provided interest and security is adequate, or in real property of the employer.
2. The "marketability" rule should not apply to loans to the employer unless the loan exceeds $200,000.
3. The "geographical dispersion" rule should not apply to real property of the employer unless the property exceeds $200,000.

C. Supporting Arguments

1. A loan with adequate security and interest is a safer investment for a pension or profit-sharing trust than employer stock.
2. Investment in employer stock is expensive and difficult for a small business which does not have its stock traded on a stock exchange.
3. A loan to the employer would provide a valuable source of capital for the employer and contribute to its growth and ability to provide better benefits for its employees.
4. Participants' investment in the employer's business would encourage productivity.

V. Taxation of Participants When Plan Inadvertently Disqualified

A. Present Structure

When a plan becomes inadvertently disqualified all benefits become fully vested and are taxable to participants even though they are not distributed. This is the present position of the IRS as set forth in proposed regulations.

B. Proposed Procedure

When a plan which originally qualified as an employee benefit plan subsequently becomes temporarily or permanently disqualified, the contributions previously paid into the trust by the employer on behalf of employees should not become taxable to the employees in the year of disqualification. The employee should not be taxed until the benefits are actually distributed or made available to him. This was the position of the IRS prior to the issuance of its proposed regulations.

C. Supporting Arguments

1. The present position of the IRS does not appear to be directly based on the law or the intent of Congress.
2. It is unfair to require participants to pay tax at regular tax rates on all of their benefits in a plan which becomes inadvertently disqualified for a short period of time when they have not received any of these benefits. Participants should not have to pay tax on their benefits until the benefits are actually distributed or made available to them.

VI. Estate Tax Exclusion

A. Present Structure

All stock owned at the date of death is included in the gross estate for estate tax purposes.

B. Proposed Structure

1. A percentage of the value of stock given to an employee stock ownership plan (or a profit-sharing plan) on the death of the owner should be excluded from the gross estate for estate tax purposes.
2. The percentage of the value of the stock excluded from the gross estate could be on a sliding scale starting at 200% for a taxable estate of under $500,000 and decreasing to 100% for a taxable estate of over $1,000,000.

C. Supporting Arguments

1. This would help to prevent small independent businesses from having to be sold, liquidated or merged to pay the substantial amounts of estate tax due on the death of the owner.
2. The growth of employee stock ownership plans (and profit-sharing plans) would be stimulated. This would encourage personal motivation and productivity of the employees.

EQUALIZATION

I. Same Rules for All Types of Entities

A. Present Rules

1. Present rules are most restrictive for individual retirement accounts.
2. Keogh plans for sole-proprietors and partnerships are subject to less restrictive rules.
3. Plans for Sub-Chapter S Corporations are subject to even less restrictive rules than Keogh plans.
4. The plans for corporations which have not elected to be taxed under Sub-Chapter S are subject to the least restrictions.

B. Proposed Rules

1. The present four sets of rules should be reduced to two.
2. Individual retirement accounts should continue to be subject to simplified rules.
3. Plans for sole-proprietors, partnerships, Sub-Chapter S corporations, and regular corporations should all be subject to the same rules. Preferably, the special restrictions applied to Keogh and Sub-Chapter S plans should be eliminated.

C. Supporting Arguments

1. The restrictions applied to Keogh plans encourage many businesses to incorporate although from a practical operational viewpoint they can be conducted more effectively without incorporation.
2. The present rules tend to discriminate against the small business. Very few large businesses are subject to the Keogh and Sub-Chapter S restrictions.
3. Eliminating the different rules for different entities would help the small business in understanding this complex subject and probably result in many more plans being created.

II. Keogh Plan Trustees

A. Present Structure

1. The trustee for a Keogh plan must be a bank or other person who demonstrates to the satisfaction of the Treasury Department that he will administer the trust in a manner consistent with the tax law.
2. Any person may act as trustee for a Corporate plan, without obtaining permission from the Treasury Department.

B. Proposed Structure

1. Any person should be allowed to act as trustee of either a Corporate or a Keogh plan without obtaining approval from the Treasury Department.

C. Supporting Arguments

1. Appointing a bank as trustee, or applying for permission to appoint an individual, adds to the administration costs of a Keogh plan and is a factor in detering many employers from setting-up a plan.
2. The limitations on who may be a Keogh plan trustee discriminates against unincorporated businesses. This encourages many businesses to incorporate even though from an operational viewpoint the business can be most effectively conducted as a sole-proprietorship.

SIMPLIFICATION

I. Prototype Plan and "Reporting Package"

A. Present Procedure

1. Plan and trust agreement are prepared by attorney.
2. Determination letter is requested from Internal Revenue Service.
3. Comprehensive plan description (Form EBS-1) is filed with Department of Labor.
4. Summary plan description is given to individuals who are plan participants and filed with Department of Labor.
5. Plan and trust agreement are amended to comply with 1974 Pension Reform Law.
6. Summary descriptions of plan modifications is given to participants and filed with Department of Labor.

B. Proposed Procedure

1. Many of the 400,000 small independent businesses which are members of the National Federation of Independent Business are interested in setting-up new pension and profit-sharing plans or are required to amend their present plans to comply with the Pension Reform Act. However, the cost of creating, amending and administering an independently designed plan deters many members.
2. The use of flexible prototype plans with matching partially filled-in forms could eliminate much of the paperwork, and its cost, for both the employers and the federal government agencies.
3. The Internal Revenue Service and the Department of Labor could encourage employers which now have a plan that needs to be amended to comply with the Pension Reform Act and, also, employers which may be considering setting-up a new plan, to consult with their attorney, accountant and pension consultant concerning the savings in time and money which can be achieved by utilizing a prototype plan instead of an individually designed plan.
4. It is estimated that 90% of the 450,000 plans which need amending have under 100 participants each. The vast majority of these plans could adopt a prototype plan and save a substantial amount of expense without any real loss of flexibility as to investments, benefit formula, or other plan provisions.
5. The present advantages of prototype plans could be considerably increased by requiring that the Internal Revenue Service approval of a prototype plan should cover not only the plan, trust agreement and adoption agreement but, also, a summary plan description for participants and a Form EBS-1, for the Department of Labor. The summary plan description would cover the basic terms of the plan and refer participants to the adoption agreement to see which options were selected by their employer. The filing of the detailed Form EBS-1 by the employer would be eliminated. Instead, the employer would file with the Department of Labor a copy of his adoption agreement.

6. The National Federation of Independent Business is now in the process of developing a series of prototype plans and would certainly be willing to prepare the related Forms EBS-1 and summary plan descriptions if the above procedure could be implemented.
7. Further savings could also be achieved for both employer and the government if the adoption of any prototype plan was deemed qualified without the necessity of applying for a determination letter from the Internal Revenue Service. This would extend the present automatic qualification of Keogh prototypes to corporate prototypes. Of course, an employer which elects in the adoption agreement to cover only a certain class of employees (e.g. salaried employees only) would not be exempted from applying for a determination letter.
8. It is understood that the Internal Revenue Service will not be able to accept applications from sponsors for approval of amended prototype plans until October or November, 1975. It may therefore be worthwhile to consider whether the effective dates of the 1974 Pension Reform Act could be postponed to allow the orderly development and implementation of the suggested prototype plans and reporting packages.
9. Prototypes should be reviewed periodically by Internal Revenue Service and sponsors should be notified if changes are necessary.

C. Supporting Arguments

1. Employers would save a considerable amount of time and money in the set-up and operation of a retirement plan. This would encourage more employers to set-up retirement plans for their employees and prevent many existing plans from being terminated due to the administrative costs being beyond the means of many small businesses.
2. Complying with changes in the pension law would be greatly simplified. Many small businesses may decide to terminate their plans instead of incurring the administrative costs of making the necessary amendments.
3. The federal government departments would save substantial amounts of time and money in eliminating much of the review and processing of probably 90% of all plans.
4. More employees would be covered by plans due to the simplification of administration encouraging more employers to set-up plans.

II. Consolidated Annual Reports

A. Present Procedure

1. Administrator files Premium Payment Declaration on Form PBGC-1 with Pension Benefit Guarantee Corporation and pays premium.
2. Fiduciary files Exempt Organization Business Income Tax Return on Form 990-T with Internal Revenue Service Center, reporting and paying tax due on unrelated business income of trust.
3. Fiduciary files Annual Return of Fiduciary of Employees' Pension or Profit-Sharing Trust on Form 990-P with Internal Revenue Service Center along with Schedule A, Form 990-P.

4. Employer files Annual Employer's Return for Employees' Pension or Profit-Sharing Plans on Form 4848 and the Annual Status Report of an Employees' Pension or Profit-Sharing Plan on Schedule A (Form 4848) with the appropriate Internal Revenue Service Center.
5. Employer or plan fiduciary files Financial Statement of Employees' Pension or Profit-Sharing Fund or Fiduciary Account on Form 4849.
6. Payer furnishes Form W-2P to recipients of periodic retirement plan distributions, showing amount subject to tax and the amount of tax withheld.
7. Payer furnishes Form 1099R to recipients of lump-sum distributions from qualified retirement plans showing tax status of various segments of the distribution.
8. Payer files copies of Form W-2P and 1099R furnished to recipients with appropriate Internal Revenue Service Center, along with transmittal Form W-3.
9. Administrator files Annual Report with Pension Benefit Guarantee Corporation.
10. Administrator files Annual Report with Secretary of Labor.
11. Administrator furnished Summary Annual Report to participants.
12. Employer of a terminating plan files Termination of Employees' Pension or Profit-Sharing Plan on Form 966-P and attached it to Schedule A (Form 4848).
13. Administrator of a terminating plan files such terminal or supplementary reports as the Secretary of Labor may prescribe and send a copy to the Pension Benefit Guarantee Corporation.
14. In additional to the above Federal reporting requirements, each State has its own reporting requirements.
15. Most of the reports listed above must be filed every year.

B. Proposed Procedure

1. The various reports now required on different dates by the Internal Revenue Service and other government agencies should be consolidated into one annual report.
2. The format of this annual report should allow the Administrator to give participants a copy of this report instead of a separate summary annual report.
3. The same information should not be required every year.
4. Plans with less than 50 participants should be allowed to file a simplified report.
5. Information from the single annual report should be input into the Internal Revenue Service computers. The portions of the information needed by other government agencies should be given to them on magnetic tape.

C. Supporting Arguments

1. Employers would save a substantial amount of time and money on the preparation of retirement plan reports.
2. Federal government agencies would save a considerable amount of time and money on the processing of reports.

III. Exemptions from Certified Annual Reports

A. Present Procedure

1. Annual report to Department of Labor certified by an independent accountant.
2. Annual report of a defined benefit plan certified by an actuary.

B. Proposed Procedure

1. Plans with 50, or fewer, participants should be exempt from filing an opinion by an independent accountant.
2. Defined benefit plans with 50, or fewer, participants should be exempt from filing an actuary's certificate.

C. Supporting Arguments

The cost of obtaining an accountant's opinion and an actuary's certificate is a very heavy burden for a plan with few participants and in many plans these costs will exceed the earnings on the trust investments.

IV. Effective Dates

A. Present Procedure

The effective dates of changes in the pension laws are fixed when the laws are passed by Congress.

B. Proposed Procedure

1. The effective dates of changes in those pension laws, which impose different operating or reporting requirements, should not be earlier than 1 year after the final regulations are issued by the government departments.
2. The effective dates of such changes as an increase in the percentage limitation on profit-sharing contributions could be effective immediately.

C. Supporting Arguments

It is very difficult to comply with changes in pension laws imposing different operating or reporting requirements before detailed regulations are finalized. For example, a new pension plan in 1975 is required to comply with the 1974 Pension Reform Law even though many of the regulations have not yet been issued.

V. Reduce Discretion of Internal Revenue Service

A. Present Procedure

1. The Internal Revenue Service has a certain amount of discretion regarding such things as vesting and coverage.

62-209 O - 76 - 31

2. The Internal Revenue Service may reduce the vesting periods stated in the Pension Reform Act of 1974 if it considers it necessary to prevent possible discrimination.
3. The Internal Revenue Service may disqualify a plan covering a certain class of employees (e.g. salaried employees) if it considers the coverage to be discriminatory.

B. Proposed Procedure

1. The Internal Revenue Service discretion regarding such things as vesting and coverage should be limited.
2. The Internal Revenue Service should not have discretion to reduce vesting periods below a defined minimum. The minimum could be 50% of the vesting periods stated in the Pension Reform Act of 1974.
3. The Internal Revenue Service should not be allowed to disqualify a plan covering a certain class of employees if not more than 50% of such class of employees are officers or highly paid employees.

C. Supporting Arguments

1. Definite limits on Internal Revenue Service discretion would assist employers in setting-up their plans. They could design their plans to comply with the most restrictive terms and avoid the time and cost of negotiating with the Internal Revenue Service concerning discretionary items.
2. The Internal Revenue Service would save a considerable amount of expense by limiting negotiations regarding many provisions in benefit plans.

VI. Committee on Pension Simplification for Small Business

A. Present Procedure

1. Pension laws are often written with the medium and large business in mind. The point of view of small businesses and their compliance problems resulting from their limited administrative staffs may be overlooked.
2. Changes in circumstances over a period of years result in many sections of the pension laws becoming inapplicable.
3. Pension laws and the interpretations issued by government departments are not reviewed to determine whether their application is within the intent of Congress.

B. Proposed Procedure

1. A permanent standing committee of the Federal Government should be established for the purpose of devoting continued attention to the simplification of the pension laws, regulations and other publications relating to small businesses.

C. Supporting Arguments

1. The committee would provide a forum for regular contact between the various Federal agencies concerned, the businesses affected and the Congress.
2. The development of pension laws and regulations, their revision in accordance with changing circumstances, and the review of their application, would not overlook the viewpoint of the small business.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
SURVEY RESULTS

Members who attended the pension seminars held by the National Federation of Independent Business at its Washington National Conference in June 1975 were asked to indicate whether or not they supported the pension reform proposals. The results are as follows:

	Yes %	No %	No Opinion %
A. A prototype plan and reporting package should be approved by the Internal Revenue Service.	84	10	6
B. Small business should be exempt from filing certified annual reports.	89	9	2
C. Uniform rules for all types of entities.	80	13	7
D. Committee on pension simplification for small business should be established.	91	7	2
E. Effective dates should be 1 year after final regulations are issued.	94	3	3
F. Limit on contributions to an individual retirement account should be increased.	91	8	1
G. Limit on contributions to a target benefit plan should be increased for older employees.	72	14	14
H. Limit on contributions to a profit-sharing plan should be increased for older employees.	73	17	10
I. An individual should be allowed to act as trustee of a Keogh plan.	78	7	15
J. Plans should be allowed to invest up to 50% of their assets in loans to the employer.	76	18	6
K. Benefits in a disqualified plan should not be taxable to employees until distributed.	90	-	10
L. Internal Revenue Service discretion on vesting, coverage, etc. should be limited.	92	4	4

NATIONAL FEDERATION OF INDEPENDENT BUSINESS
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FOR IMMEDIATE RELEASE
September 25, 1975
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SMALL BUSINESS TAX MEASURE
WOULD CUT UNEMPLOYMENT

Washington, D.C. -- A proposed investment credit for small business job creation could put over 10 million people back to work and cut the nation's unemployment compensation costs by $2.5 billion.

Bruce Fielding, a California CPA and member of the board for the National Federation of Independent Business, outlined these and other benefits in a comprehensive small business tax package proposed before a joint hearing of the Senate Small Business Committee and Senate Finance Committee in Washington Thursday.

Fielding said that existing tax investment credit measures create incentives for larger businesses to buy equipment that replaces people in production. A small business "job creation investment credit", he said, would provide incentive to put at least 13 per cent of the country's 8 million unemployed back to work.

"This measure alone would save several billion dollars at no extra cost to the taxpayers," said Fielding. "The loss to the Federal government in taxes would be offset by a corresponding savings in unemployment compensation costs."

Fielding's package of tax measures designed specifically for small business is greatly needed he said, to defeat the nation's current economic problems.

"Small business employs over half the private sector workers in the nation and accounts for 43 per cent of the Gross National Product," added Fielding, "and the Congress has yet to advance any measures to stimulate this important sector of the economy."

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Fielding also called for tax measures that would treat small business partnerships and proprietorships as incorporated businesses. He said current tax standards are not equitable to nearly 75 per cent of the nation's small businesses.

Fielding represented NFIB's 425,000 member small businesses before the Senate hearings. NFIB is the largest business organization in the United States.

Senator BENTSEN. Thank you. Let me say, the things I cited to you in the way of affirmative action in some of this legislation that has been introduced is the result of some of these hearings; some of these things that I was telling you about earlier. Now I am hopeful too that we will see those finally implemented into law.

Mr. FIELDING. We will do all we can to help in the implementation of those. Perhaps we need more publicity.

Senator BENTSEN. Mr. Chairman, I have no further questions.

Senator NELSON. Thank you very much, Mr. Fielding. We appreciate your taking the time to draft your very comprehensive statement and supplemental material. We are interested in all aspects of it as well as specifically the pension reform proposals that you make.

I would hope that we could arrange either hearings in the Finance Committee or joint hearings of the Small Business and Finance Committees on this precise question of the pension reform proposals. Thank you very much.

Our next witness is Mr. William McCamant, executive vice president, National Association of Wholesaler-Distributors. Mr. McCamant, we are pleased to have you here today. Your statement will be printed in full in the record. You may present it however you desire.

[The prepared statement of Mr. McCamant in full follows:]

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

STATEMENT OF

William C. McCamant, Executive Vice President
and
Dr. Norman B. Ture, Consulting Economist

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS
AND
SUBCOMMITTEE ON FINANCIAL MARKETS,
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

ON

TAX REFORM: CAPITAL FORMATION IN THE WHOLESALE-DISTRIBUTION INDUSTRY

SEPTEMBER 25, 1975

1725 K Street, N.W. · Washington, D.C. 20006 · 202/872-0885

My name is William C. McCamant, Executive Vice President of the National Association of Wholesaler-Distributors (NAW). With me is our Association's consulting economist Dr. Norman B. Ture, President of Norman B. Ture, Inc.

The National Association of Wholesaler-Distributors (NAW) is a federation of 95 national commodity-line associations which in turn are composed of 30,000 merchant wholesaler establishments located throughout the fifty states. As will be detailed later, our industry is composed primarily of small, closely-held, family-owned businesses.

We believe that your in-depth study of the effects of the tax structure on small business---of which these hearings are a part---is most important to the future economic health of small business. We appreciate and value this opportunity to appear here today.

Capital Formation Is The Key

While there is a lengthy list of tax policy matters of import to small business, we will focus our attention today on the need for modifications in the tax code which significantly increase small business' ability to raise capital. A capital formation deficiency is our most urgent economic problem. It is, in large measure, attributable to existing tax policy. Failure to resolve it will have profound implications for the national economy, not just for our industry.

I stress the role of tax policy in creating this capital shortfall. The Congress, thanks in large measure to the leadership of this Committee,

recognized this in concept in the Tax Reduction Act of 1975, which temporarily increased the corporate surtax exemption to $50,000. We are here today to urge a permanent increase in the corporate surtax exemption to $100,000.

We recognize that the Congress needs hard-headed, factual analyses in order to evaluate tax proposals and to reach decisions about appropriate changes in the tax law. Our objective is to provide a factual basis to assist in examining tax reform for small business.

Dr. Ture is a recognized expert on capital formation and tax policy whose reputation is well known to you and which thus needs no elaboration. He has prepared a detailed examination of the capital formation process within wholesale distribution and the role played by tax policy in this process for presentation at these hearings and inclusion in your study's data base. A primary objective of Dr. Ture's study was to determine whether a capital shortfall is in prospect for our industry and, if so, the type of tax reform which most effectively would correct this deficiency. Additionally, he was asked to examine the revenue impact and overall economic impact of an increase in the corporate surtax exemption.

Wholesale-Distribution: A Primary Economic Sector

Dr. Ture's analysis will be presented to you momentarily. First, I would like briefly to familiarize you with the merchant wholesaler-distributor in order to establish the significance of our industry and its functions.

Merchant wholesale distribution is an industry of predominantly small

businesses. In 1972, (the latest year for which census data are available) for example, there were on the average, only 10.4 employees per establishment in the industry. Total sales of these companies, however, were about $300 billion. In short, merchant wholesale distribution is a very large industry of a very large number of small firms.

Wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, store, break bulk, sell, deliver, and extend credit to retailer dealers, and industrial, commercial, institutional, governmental, and contractor business users.

Wholesaler-distributors are essential to the efficient distribution of our everyday consumer and business needs. Further, by the market coverage which they offer suppliers and the support which they provide customers, they preserve and enhance competition, the critical safeguard in our economic system. According to a recent NAW survey, the typical wholesaler establishes the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businesses who must rely on wholesaler-distributors to establish, maintain and nurture markets for their products. Many customers are small businesses also who must look to the merchant wholesaler to provide merchandise availability, credit, and other services.

A healthy wholesale distribution sector is fundamental to the economic health of the nation at large. Yet, our ability to sustain, let alone improve our contribution to the economy will be seriously weakened unless appropriate revisions are made to augment the availability of saving and capital for the industry, as Dr. Ture will now detail.

SUMMARY OF STATEMENT BY DR. NORMAN B. TURE

The National Association of Wholesaler-Distributors believes that a large and varied list of tax revisions is needed to adapt the Federal tax system to the economy's long-range requirements. Because of time constraints, we are limiting our comments on this occasion to a single proposal --- to increase the corporate surtax exemption to $100,000. The enactment of this proposal, we believe, by materially enhancing the financial capacity of merchant wholesaler-distributors and other independent, small and medium size businesses to acquire additional capital resources, will by 1977 provide about 720,000 additional jobs in the private business sector. It will also increase real wages by about $10 billion over the amount that would otherwise be reached in that year. GNP originating in the private business sector would be more than $17 billion higher (in constant dollars) than otherwise. The additional output, employment, and income would generate additional Federal revenues at least equal to the "initial impact" revenue loss.

The Nation's Surging Capital Requirements

The most critical challenge facing the U.S. economy is to increase substantially the share of GNP which is saved and invested. This increase is essential if we are to maintain at least the postwar trend rate of increase in employment, productivity, and real wage rates, while meeting a wide range of government-imposed demands for capital to advance the Nation's housing standards, protect the environment, achieve a substantially higher degree of energy self-sufficiency, expand and improve mass transit systems, etc. All of these objectives impose demands for allocating a larger share of our total production

capacity and output to capital formation.

Tax Changes Needed to Increase Saving

Since there must be a dollar of saving for every dollar of capital outlay, meeting these surging capital demands will require a substantial increase in the proportion of GNP which is saved compared to that which is consumed or used by government. Attaining a higher rate of saving and capital formation will require reducing the bias in the existing tax system against private saving and investment compared to consumption. Finding appropriate means for moderating this anti-saving tax bias is the most critical challenge facing the Congress. It cannot be emphasized strongly enough that if appropriate changes in the tax system are not made, hence, if the private saving and investment rate is not materially increased, the principal cost will be inadequate growth in jobs, productivity, and real wage rates.

Diversity of Demands for Capital

There is an understandable inclination to think of increases in capital formation solely in terms of fixed investment---plant, machinery, and equipment. To be sure, capital in this form constitutes a substantial part of the total stock of capital, and more rapid growth in fixed capital is an integral part of the overall requirements for accelerating capital formation. Making permanent an increased investment tax credit and reducing the capital recovery periods for depreciable assets, therefore, are highly constructive measures.

These are not, however, the only tax revisions which should be undertaken. Of equal urgency are more broadly applicable tax changes to allow all

business and individual taxpayers to increase their saving in order to meet the highly diverse demands for capital throughout the economy.

Merchant Wholesaler-Distributors' Capital Demands

The prospective surge in the Nation's capital requirements is not confined to goods producing, energy, transportation, and utility industries. Expanding manufacturing capacity and output necessarily requires increases in the capacity of merchant wholesaler-distributors to distribute these goods to users. The capital requirements of merchant wholesaler-distributors, therefore, will expand at least as rapidly as those of the rest of the business sector. Failure to satisfy these requirements will significantly impair the efficiency, hence raise the costs, of the wholesale function of collecting and distributing the myriad variety and huge number of manufactured products to the enormous number of buyers of these products.

Merchant Wholesaler-Distributors Depend on Retained Earnings

For merchant wholesaler distributors, growth in capacity depends far more on growth in working capital than on expansion of fixed capital. These companies, preponderantly small to medium sized and closely held, have extremely limited access to the capital markets for equity financing of their expanding capital requirements. They must depend very largely on short-term borrowing and on internally generated funds, only a relatively small portion of which can be provided by depreciation allowances. Prudent financing of their expanding capital requirements makes them highly dependent on retained net profits. This dependency is reflected in the fact that for many years past, merchant wholesaler-distributor corporations have retained and invested in productive assets 80 per-

cent of their after-tax profits, a far higher ratio than that for all corporations.

Increase the Corporation Surtax Exemption to $100,000

If merchant wholesaler-distributors are to be able to finance the additional capital they will need to provide the wholesale distribution services the economy will require, their internally generated saving will have to increase at an accelerated rate. To meet this objective with a minimum loss of Federal revenues, the corporation surtax exemption should be increased to $100,000 on a permanent basis. At 1975 levels of economic activity, we estimate that this surtax exemption increase would result in an "initial impact" revenue loss of about $2 billion. By far the largest proportion, about 60 percent, of these tax savings would be realized by corporations with net incomes of $100,000 or less. It must be emphasized that this revenue estimate unrealistically assumes no change in the volume of economic activity resulting from the tax reduction and consequent increase in business saving and capital formation. Taking these responses into account, a substantial net revenue gain would be realized.

Economic Effects of Increasing Surtax Exemption

The proposed increase in the surtax exemption would result in a significant increase in employment. Based on historical relationships, we estimate that the increase in business investment and output resulting from the increase in the surtax exemption would increase full time equivalent employment by 720,000 and total real wages and salaries by about $10 billion by 1977. Total business sector output would be $17.2 billion greater than otherwise. These increases in output, employment, and income would result in additional Federal revenues more than offsetting the "initial impact" reve-

nue loss; by 1977, a net revenue gain of $3 billion would be realized.

Meeting the Nation's saving and capital requirements will require a large number of tax revisions. We respectfully submit that increasing the corporate surtax exemption to $100,000 is high on the list of tax changes appropriate to this end.

TAX REVISIONS AND THE NATION"S CAPITAL FORMATION GOALS

The Current Focus of Tax Policy

Earlier this year, massive individual and business income tax reductions were enacted, aimed at arresting the recession and promoting economic recovery. There are now numerous indications that the recovery phase is well underway.

The possibility of false signs, of course, must not be discounted, nor should the Congress, the Administration, and the monetary authorities relax their concerns over the present high rate of unemployment and the underutilization of production capacity. Notwithstanding these cautions, shifting the focus of tax policy from these concerns to the long-range requirements of the U.S. economy is timely, indeed urgent.

The basic long-range problem facing the economy is whether we can accumulate sufficient capital to provide both for maintaining---if not accelerating---the postwar average rate of increase in productivity and real wage rates and rapidly expanding government-imposed demands on total production capacity.

From 1947 through 1973, the number of full-time equivalent employees in the business sector increased at an average annual rate of 1.5 percent, while their productivity and real wage rates advanced, on the average, by 2.3 percent a year. This increase in jobs, productivity, and real wage rates was related to an average annual

rate of increase in the net stock of capital of 4.3 percent and in the ratio of capital to labor inputs of 2.7 percent a year. It is this increase in the amount of capital with which employees work, along with advances in the state of the industrial arts, which principally determines the pace of improvement in workers' productivity, hence their real wage rates. Maintaining at least this trend rate of increase in jobs and real wage rates means that, in constant 1974 dollars, the total stock of capital in the business sector will have to increase by about $675 billion through 1985; this will require capital outlays of about $2.4 trillion.

Substantial additional amounts of capital formation, however, will be required to meet public and private demands for housing, to achieve environmental protection goals, to attain some substantial degree of energy self-sufficiency, to improve and expand mass transit systems, to provide safer and healthier working conditions for labor, and to realize a wide range of other objectives set by the political processes in the Nation.

Every dollar of capital outlay, of course, must be matched by a dollar of saving. On very conservative assumptions about the magnitude of these total capital requirements---those determined in the private-market place plus those imposed by public policies---and of government budget deficits, and about the rate of inflation, the private sector's saving will have to finance a total of $4.3 trillion through 1985.

At the implied rate of growth of GNP, meeting these saving targets will require a 12.7 percent increase in the fraction of GNP saved by the private sector, from the postwar average of 15.68 percent to at least 17.67 percent. With more realistic assumptions about inflation and the magnitude of government-mandated

62-209 O - 76 - 32

capital requirements, the required increase in the private saving rate is far more substantial, 15 percent or more greater than the postwar average. Indeed, even the most conservative estimate of the required private saving rate significantly exceeds the highest rate achieved in any postwar year.

What will happen if private saving does not increase sufficiently? Clearly, some capital formation will have to be foregone. If government requirements and demands are not relaxed, a smaller amount of capital will be added in the form which contributes directly to increasing productivity and output. The consequence will be a slower rate of growth of jobs and real wage rates.

Solving the capital shortage problem, about which the Committee has heard at length, is a primary concern for all Americans, not merely business. Indeed, since the labor share of our total national income is three times that of the capital share and since the increase in labor income depends fundamentally on increasing the amount of capital with which labor is employed, the capital shortage problem is---or should be---of even greater concern to labor than to those who own the capital.

As indicated, resolving the capital shortage problem will require a substantial increase in the private saving rate. That increase will not occur automatically. Providing a tax climate in which individuals and businesses will want to and will be able to save a larger fraction of their incomes is the most urgent challenge facing tax policy today.

The present tax system is heavily biased against private saving and investment and in favor of consumption. Analysis of the economic record shows

that business and personal saving and investment are highly sensitive to tax changes which increase or decrease the weight of the anti-saving tax bias. Tax policy today, therefore, faces not only a serious challenge but major opportunities to ease the extra tax burden on saving compared with consumption and to deal vigorously and effectively with the problem of capital inadequacy.

Emphasis Has Been On Depreciable Assets

In the past, the Congress has on occasion perceived the desirability of reducing tax impediments to private saving and investment and has enacted a variety of tax measures to this end. For the most part, however, these measures have been directed primarily toward increasing capital outlays for depreciable facilities. This emphasis is understandable; most of us are inclined to think of capital principally in the form of fixed investment in manufacturing plants, other industrial structures, machinery, and equipment. To be sure, these production facilities constitute a substantial part of the total stock of capital; more rapid growth in fixed capital is an important part of the overall requirements for accelerating capital formation.

The investment credit, accelerated depreciation, the guideline life system, and the ADR have been highly constructive measures in moderating the anti-saving and anti-investment tax bias. By the same token, such tax revisions as increasing the investment credit, on a permanent basis, and extending the ADR to, say, 40 percent, would contribute significantly to the solution of the capital shortage problem. The National Association of Wholesaler-Distributors endorses and vigorously supports such progressive measures in the interests of expanding jobs, output, and

real wage rates not only in the near future but over the long term as well.

Diversity of Demands for Capital

These tax revisions, however, do not exhaust the far larger list of tax changes which should be undertaken in pursuit of these objectives. Of equal importance are more broadly applicable tax revisions to allow all business and individual taxpayers to increase their saving and investment in order to meet the highly diverse demands for capital throughout the economy.

The surge in the Nation's capital requirements is not selective. The capital shortage problem is not confined to this or that industry. Urgent as are the demands for more rapid capital formation in the goods producing, energy, transportation, and utility industries, there are equally urgent requirements for a higher rate of capital additions in all of the major sectors of the economy. And since the character and form of the capital required varies from industry to industry, all sorts of additional capital, not solely plant and equipment, are required.

The high degree of interdependence of all parts of the business sector is so commonplace a fact that we tend to ignore it. Surely, however, it must be clear that focusing solely on the expansion of one sector or one type of capital formation while failing to provide for or restricting expansion of others reduces overall economic efficiency. Expanding output of raw agricultural products, for example, without a commensurate increase in capacity to transport this output to the markets in which it has the greatest value obviously reduces the overall productivity of the agricultural sector. For precisely the same reasons, it should not be overlooked that expanding production capacity and output of manufactured goods increases the

capacity required by merchant wholesaler-distributors to perform their essential function.

Importance of Merchant Wholesaler Distributors to the Economy

Most of us probably seldom give a thought to the critical role of merchant wholesale distribution in advancing the economy's overall productivity and living standards. The more than 500,000 merchant wholesaler-distributors, while only about 4 percent of the U.S. business population, perform an enormously complex function of mobilizing a substantial proportion of the myriad number and enormous volume of manufactured products for allocation to the millions of retail outlets selling these products and to the hundreds of thousands of other business customers. Over the 10-year period 1964-1973, merchant wholesaler-distributors collected and distributed between 27 percent and 32 percent of the total output of the manufacturing sector. In 1973 over $270 billion of manufactured products were sold to merchant wholesaler-distributors. (Table 1)

Another measure of the importance of the merchant wholesaler-distributor function is the volume of manufactured products distributed by merchant wholesaler-distributors to retail purchasers. As shown in Table 2, in the 10-year period 1964-1973 merchant wholesaler-distributors' sales ranged from 86 to 97 percent of the total volume of goods acquired by retailers. Since about 50 percent of wholesale sales are to non-retailer and non-household purchasers, the annual percentages shown in the table overstate the proportions of retailers' purchases accounted for by purchases from merchant wholesaler-distributors. Of their total purchases, retailers' purchases from merchant wholesaler-distributors ranged during the 10-year

Table 1
Percent of Manufacturers' Total Sales
Distributed by
Merchant Wholesaler-Distributors

(dollar amounts in billions)

Year	Manufacturers' Sales		
	Total	To Merchant Wholesaler-Distributors	Sales to Merchant Wholesaler-Distributors As Percent of Total
1964	448.0	132.7	29.6
1965	492.0	142.4	28.9
1966	538.4	154.7	28.7
1967	557.4	153.4	27.5
1968	603.4	162.5	26.9
1969	642.7	173.8	27.0
1970	634.3	179.6	28.3
1971	671.0	194.8	29.0
1972	749.6	216.8	28.9
1973	856.8	273.3	31.9

Source: U.S. Department of Commerce, Survey of Current Business.

Table 2
Merchant Wholesaler-Distributors' Sales as Percent of Retailers' Total Purchases

(dollar amounts in billions)

Year	Retailers' Total Purchases	Merchant Wholesaler-Distributors' Sales	
		Amounts	Percent of Retailers' Purchases
1964	198.6	174.3	87.8
1965	216.6	187.1	86.4
1966	231.0	203.8	88.2
1967	235.7	205.2	87.1
1968	255.6	219.9	86.0
1969	264.3	236.7	89.6
1970	276.1	246.6	89.3
1971	299.5	267.4	89.3
1972	331.4	298.2	90.0
1973	376.0	364.9	97.0

Source: U.S. Department of Commerce, Survey of Current Business

period from about 43 percent to 48½ percent.

It is obvious that manufacturers distribute so huge a volume of output through merchant wholesaler-distributors only because they can and do perform this distribution function more efficiently, i.e., at a lower cost, than manufacturers could themselves. By the same token, it is clear that retailers acquire so much of their inventories from merchant wholesaler-distributors only because it would be more costly for them to purchase directly from manufacturers. If merchant wholesaler-distributors are unable to expand their capacity and increase the productivity of their work force at least in line with the expansion of manufacturing output, the ultimate costs of manufactured products to their

final purchasers will have to increase above the levels that would otherwise prevail.

The increasing value which the economy as a whole places on the specialized distribution function performed by merchant wholesaler-distributors is shown in Table 3. The value added by merchant wholesaler-distributors to the total value of goods and services produced by the business sector of the economy has increased quite steadily over the 10-year period 1964-1973, from about 7.5 percent in the mid-sixties to 8.4 percent in 1973. In 1971, the 515,321 merchant wholesalers represented only 4.2 percent of the total number of U.S. businesses, yet they accounted for 8.2 percent---almost twice as large a proportion---of total GNP originating in the business sector.

Over half of merchant wholesaler-distributors' gross product is employee compensation, about the same proportion as for the entire business sector (Table 4). In contrast with the rest of business, however, indirect business taxes (primarily sales and excise taxes) represent a sizeable portion of merchant wholesaler-distributors' value added, about one-fourth compared with about one-ninth for all business. And while merchant wholesaler-distributors' capital consumption allowances on fixed assets have been a rising fraction of the industry's gross product, it is less than half the ratio for all business.

Profits are a Small Share of Merchant Wholesaler-Distributor's Gross Product and Sales

Of particular importance is the fact that profit-type income [1/] is a substantially

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1/ Profit-type income, as measured in the National Income Accounts, consists of pre-tax corporate profits after inventory valuation adjustment, proprietors' income, and rental income of persons

Table 3
Merchant Wholesaler-Distributors'
Gross Product*

(dollar amounts in billions)

Year	Wholesaler-Distributors Gross Product	Sector Gross Product	Merchant Wholesaler-Distributors' Gross Product as Percent of Total Business Sector
1964	41.6	548.2	7.6
1965	44.7	594.4	7.5
1966	49.1	648.9	7.6
1967	51.8	681.6	7.6
1968	57.4	739.0	7.8
1969	62.9	794.1	7.9
1970	67.0	827.0	8.1
1971	72.6	890.5	8.2
1972	81.4	977.9	8.3
1973	91.6	1,096.8	8.4

* Gross product is equal to the gross national product originating in or gross value added by the industry of sector.

Source: U.S. Department of Commerce, Survey of Current Business.

Table 4
Percent Distribution of Gross Product
by Components of Gross Product

A. Merchant Wholesaler-Distributors

Year	Indirect Business Taxes	Capital Consumption Allowances	Employees Compensation	Net Interest	Profit-Type Income
1964	23.8	4.3	53.4	0.7	17.8
1965	24.6	4.3	53.5	0.7	16.8
1966	24.8	4.3	53.4	0.8	16.7
1967	25.1	4.4	54.2	0.8	15.4
1968	26.0	4.4	53.3	0.9	15.5
1969	26.1	4.5	53.7	1.0	14.9
1970	26.6	4.5	54.5	0.9	13.6
1971	28.1	4.4	53.4	0.8	13.1
1972	26.8	4.8	52.3	0.9	15.2
1973	26.3	4.8	51.7	1.0	16.2

B. Total Business Sector

Year	Indirect Business Taxes	Capital Consumption Allowances	Employees Compensation	Net Interest	Profit-Type Income
1964	11.1	10.2	50.8	2.9	24.5
1965	11.0	10.1	50.2	3.1	25.2
1966	10.6	9.8	50.7	3.3	24.7
1967	10.8	10.1	51.1	3.6	23.3
1968	11.1	10.1	51.6	3.6	22.4
1969	11.3	10.3	53.0	3.8	20.8
1970	11.7	10.5	53.5	4.4	18.9
1971	12.0	10.5	52.9	4.7	18.9
1972	11.7	10.5	53.0	4.7	19.2
1973	11.3	10.1	52.8	4.8	20.3

Source: U.S. Department of Commerce, Survey of Current Business.

smaller share of the merchant wholesaler-distributor's gross product than in business generally. This income component of merchant wholesaler-distributors fell from 17.8 percent of gross product in 1964 to 13.1 percent in 1971 before recovering to 16.2 percent in 1973. For the entire business sector, profit-type income declined from about 25 percent of gross business product in the mid-1960's to 18.9 percent in 1971, recovering to 20.3 percent in 1973. Including capital consumption allowances, gross returns on capital are also consistently a substantially smaller share of the industry's gross product than is the case for the entire business sector. For merchant wholesaler-distributors, profit-type income plus capital consumption allowances ranged from a low of 17.5 percent to a high of 22.1 percent of gross product; for the total business sector, the ratio ranged from a low of 29.4 percent to a high of 35.3 percent. (Table 4)

Merchant wholesaler-distributors' before-tax profits are also consistently a smaller fraction of sales than in the case of the total business sector. Per dollar of sales (business receipts), profits are consistently less in the merchant wholesale-distribution industry than in all industries taken together. (Table 5)

The relatively small profit-type income share of the sales dollar and of gross product in merchant wholesale distribution takes on particular significance in view of (a) the type of assets upon which growth in the capacity of these companies depend and (b) the constraints on these companies in financing their capital additions.

Wholesalers' Growth Depends on Growth in Working Capital

A very large proportion of the growth in merchant wholesaler-distributors' capacity to perform their distribution function depends on the increase in their

Table 5

Profits Before Tax as a Percent of Business Receipts
1964 - 1971*

Year	Merchant Wholesale-Distribution	All Industries
1964	2.80	7.52
1965	2.77	8.00
1966	2.79	8.01
1967	2.71	7.59
1968	2.88	7.57
1969	2.76	6.63
1970	2.54	5.59
1971	2.95	5.92

*Profits of incorporated and unincorporated businesses.

Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income, Business Income Tax Returns.

inventories and other current assets. As Table 6 shows, over the 10 year period from 1960 through 1970, more than 27 percent of the increase in the total assets of the average merchant wholesaler-distributor corporation consisted of increases in inventories; an additional 28 percent consisted of increases in accounts receivable, notes receivable and cash. More than 55 percent, in other words, of their total asset growth consisted of relatively quick assets. For the average of all corporations, in contrast, only 5.7 percent of the increase in total assets was accounted for by inventories; the growth in quick assets was only 34.8 percent of the increase in total assets. 1/

1/ These data are limited to corporations since balance sheet information is not available for unincorporated businesses.

Table 6

Increase in Assets and Sources of Saving for the Average Merchant Wholesaler-Distributor Corporation and the Average of All Corporations
1960 - 1970

(dollar amounts in thousands)

	Merchant Wholesaler-Distributor Corporations		All Corporations	
	Amount	(Percent)	Amount	(Percent)
Increase in Gross Assets	167.1	100.0	594.4	100.0
Current:	92.0	55.1	206.7	34.8
Cash, Notes, & Accounts Receivable	46.8	28.0	172.8	29.1
Inventories	45.2	27.1	33.9	5.7
Fixed Assets, Investments, and All Other Assets	75.2	45.0	387.6	65.1
Increase in:				
Total Liabilities	115.4	69.1	430.6	72.4
Capital Stock and Paid-in Surplus	8.7	5.2	57.5	9.7
Internal Funds (Earned Surplus and Capital Recovery Reserves)	43.0	25.7	106.3	17.9
Total	167.1	100.0	594.4	100.0

Source: Department of the Treasury, Internal Revenue Service, *Statistics of Income: Corporation Income Tax Returns*.

In the very nature of their business, merchant wholesaler-distributors' expansion of sales depends on the increase in their inventories to a far greater extent than in most other businesses. Businesses whose output and sales depend more on fixed assets enjoy substantial latitude in timing the acquisition of additional facilities without significant near-term impact on output and sales volume. In contrast, increases in inventories by merchant wholesaler-distributors cannot be deferred to any significant degree without quickly reducing sales. Very much the same is true with regard to accounts receivable. Virtually all of merchant wholesaler-distributors' sales are made on open trade account, with an estimated average duration of 40 to 45 days for such credit extended to customers. Accounts receivable, therefore, must increase in lock step with an increase in sales. Financing these accounts receivable, of course, imposes costs on merchant wholesaler-distributors, since for the most part, no explicit interest or service charges are imposed on customers for the credit provided them. The increasing physical volume and rising costs of their inventories and the increasing costs of financing their trade credit imposes continuing pressures on merchant wholesaler-distributors, therefore, to plow back the largest possible proportion of their net cash flow into financing their working capital requirements.

Merchant Wholesaler-Distributors Are Highly Dependent on Retained Earnings

To a substantially greater extent than most other businesses, merchant wholesaler-distributors must depend on internally generated funds. The companies are preponderantly closely-held, small to medium size companies. As shown in Table 7, almost 70 percent of merchant wholesaler-distributor corporations in 1970 had total assets less than $250,000; the average amount of total assets for these

corporations amounted to about $509,000.

Table 7

Distribution of Merchant Wholesaler-Distributor Corporations
by Size of Total Assets, 1970

Asset Size Class	Number of Returns	Percent
Under $250,000	115,509	69.8
$250,000 under 500,000	24,387	14.7
500,000 under 1,000,000	14,009	8.5
1,000,000 under 10,000,000	10,959	6.6
10,000,000 under 50,000,000	608	0.4
50,000,000 under 100,000,000	53	*
100,000,000 and over	50	*
Total	165,575	100.0

*Less than 1/2 of 1 percent

Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income-Corporations Income Tax Returns.

As small to medium size, closely held companies, merchant wholesaler-distributor corporations' access to the capital markets for equity financing of their expanding capital requirements is highly limited. Table 6 shows that the increase in capital stock and paid-in surplus between 1960 and 1970 represented only 5.2 percent of the average merchant wholesaler-distributor corporation's increase in gross assets; for the average of all corporations, new equity financing amounted to 9.7 percent of the increase in gross assets. Internal funds, i.e., retained earnings and capital recovery allowances, on the other hand, provided 25.7

percent of the increase in total assets of the average merchant wholesaler-distributor, compared with 17.9 percent for the average of all corporations.

Since depreciable assets are a relatively small fraction of their total assets, merchant wholesaler-distributor corporations derive a far smaller part of their net cash flow from capital recovery allowances than do other corporations. In 1971, these allowances were 53.8 percent of internal funds for merchant wholesaler-distributors; in sharp contrast, capital recovery allowances were 78.9 percent of net cash flow for all corporations in that year (Table 8) Merchant wholesaler-distributors, accordingly, must rely on retained earnings to a considerably greater extent than corporations generally. To this end, their dividend payout policies are highly restrictive in comparison with that of all corporations. As Table 8 shows, merchant wholesaler-distributor corporations paid out only 25.2 percent of their after-tax net incomes [1/] in 1971, compared with 60.7 percent by all corporations that year. Over an extended period of years, merchant wholesaler-distributor corporations have had to retain and reinvest in productive assets a far higher proportion of after-tax incomes than other corporations.

Although merchant wholesaler-distributors retain so high a fraction of their after-tax earnings, their outlays other than for additions to working capital and fixed assets are smaller in relation to their sales than in the case of all corporations. As Table 9 shows, merchant wholesaler-distributor corporations' deductions for compensation of officers, contributions to pension

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1/ Profits after tax and after inventory valuation adjustment. Ignoring the inventory valuation adjustment, the payout rate was about 80 percent.

Table 8

Pretax Net Income, Income Taxes, Dividends, and Cash Flow, Merchant Wholesaler-Distributor and All Corporations, 1971

(dollar amounts in billions)

	Merchant Wholesaler-Distributors	All Corporations
Pretax net income*	4.5	78.7
Corporate profits tax	2.2	37.5
(Percent of pretax net income)	(50.5)	(47.6)
Net income after tax	2.2	41.2
(Percent of pretax net income)	(49.5)	(52.4)
Dividends	.6	25.0
(Percent of net income after tax)	(25.2)	(60.7)
Retained earnings	1.7	16.2
(Percent of net income after tax)	(74.8)	(39.3)
Capital recovery allowances	1.9	60.4
Net cash flow	3.6	76.8
(Percent: Retained earnings	(46.2)	(21.1)
Capital recovery allowances	(53.8)	(78.9)

*Profits after inventory valuation adjustment.

Source: U.S. Department of Commerce, Survey of Current Business.

Note: Percentages calculated from unrounded numbers.

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Table 9

Selected Business Deductions as Percent of Business Receipts, Merchant Wholesaler-Distributors and All Corporations, 1970

Deduction	Percent of Business Receipts	
	Merchant Wholesaler-Distributor	All Corporations
Compensation of officers	1.8	2.0
Pension, profit-sharing, stock bonus, annuity plans	0.2	0.8
Other employee benefit plans	0.1	0.5
Other deductions*	10.3	15.3

*Includes administration, general, and selling expenses, bonuses and commissions, travel and entertainment expenses, salaries and wages not reported as cost of sales, and miscellaneous items.

Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income-Corporated Returns.

and profit sharing plans, other employee benefit plans, and so forth are significantly smaller fractions of business receipts than in the case of all corporations. The explanation for their high rate of retained earnings is not to be found in merchant wholesaler-distributors' use of business financial resources to pay inordinately high salaries or other compensation for stockholder-officers. The explanation, instead, lies in the facts cited above---their limited access to external sources of funds, the relatively small contribution of depreciation allowances to their net cash flow, and the continuing financial pressures they encounter in meeting the rising costs of their inventory and working capital requirements.

Of signal importance in merchant wholesale distribution, as noted above, is the extent to which these businesses finance their customers' purchases through the extension of open account credit. As Table 10 shows, the ratio of accounts and notes receivable to sales is very close to 100 percent each year from 1960 through 1970 (the latest year for which data are available). By far the largest proportion of the total of the receivables are accounts receivable, on which, of course, no interest is earned. Merchant wholesaler-distributors, therefore, provide credit financing at zero interest expense to their customers, for virtually the entire amount of their annual sales.

To be sure, merchant wholesaler-distributors are also the beneficiary of open trade credit extended to them by their suppliers. Table 11 shows, however, that merchant wholesaler-distributors incur a substantial net amount of implicit interest costs, that is, the amount of the interest income they forego by extending open trade credit to their customers exceeds the amount of interest expense they do not incur on the open trade credit extended to them by their suppliers. Moreover, merchant wholesaler-distributors make substantial interest payments on the notes payable and other short-term loans they obtain to help finance their working capital requirements.

In periods of stable conditions in financial markets, with relatively low interest rates, the net real costs incurred by merchant wholesaler-distributors in financing their customers' purchases may be accomodated as an expected and customary cost of doing business. On the other hand when financial conditions are highly unstable and subject to substantial inflationary pressures, as in

Table 10

Trade Credit and Sales, Merchant Wholesaler-Distributor Corporations, 1960-1970

(dollar amounts in millions)

Year	Notes and Accounts Receivable[1/]	Sales (Business Receipts)	Ratio of Receivables to Sales
1960	130,834	130,637	1.002
1961	138,308	130,588	1.059
1962	-	-	-
1963	149,268	145,810	1.024
1964	156,304	157,538	.992
1965	175,623	171,414	1.025
1966	185,879	182,166	1.020
1967	179,179	182,687	.981
1968	211,305	204,042	1.036
1969	233,846	229,181	1.020
1970	239,944	234,885	1.022

[1/] Annual volume of notes and accounts receivable, assuming accounts are outstanding an average of 42.5 days.

Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income-Corporations Income Tax Returns.

Table 11

Net Interest Income Foregone and Interest Expense of Merchant Wholesaler-Distributor Corporations, 1960-1970
(dollar amounts in millions)

Year	Interest Income Foregone on Accounts Receivable[1/]	Accounts Payable	Interest Expense not Incurred on Accounts Payable[1/]	Net Interest Income Foregone	Mortgages and Notes Payable in Less Than One Year	Interest Expense on Mortgages and Notes Payable	Interest Foregone Plus Interest on Short-term Debt
1960	670	9,986	439	231	4,853	214	445
1961	593	10,510	387	206	5,144	189	395
1962	-	-	-	-	-	-	-
1963	706	11,284	459	247	5,529	224	471
1964	910	12,298	615	295	6,249	312	607
1965	983	14,087	677	306	7,440	358	664
1966	1,259	15,422	897	362	8,325	485	847
1967	1,249	14,669	878	371	8,497	509	880
1968	1,643	17,158	1,146	497	10,167	679	1,176
1969	2,235	19,733	1,620	615	11,815	970	1,585
1970	2,369	20,351	1,726	643	13,109	1,112	1,755

[1/] Computed using the average annual rate on short-term business loans from U.S. Department of Commerce, Survey of Current Business.

Source: U. S. Treasury Department, Internal Revenue Service, Statistics of Income-Corporation Income Tax Returns.

recent years, the implicit net costs incurred by merchant wholesaler-distributors in extending so large a volume of non-interest bearing trade credit become a matter of significant concern. In such circumstances, interest rates, particularly those on short-term obligations, tend to rise sharply. The foregone interest revenue on any given amount of accounts receivable, therefore, also escalates (as does the interest expense they do not incur on their accounts payable). So, too, does their actual interest payments on the substantial amount of their short-term borrowing. On balance, therefore, these companies face sharply rising net interest costs on (1) the excess of their accounts receivable over their accounts payable and (2) their short-term borrowing.

In view of the fact that growth in their capital requirements, to a substantially greater extent than in corporations generally, takes the form of additions to inventories, accounts receivable, and other current assets, merchant wholesaler-distributor corporations derive less financial assistance from tax provisions affecting fixed depreciable assets than do corporations in general. Given their substantial dependence on retained earnings to finance their increasing capital requirements, merchant wholesaler-distributor corporations must look primarily to the growth of pretax net income as a percent of sales and to the Federal income tax bite out of that net income. Yet as Table 12 shows, merchant wholesaler-distributor corporations' pretax net income has consistently been a smaller proportion of the sales dollar than is the case for all corporations. Out of that smaller share, corporate income taxes have consistently taken a larger fraction than from all corporations. Thus, even though merchant wholesaler-distributor corporations' dividends are, as already

Table 12

Pretax Net Income*, Income Taxes, Dividends, and Retained Earnings Per Dollar of Sales, Merchant Wholesaler-Distributor and All Corporations, 1964-1973

(Cents per dollar of sales)

Year	Pretax Net Income		Income Taxes		Dividends		Retained Earnings	
	Wholesale	All	Wholesale	All	Wholesale	All	Wholesale	All
1964	2.0	6.9	0.8	2.9	0.2	1.9	1.0	2.1
1965	2.0	7.2	0.9	3.0	0.3	1.9	0.8	2.4
1966	2.1	7.1	0.9	3.0	0.3	1.8	0.9	2.4
1967	2.0	6.5	0.9	2.7	0.3	1.8	0.9	2.0
1968	2.0	6.4	1.0	3.0	0.3	1.8	0.8	1.6
1969	1.9	5.4	1.0	2.7	0.2	1.7	0.7	1.0
1970	1.8	4.5	0.9	2.3	0.2	1.6	0.6	0.6
1971	1.7	4.8	0.9	2.3	0.2	1.5	0.6	1.0
1972	1.9	5.0	0.9	2.2	0.2	1.5	0.9	1.3
1973	1.8	4.8	0.9	2.3	0.2	1.4	0.7	1.2

*Pretax net income is corporate profits before tax after inventory valuation adjustment.

Source: U.S. Department of Commerce, Survey of Current Business.

noted, a far smaller share of their after-tax income, their retained earnings per dollar of sales are substantially less than for all corporations. Merchant wholesaler-distributor corporations can hardly look to an increase in pretax net income per dollar of sales as a source of the additional saving they require. And, clearly, there is little opportunity for these companies to increase their saving by reducing their dividend pay-out rates. Increasing their financial capacity to meet their expanding capital requirements, accordingly, will depend significantly on reducing the Federal income tax.

Prospective Capital Shortfall

Over the 24-year period, 1947 to 1971, merchant wholesaler-distributor corporations' net cash flow (i.e., retained earnings plus depreciation) has increased on the average by 6.0 percent a year. The adequacy of continuing growth in cash flow at this rate obviously depends on the rate of expansion of these corporations' demands for capital. If cash flow growth lags behind the increase in capital required by the industry to keep pace with the business sector, either merchant wholesaler-distributors will have to rely increasingly on borrowing to finance their capital requirements or their growth in capacity will fall short of the demands on it from the rest of business. Since these companies must rely primarily on short-term borrowing and since the costs of such borrowing tend to rise faster than the general level of prices in inflationary periods, increasing dependency on borrowing to meet their capital requirements is particularly precarious and costly to merchant wholesaler-distributors.

In either event, whether they turn more to borrowing or their capacity growth

lags, the result would be a slower growth in productivity and efficiency for merchant wholesaler-distributors, hence rising unit costs of wholesale distribution operations, to the detriment of the economy as a whole.

On the basis of the increasing ratio of merchant wholesaler-distributors' gross business product to total business product, the industry's capital requirements are estimated to increase at an average annual rate of 4.9 percent through 1985. Since this estimate is measured in constant dollars, it is highly conservative; it takes no account of any possible --- indeed, probable --- increase in the general level of prices, hence of the likelihood that inflation will increase capital requirements more rapidly than over the past decade. If inflation is projected at even the moderate rate of 3.0 percent a year (compared with the actual average annual rate of 5.8 percent from 1969 through 1974), the industry's capital requirements are estimated to grow at a rate of 7.9 percent annually, substantially faster than the projected growth in its internal funds. With a higher inflation rate, e.g., 5.8 percent, the industry's capital requirements are projected to grow at an annual rate of 10.7 percent. The capital shortfall is, prospectively, even larger.

In the light of these projected capital requirements, the dependence of merchant wholesaler-distributors on retained net profits, and the estimated inadequacy of the growth in retained earnings, it is obvious that the industry is most unlikely to be able to meet its growing demands for capital unless Federal income taxes are reduced.

Economic Effects of Increasing the Surtax Exemption

The NAW respectfully submits that the most efficient way to effect this

reduction in the corporation income tax is by increasing the surtax exemption. Specifically, NAW urges that the corporation surtax exemption be increased to $100,000, on a permanent basis.

At estimated 1975 levels of economic activity, this increase in the surtax exemption would result in an "initial impact" revenue loss of about $2 billion. As shown in Table 13, by far the largest proportion, almost 60 percent, of these tax savings would be realized by corporations with net incomes of $100,000 or less. Moreover, the increase in after-tax net earnings would be proportionately far greater for small and medium size companies than for very large corporations,

Table 13

Distribution of Tax Saving from Increasing Surtax Exemption to $100,000, All Corporations, by Net Income Classes, 1975

Net Income Class	Tax Saving	
	Amount	Percent of Total
under $50,000	418,204	20.0
$50,000 under $100,000	796,283	38.0
$100,000 under $250,000	520,280	24.8
$250,000 under $1,000,000	267,638	12.8
$1,000,000 and over	93,717	4.5

as Table 14 shows. Since small and medium size companies are generally more dependent than large companies on retained earnings to finance their capital outlays, the indicated distributions of tax savings and of percent increases in after-tax net income shows that the proposed increase in the surtax exemption is particularly suitable to the needs of such companies.

Table 14

Percent Increase in After-tax Net Income From $100,000 Surtax Exemption, by Net Income Classes, 1975

Net Income Class	Percent Increases in After-tax Net Income
under $50,000	5.3
$50,000 under $100,000	27.0
$100,000 under $250,000	12.9
$250,000 under $1,000,000	4.4
$1,000,000 and over	.2

The "initial impact" revenue estimate, it must be emphasized, is based on the wholly unrealistic assumption that there is no change in the volume of economic activity resulting from the proposed increase in the surtax exemption and the consequent increase in private saving and capital formation . Even on very conservative assumptions about the responsiveness of the amount of private saving to the reduction in its cost from increasing the surtax exemption, however, substantial increases in jobs, wages and salaries, and other income must be expected.

On the basis of the postwar relationships among increases in the stock of capital, full-time equivalent employment, total output, productivity, and real wage rates in the business sector, it is estimated that the increase in the surtax exemption to $100,000 would result in a 1.2 percent increase in full-time equivalent jobs in the business sector. At the present trend rate of increase in business sector employment, the increase in full time equivalent employment in 1977 would

be about 720,000.

Associated with the increase in jobs and in capital, business sector gross product would be $17.2 billion greater (in 1974 prices). Total employee compensation in the business sector would also rise above the amount projected without the surtax exemption increase; ignoring inflation, real wages and salaries would be about $10 billion more. The resulting increase in Federal tax revenues would more than offset the "initial impact" revenue loss and generate a net revenue gain of about $3 billion in 1977. 1/

Conclusion

One of the difficult facts of political life with which the Congress must continuously deal is that any proposal to make private saving and capital formation relatively less costly is characterized as a "loophole", a "tax expenditure", a tax "break", for business or for upper bracket individuals.

It is, one must acknowledge, difficult to get past these pejoratives to the analytical substance of what we may reasonably expect to result from such tax revisions. But if we carefully examine the Government's national income accounts, we find that employee compensation represents a highly stable share of total national income over an extended period of years. A solid inference to be drawn from these data is that for every additional dollar of capital the economy accumulates, it gets about four additional dollars of wages and salaries.

However imbalanced a tax proposal may be made to seem in terms of who

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1/ The derivation of these estimates of the effects of increasing the surtax exemption is described in the attached appendix.

gets the "initial impact" tax saving, it is essential to look beyond to the ultimate effects on national income and the labor share thereof. This perception, I believe, affords a far more constructive way of examining tax proposals. In this context, the proposal to increase the surtax exemption to $100,000 warrants favorable consideration as an effective means not only for dealing with the urgent capital demands of U.S. business but for more rapidly advancing the productivity and compensation of U.S. labor, as well.

Appendix
Procedures for Estimating the Economic Effects of Increasing the Surtax Exemption to $100,000

The enactment of an increase in the corporation surtax exemption to $100,000, proposed by the National Association of Wholesaler-Distributors, would by the end of 1977 increase the business sector's GNP by more than $17 billion (measured in 1974 dollars), add about 720,000 new jobs, and generate increases in Federal tax revenues which would more than offset the "initial impact" revenue loss.

The quantitative analysis which produces these estimates begins with a determination of the effect of the increase in the surtax exemption on the cost of capital. Cost of capital may be defined in alternative but equivalent ways. A useful concept is the required amount of the annual pretax cash flow on a given amount of capital if the present value of the after-tax cash flow is to be equal to the present value of the expenditures to acquire the capital. So defined, cost of capital is sensitive to effective tax rates and to the discount rate used to convert future receipts and expenditures to their present values. Effective tax rates are determined by the statutory rates, allowable deductions (e.g., for depreciation), tax credits, and other provisions of the tax laws and regulations.

An increase in the cost of capital results in a reduction in the optimum stock of capital business will want to hold at any point in time; a decrease in the cost of capital will increase the desired stock of business capital.

A change in the stock of capital relative to the amount of labor services

changes the marginal productivity of labor. An increase in the capital-labor ratio raises labor's productivity; a decrease in this ratio reduces labor's productivity.[1/] The amount of the change in labor's productivity and in total output for a given change in the amount of capital depends on the technical conditions of production, i.e., the production function.

To maximize its profits (or minimize its losses), a business will use that amount of any production input which just adds as much to its total revenues as it adds to its total costs. Thus, if a change in the tax law reduces the cost of capital, businesses will want to use more capital in combination with a given amount of labor services. The increase in the amount of capital businesses will want to use will depend on the extent of the reduction in the cost per unit of capital, the conditions of supply of capital and of labor services, the production function, and the conditions of demand for output. With quantitative estimates of these conditions, therefore, it is possible to estimate the increase in the net stock of capital, in output, in the amount of employment, in labor's productivity, and in real wage rates. On the basis of these estimates, it is also possible to estimate the increase in business GNP, total wages and salaries, and total returns to capital. Finally, these last estimates permit calculation of the increase in total tax revenues.

<u>Effect of Increase in Surtax Exemption to $100,000 on Cost of Capital and Stock of Capital</u>

An increase in the corporation surtax exemption to $100,000, at estimated

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1/ This is the outcome of the law of diminishing returns which holds that the greater the amount of one production input used in combination with a given amount of other inputs, the less is the addition to output of the marginal unit of that input. By the same token, the greater is the addition to output of the marginal unit of one of the other production inputs.

1975 levels of economic activity, is equivalent to a 2 percentage point reduction in the effective corporation income tax rate. In turn, this would decrease the cost of capital, as defined above, by 1.2 percent. The change in the desired stock of capital in response to this 1.2 percent decrease in its cost depends on the elasticity of demand for capital and the elasticity of supply of saving. On the basis of an estimated production function for the business sector in the post-war period, we estimate the elasticity of demand for capital as equal to -1.[1/] This means that the desired stock of capital would increase by 1.2 percent in response to the 1.2 percent decrease in the cost of capital. Assuming the elasticity of the supply of saving is quite large,[2/] the net result is a percentage increase in the stock of capital closely approximating the percentage reduction in its cost, i.e., a 1.2 percent increase in the net stock of capital.

This increase in the net stock of capital will not be effected instantaneously. For a substantial proportion of fixed capital, there is a significant lead time between the decision to increase the stock of it and delivery and installation of the facilities. A three-year transition period to the new desired stock of capital has been assumed in this analysis.

1/ Cf. Norman B. Ture, Tax Policy, Capital Formation, and Productivity, A Study Prepared for the Committee on Taxation, National Association of Manufacturers, 1973, pp. 35 ff.

2/ Abstract analysis argues that the elasticity of private saving with respect to its relative cost must be extremely high. Empirical analysis tends to confirm, not to refute, this conclusion.

Effect of Increase in Stock of Capital on Employment and Wages and Salaries

The increase in the net stock of capital, over and above the increase which would otherwise have occurred, increases the marginal productivity of labor. The result will be a faster increase in real wage rates and/or in the total number of jobs than otherwise. In either event, the total amount of wages and salaries paid in the business sector will increase by roughly the same proportion as the increase in capital, i.e., by about 1.2 percent, above the amounts otherwise paid. With present and prospective unemployment conditions, a substantial fraction of the increase in total employee compensation is likely to reflect increases in the number of jobs above the trend increase in employment. By the end of 1977, it is estimated that the trend level of employment in the business sector would be 60.6 million full-time equivalent employees. The estimated 1.2 percent increase in employment, thus, is about 720,000 more jobs in that year, created by increasing the surtax exemption.

Real wage rates, on these assumptions, would increase at their trend rate in 1975 through 1977. With the estimated increase in employment resulting from the increase in the surtax exemption, total business sector employee compensation is estimated to rise $9.7 billion (in 1974 dollars) above the level otherwise attained in 1977.

Effect on Federal Tax Revenues

In constant 1974 dollars, the estimated increase in employment and in capital in the business sector resulting from the increase in the surtax exemption would raise national income originating in the business sector by about 1.2

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percent above the trend level in 1977. Assuming no changes in indirect business tax rates or in capital recovery provisions, business sector GNP would increase above trend in the same proportion, or by about $17.2 billion (constant 1974 dollars) in 1977.

These increases in business sector output and income obviously increase the Federal tax base and revenues as well. The increase in Federal tax revenues results from

- the increase in taxes---at an estimated effective rate of 33 percent, giving effect to the increase in the surtax exemption---on the profits on the additional capital;
- the increase in individual income taxes and payroll taxes---at a combined marginal rate of about 33 percent---on the additional wages and salaries; and
- the increase in excise tax and other indirect business tax revenues, roughly 1.9 percent of business GNP in recent years.

In all, these revenue sources would add more than $5 billion to Federal tax revenues in 1977. Instead of the $2 billion "initial impact" revenue loss, which unrealistically assumes no change in investment, employment, output, and income in response to the increase in the surtax exemption to $100,000, this tax change would generate a substantial increase in Federal tax receipts.

STATEMENT OF WILLIAM C. McCAMANT, EXECUTIVE VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, ACCOMPANIED BY DR. NORMAN B. TURE, CONSULTING ECONOMIST

Mr. McCAMANT. Thank you very much, Mr. Chairman. My name is William McCamant and I am executive vice president of the National Association of Wholesaler-Distributors. I have with me today our consulting economist, Dr. Norman Ture.

We are a federation of 95 national commodity-line associations which, in turn, are composed of 30,000 merchant wholesaler distributors.

We are primarily concerned about problems of capital formation, which is the worst problem and most urgent in our industry, and the impact of tax policy on capital formation.

We are very grateful for the work that this committee did which led to the Tax Reduction Act of 1975 which temporarily increased the corporate surtax exemption. We are here to recommend that it be increased permanently to $100,000.

Senator PACKWOOD. Do you think it ought to be extended? I notice in the testimony just prior to yours they were suggesting a stepped increase on small business from 10 to 50 percent up to $500,000.

Mr. McCAMANT. Up to what? Oh, no, our recommendation is not a step.

Senator PACKWOOD. Not a step?

Mr. McCAMANT. Our recommendation is primarily to have it at $100,000.

Senator NELSON. To what figure?

Mr. McCAMANT. To $100,000.

We have done what we feel is a very fine study, a very fine data base prepared by Dr. Ture simply so that this committee and others in the Congress will have a core of hard facts on which to base a decision.

Wholesale distribution is primarily small business. I might say the average wholesale firm has 10 employees. I would also like to indicate the type of role wholesalers play in the economy. We are about the only way a small manufacturer can go to market. We are also about the only way a smaller businessman can purchase, whether he be a contractor or a building contractor or whether he is a retailer or in another type of business. The average wholesale firm distributes the product of 133 manufacturers and has approximately 533 business customers. These small people are looking for the services of the wholesaler distributor so we help a great deal toward competition in the marketplace, which we feel is very important from an economic standpoint as well as for extended credit and the usual things that are typical of wholesalers and distributors.

With that as a preliminary statement, I would like to ask Dr. Ture to detail the findings of his particular study which incorporates the foundation for our recommendations.

Dr. TURE. Thank you. I am Norman B. Ture, and am president of Norman B. Ture, Inc.

The National Association of Wholesaler-Distributors believes that a large and varied list of tax revisions is needed to adapt the Federal

tax system to the economy's long-range requirements. Because of time constraints, we are limiting our comments on this occasion to a single proposal to increase the corporate surtax exemption to $100,000. The enactment of this proposal, we believe, by materially enhancing the financial capacity of merchant wholesaler-distributors and other independent, small- and medium-size businesses to acquire additional capital resources, will by 1977 provide about 720,000 additional jobs in the private business sector. We estimate it will also increase real wages by about $10 billion over the amount that would otherwise be reached in that year and it is measured in constant 1974 dollars. GNP originating in the private sector would be more than $17 billion higher, in constant dollars, than otherwise. The additional output, employment, and income would generate additional revenues at least equal to the "initial impact" revenue loss. And we believe the enactment of this would actually increase Federal revenue by about $3 billion net.

The most critical challenge facing the U.S. economy is to increase substantially the share of GNP which is saved and invested. Attaining a higher rate of saving and capital formation will require reducing the bias in the existing tax system against private saving and investment compared to consumption. Finding appropriate means for moderating this antisaving tax bias is the most critical challenge facing the Congress. It cannot be emphasized strongly enough that if appropriate changes in the tax system are not made, hence, if the private saving and investment rate is not materially increased, the principal cost will be inadequate growth in jobs, productivity, and real wage rates.

There is an understandable inclination to think of increases in capital formation solely in terms of fixed investment—plant, machinery, and equipment. To be sure, capital in this form constitutes a substantial part of the total stock of capital, and more rapid growth in fixed capital is an integral part of the overall requirements for accelerating capital formation. Making permanent an increased investment tax credit and reducing the capital recovery periods for depreciable assets, therefore, are highly constructive tax revisions.

These are not, however, the only tax revisions which should be undertaken. Of equal urgency are more broadly applicable tax changes to allow all business and individual taxpayers to increase their saving in order to meet the highly diverse demands for capital throughout the economy.

The prospective surge in the Nation's Capital requirements is not confined to goods producing, energy, transportation, and utility industries, about which we hear most. Expanding manufacturing capacity and output necessarily requires increases in the capacity of merchant wholesaler-distributors to distribute these goods to users. The capital requirements of merchant wholesaler-distributors, therefore, will expand at least as rapidly as those of the rest of the business sector. With their cash flow projected at average postwar year levels, merchant wholesalers and distributors will come up about 5 percent short each year of their capital requirements. This shortfall will significantly impair the efficiency and therefore raise the costs of the wholesale function of collecting and distributing the myriad variety and huge number of manufactured products to the enormous number of buyers of these products.

For merchant wholesaler-distributors, growth in capacity depends far more on growth in working capital than on expansion of fixed capital. These companies, preponderantly small- to medium-sized and closely held, have extremely limited access to the capital markets for equity financing of their expanding capital requirements. They must depend very largely on short-term borrowing and on internally generated funds, only a relatively small portion of which can be provided by depreciation allowances. Prudent financing of their expanding capital requirements makes them highly dependent on retained net profits.

This dependency is reflected in the fact that for many years past, merchant wholesaler-distributor corporations have retained and invested in productive assets 80 percent of their after-tax profits, a far higher ratio than that for all corporations taken together.

If merchant wholesaler-distributors are to be able to finance the additional capital they will need to provide the wholesale distribution services the economy will require, their internally generated saving will have to increase at an accelerated rate. To meet this objective with a minimum loss of initial impact Federal revenues, the corporation surtax exemption should be increased to $100,000 on a permanent basis. At 1975 levels of economic activity, we estimate that this surtax exemption increase would result in an "initial impact" revenue loss of about $2 billion. By far the largest proportion of this, about 60 percent, of these tax savings would be realized by corporations with net incomes of $100,000 or less.

Senator NELSON. What was that again?

Dr. TURE. About 60 percent, sir. It must be emphasized that this revenue estimate unrealistically assumes no change in the volume of economic activity resulting from the tax reduction and consequent increase in business saving and capital formation. Taking these responses into account, a substantial net revenue gain would be realized.

The proposed increase in the surtax exemption would result in a significant increase in employment. Based on historical relationships, we estimate that the increase in business investment and output resulting from the increase in the surtax exemption would increase full-time equivalent employment by 720,000 and increase total real wage and salaries by about $10 billion by 1977. Total business sector output would be $17.2 billion greater than otherwise. And these are all measured in constant 1974 dollars, Mr. Chairman. These increases in output, employment, and income would result in additional Federal revenues more than offsetting the "initial impact" revenue loss; by 1977, a net revenue gain of $3 billion would be realized.

Meeting the Nation's saving and capital requirements will require a large number of tax revisions. We respectfully submit that increasing the corporate surtax exemption to $100,000 on a permanent basis is high on the list of tax changes appropriate to this end.

Senator NELSON. Thank you. Do you have any questions?

Senator BENTSEN. I have no questions.

Senator PACKWOOD. I have a question. Earlier this year Secretary Simon testified and said one of the ways that Western Europe manages to achieve such a large formation of capital, even though they have a high per capita taxation, is they have shifted heavily to consumption taxes.

Dr. TURE. I think that is a major contribution.

Senator PACKWOOD. And maybe also the value added tax——

Dr. TURE. They also have a much more favorable capital consumption allowance.

Senator PACKWOOD. Would you recommend this country move toward the value added tax?

Dr. TURE. I think there is a great deal to be said for introducing the value added tax as a replacement for part or all of the presently taxed business income.

Senator PACKWOOD. Thank you.

Senator NELSON. Thank you very much, gentlemen. We appreciate your taking the time to prepare this testimony and present it to our two committees.

Our next witness is Mr. Murray Mendelsohn, member of the Independent Stores Board, National Retail Merchants Association. Mr. Mendelsohn, if you would identify for the record your associates?

STATEMENT OF MURRAY MENDELSOHN, MERCHANT, AND MEMBER, INDEPENDENT STORES BOARD, NATIONAL RETAIL MERCHANTS ASSOCIATION, ACCOMPANIED BY VERRICK O. FRENCH, NRMA, VICE PRESIDENT FOR GOVERNMENTAL AFFAIRS; AND MARTIN B. AMDUR, OF WEIL, GOTSHAL & MANGES OF NEW YORK CITY, AND COUNSEL TO THE NRMA

Mr. MENDELSOHN. Thank you, Mr. Chairman.

Good morning. My name is Murray Mendelsohn, and I am president of Mendelsohn's Luggage Shop, Inc. of Paramus, N.J. I appear before you today, however, not in my individual corporate capacity, but rather on behalf of general merchandise retailing as spokesman for the National Retail Merchants Association ("NRMA"). I am accompanied by Verrick O. French, NRMA vice president for governmental affairs, and Martin B. Amdur, of Weil, Gotshal and Manges of New York City, counsel to the NRMA.

The National Retail Merchants Association, a nonprofit corporation, represents approximately 30,000 department, chain, and specialty stores in the United States, many of which are operated by small retailers. The aggregate annual sales volume of our members exceeds $80 billion. I would just like to add that I represent all those zeros at the end.

The retailing industry is a labor intensive industry which is required to employ its capital resources predominantly in payroll, inventory, receivables and other current working capital requirements. We employ a large percentage of the Nation's labor force and operate on a profit margin which is quite low in comparison to most other industries. Retailing also is very sensitive to changes in the economy, in consumer buying habits and in prices. This is due in large part to the fact that retailing is highly competitive, with many apparently dissimilar businesses operating in close proximity.

Because many members of the NRMA, including myself, are small retailers, the NRMA would like to present its views on small business tax reform. Also, since no major small business tax reform legislation has been enacted since 1958, it now is appropriate that attention be

directed to the problems faced by small business, problems which were caused in part by the substantial inflation over the past decade. Such inflation has resulted in one of the more immediate and direct problems faced by every small business owner—limited availability of capital for both the normal conduct of business and possible expansion.

As an aside I should like to begin by paraphrasing a famous saying: "God must love the small business owner because he created so many of them." It seems that everyone else also loves the small business owner, as I have yet to hear the first bad word about him or her. Unfortunately, most of the time it ends right there. While everyone claims to want to lend a helping hand, actual assistance has been relatively limited, present company excepted.

Time could be running out for many small businesses unless certain concrete efforts are made. Tax legislation is an excellent place for Congress to start. I should like to add that the tax savings suggested later in my remarks, of course, will remain in and be reinvested by the small business owner in the business. In these days when every stimulus is needed for our economic recovery, it is the small business owner who offers a significant source of potential for economic growth, because he or she, almost by definition, reinvests in his or her business. Furthermore, many of the innovations in our economy have been started and advanced from very modest and humble beginnings. There thus is tremendous growth potential in many small businesses—if they are given the opportunity to nurture.

It is important to point out the large amounts of capital necessary today to open a small business, such as a small store like mine.

If I could just digress from the printed record? We just opened a new store in a large regional shopping center last year. And while I consider myself a small businessman, and I am, the amount of money that we had to raise to open this business was really quite considerable. I feel it is the type that not every small businessman would be interested in taking on as a risk. And I think this is one of the problems we face in the continuation of small entrepreneurship. The minimum costs required for our construction in our shopping center in New Jersey was in the neighborhood of $25 to $30 a square foot.

We came in even higher than that because when you come in with major department stores and specialty chains in a center such as ours, you have to come in in a competitive manner. You cannot look any worse than the other stores when you have an Abraham and Straus at one end and a Sears at the other end. In this situation you are not going to come in with a plain piperack store to display your merchandise. So this requires a considerable investment. It is very difficult for the average small businessman to accumulate the capital necessary for this type of operation. He looks to his usual friends and relatives and I guess they don't remain his friends very long. As far as relatives are concerned, not too many of us have rich uncles. The banks, of course, are the primary source for this type of operation, but their rates are extremely high and discouraging to the small businessman. We ourselves turned to the SBA. And contrary to the many horror stories about the SBA, we were pleasantly surprised with the relative ease with which our loan was made.

We have had a problem in the sense that we feel that the interest rates that we pay on this SBA loan are far too high. We feel that with

the Government guaranteeing 90 percent of this loan, there is no reason that we have to pay several percentage points above the prime rate. The bank has very little exposure on loans of our type. We also feel that many of the requirements of the SBA as to collateral, mortgaging of everything, and so on are too stringent. My house is mortgaged 100 percent to the SBA. God forbid that something should happen to our business. I will be out on the street. But, of course, I have enough confidence in my own ability that I am willing to take that risk.

Now, to go back to the statement. Because we are dealing with small business, it must be recognized that any proposal to be meaningful must not further complicate an already overly complex tax structure. Complex and highly sophisticated legislation favoring small business, while it might achieve abstract equity among small businesses, would not likely accomplish the desired purpose because of the limited resources available to most small businesses for tax planning and tax return preparation.

The NRMA believes the following proposals represent appropriate legislation to assist the small business owner, while at the same time providing simplicity in the tax structure that is of special significance to him. We also feel they are quite modest as we realize the Government is called upon from all sides to assist in many areas and we feel that we want to be responsible in these proposals.

INCREASE OF CORPORATE SURTAX EXEMPTION

Although the coprorate surtax exemption was recently increased to $50,000 by the Tax Reduction Act of 1975, this increase was temporary; the exemption will revert to its former $25,000 level for taxable years ending after December 31, 1975. Accordingly, despite the substantial erosion of the dollar in the last quarter of a century, the exemption for taxable years ending after 1975 will be no greater than that available in 1950. The NRMA believes it now is appropriate to permanently increase the surtax exemption at least to $50,000.

Senator PACKWOOD. I am curious about something you skipped over. You say you reject as overly complex a "notch" corporate tax. I don't see what is complex about it.

Mr. MENDELSOHN. Well Senator, I think while it is not complex in the overall view, I think the average small businessman is just not too aware of many of the niceties of the law. I think that we basically have to keep it simple.

Senator PACKWOOD. But here isn't it relatively simple? If you are having a notch, you simply pay a certain percentage based on what your profit is, so it is not different from the individual notch. That wouldn't be beyond the ken of most small businessmen to figure out.

Mr. AMDUR. I think, Senator, the thing that has concerned a number of the members of NRMA was the ability to realize that suddenly by expanding the business you are shifting into a significantly or potentially significantly higher tax bracket.

Senator PACKWOOD. So it would be an inducement to keep businesses small or middle sized?

Mr. AMDUR. Well an inducement not to expand. That is what we were sort of afraid of. It was the same problem that Congress faced

when suddenly deciding what should we do about the income rate on the maximum tax on earned income; the fear that suddenly we are going to have a small businessman being told by his accountant to not expand too much because you are going to shift the tax bracket significantly. That was the kind of fear we were afraid was going to present potentially a problem. It is not complex in the other sense, but it was the fear of the possibility of getting into these kinds of adverse planning possibilities and we thought this was questionable. It certainly doesn't answer the question.

THE INCREASE IN FIRST YEAR DEPRECIATION ALLOWANCE

Mr. MENDELSOHN. The current additional first-year depreciation allowance contained in Section 179 of the Internal Revenue Code was added in 1958 as part of the small business tax reform enacted in that year. As noted in the legislative history of the Small Business Tax Revision Act of 1958, H.R. 8381, not only have small businesses traditionally obtained funds for expansion and development through the reinvestment of earnings, but also depreciation reserves traditionally have been a major source of internal financing by small businesses.

The first-year writeoff was designed to make possible the use of depreciation reserves for expansion, since normal depreciation reserves were viewed only as enabling business to maintain its current position. By limiting the cost of property to which a first-year writeoff can be taken, the benefits of Section 179 are concentrated largely in the area of small business. I would like to add there is an extremely high mortality rate in small businesses. We are, of course, concerned with the small retail area in the first 3 years and with those stores that are opening up in shopping centers, for many of these centers just do not start to do business in a normal manner for 1, 2, or 3 years. Anything that will assist the small businessman to get over the hump of the startup years will be highly advantageous.

In the light of the growth of our economy and the continuing need to incur sizable investments in equipment—which for the small retailer means store fixtures that must be paid for by means of internal financing—the NRMA believes it appropriate to increase the percentage of the total cost of an asset which may be written off in the year of acquisition and the dollar limit on the cost of property (with respect to which the percentage writeoff can be taken) from the current 20 percent of a $10,000 maximum cost to 100 percent of the first $25,000 and 50 percent of the next $25,000.

Senator NELSON. $25,000?

Mr. MENDELSOHN. Yes sir, the first $25,000, Senator, and then 50 percent of the next $25,000.

These increases in the section 179 limitations will encourage small business modernization and expansion. The changes do not require complex or novel legislation and, thus, are consistent with the goal of simplicity. Again, the small businessman cannot stand still these days with the large competition he faces on all sides. He must make at least periodic modernization improvements in his own business.

PERMANENT ADDITIONAL SMALL BUSINESS INVESTMENT CREDIT

The Tax Reduction Act of 1975 changed the investment credit rate from 7 percent to 10 percent. This change was designed to be a temporary measure effective only through 1976. The NRMA advocates the permanent use of the investment credit mechanism as an incentive to small business investment. While a substantial across-the-board increase in the investment credit rate would have a salutary effect on business investment, the NRMA believes that such a program could precipitate an unjustifiably large decline in the Federal revenue. Accordingly, to limit the impact of the credit to the small business area, the NRMA supports a permanent investment credit having a rate of 15 percent for the first $50,000 of qualified investment and 10 percent thereafter.

DECREASE IN THE FREQUENCY IN THE PAYMENT OF COLLECTED TAXES

The NRMA favors a limitation on the frequency with which small business is required to remit withheld income and employment taxes. Specifically, the NRMA believes that a small business whose aggregate withheld income taxes, employment taxes and manufacturers' excise taxes do not exceed $1,000 in a calendar quarter should not be required to deposit these taxes more than once each quarter. For the small business whose tax collection obligation is under the dollar limitation suggested, current recordkeeping and reporting requirements necessitated by the more frequent depositing of taxes impose a burden out of proportion to the revenue advantage and the business' other recordkeeping requirements. In this area it would be of great advantage to many small businessmen in the sense that where they are now required to make these deposits on a monthly basis, and many of them have an accountant come in to do so, if this could be done on a quarterly basis, many of the stores could eliminate the accountant coming in eight extra times a year. This would be a considerable saving to the small businessman. I think that the amount of money involved in the tax fund would not be that great.

We want to thank the committee for the opportunity to comment on the small business tax reform legislation, which is of special significance to many of our members. We would like to request that our statement be included in the printed record of the committee's hearings. Representatives of the National Retail Merchants Association would be more than happy to render assistance to the committee and its consideration of these proposals.

[The prepared statement of Mr. Mendelsohn in full follows:]

TESTIMONY

OF

MR. MURRAY MENDELSOHN

ON BEHALF OF THE

NATIONAL RETAIL MERCHANTS ASSOCIATION

BEFORE THE

SENATE SELECT COMMITTEE

ON

SMALL BUSINESS

* * *

September 25, 1975

Good morning. My name is Murray Mendelsohn, and I am President of Mendelsohn's Luggage Shop, Inc. of Paramus, New Jersey. I appear before you today, however, not in my individual corporate capacity, but rather on behalf of general merchandise retailing as spokesman for the National Retail Merchants Association ("NRMA"). I am accompanied by Verrick O. French, NRMA Vice President for Governmental Affairs, and Martin B. Amdur, of Weil, Gotshal & Manges of New York City, counsel to the NRMA.

The National Retail Merchants Association ("NRMA"), a non-profit corporation, represents approximately 30,000 department, chain and specialty stores in the United States, many of which are operated by small retailers. The aggregate annual sales volume of our members exceeds $80 billion.

The retailing industry is a labor intensive industry which is required to employ its capital resources predominantly in payroll, inventory, receivables and other current working capital requirements. We employ a large percentage of the nation's labor force and operate on a profit margin which is quite low in comparison to most other industries. Retailing also is very sensitive to changes in the economy, in consumer buying habits and in prices. This is due in large part to the fact that retailing is highly competitive, with many apparently dissimilar businesses operating in proximity.

Introduction

Because many members of the NRMA, including myself, are small retailers, the NRMA would like to present its views on small business tax reform. Also, since no major small business tax reform legislation has been enacted since

1958, it now is appropriate that attention be directed to the problems faced by small business, problems which were caused in part by the substantial inflation over the past decade. Such inflation has resulted in one of the more immediate and direct problems faced by every small business owner--limited availability of capital for both the normal conduct of business and possible expansion.

As an aside I should like to begin by paraphrasing a famous saying: "God must love the small business owner because he created so many of them." It seems that everyone else also loves the small business owner, as I have yet to hear the first bad word about him or her. Unfortunately, most of the time it ends right there. While everyone claims to want to lend a helping hand, actual assistance has been relatively limited.

Time could be running out for many small businesses unless certain concrete efforts are made. Tax legislation is an excellent place for Congress to start. I should like to add that the tax savings suggested later in my remarks, of course, will remain in and be re-invested by the small business owner in the business. In these days when every stimulus is needed for our economic recovery, it is the small business owner who offers a significant source of

potential for economic growth, because he or she, almost by definition, reinvests in his or her business. Furthermore, many of the innovations in our economy have been started and advanced from very modest and humble beginnings. There thus is tremendous growth potential in many small businesses -- if they are given the opportunity to nurture.

It is important to point out the large amounts of capital necessary today to open a small business, such as a small store like mine. In order to open a competitive small retail store in the average large shopping center, $50,000 typically is the minimum investment. Our problem is raising the $50,000. We believe that our proposals represent practical means by which the tax laws can enable the small business owner to make that investment and to make our economy grow and prosper.

Because we are dealing with small business, it must be recognized that any proposal to be meaningful must not further complicate an already overly complex tax structure. Complex and highly sophisticated legislation favoring small business, while it might achieve abstract equity among small businesses, would not likely accomplish the desired purpose because of the limited resources available to most small

businesses for tax planning and tax return preparation.

The NRMA believes the following proposals represent appropriate legislation to assist the small business owner, while at the same time providing simplicity in the tax structure that is of special significance to him.

Small Business Tax Reform Proposals

1. Increase of Corporate Surtax Exemption

Although the corporate surtax exemption was recently increased to $50,000 by the Tax Reduction Act of 1975, this increase was temporary; the exemption will revert to its former $25,000 level for taxable years ending after December 31, 1975. Accordingly, despite the substantial erosion of the dollar in the last quarter of a century, the exemption for taxable years ending after 1975 will be no greater than that available in 1950. The NRMA believes it now is appropriate to permanently increase the surtax exemption at least to $50,000. As noted in the Legislative History of the Revenue Act of 1964, H.R. 8363, it is important to provide a lower rate of tax for small businesses because of the importance of small enterprises in maintaining competitive pricing in our economy and the greater difficulty small businesses encounter

in securing outside capital to finance day-to-day activity and expansion.

Many other legislative proposals directed to fundamental small business tax relief have been introduced in the recent past, particularly the concept of an initial start-up exemption for new small businesses. After extensive consideration, we have rejected such a concept partly because of its obvious and inherent complexity: When is a small business enterprise "new"? Similarly, we have rejected as overly complex such other concepts as a "notch" corporate tax and an interest-free start-up tax deferral for new businesses. Finally, while others have proposed larger increases in the surtax exemption, in view of current federal budgetary demands we are concerned that a surtax exemption in excess of $50,000 may not be appropriate at the present time.

2. Increase in First-Year Depreciation Allowance

The current additional first-year depreciation allowance contained in Section 179 of the Internal Revenue Code was added in 1958 as part of the small business tax reform enacted in that year. As noted in the Legislative

History of the Small Business Tax Revision Act of 1958, H.R. 8381, not only have small businesses traditionally obtained funds for expansion and development through the reinvestment of earnings but also depreciation reserves traditionally have been a major source of internal financing by small businesses. The first-year writeoff was designed to make possible the use of depreciation reserves for expansion, since normal depreciation reserves were viewed only as enabling business to maintain its current position. By limiting the cost of property to which a first-year writeoff can be taken, the benefits of Section 179 are concentrated largely in the area of small business.

In the light of the growth of our economy and the continuing need to incur sizable investments in equipment--which for the small retailer means store fixtures that must be paid for by means of internal financing--the NRMA believes it appropriate to increase the percentage of the total cost of an asset which may be written off in the year of acquisition and the dollar limit on the cost of property (with respect to which the percentage writeoff can be taken) from the current 20% of a $10,000 maximum cost to 100% of the first $25,000 and 50% of the next $25,000. These increases in the Section

179 limitations will encourage small business modernization and expansion. The changes do not require complex or novel legislation and, thus, are consistent with the goal of simplicity.

3. Permanent Additional Small Business Investment Credit

The Tax Reduction Act of 1975 changed the investment credit rate from 7% to 10%. This change was designed to be a temporary measure effective only through 1976. The NRMA advocates the permanent use of the investment credit mechanism as an incentive to small business investment. While a substantial across-the-board increase in the investment credit rate would have a salutary effect on business investment, the NRMA believes that such a program could precipitate an unjustifiably large decline in the federal revenue. Accordingly, to limit the impact of the credit to the small business area, the NRMA supports a permanent investment credit having a rate of 15% for the first $50,000 of qualified investment and 10% thereafter.

4. Decrease in the Frequency in the Payment of Collected Taxes

The NRMA favors a limitation on the frequency with which small business is required to remit withheld income and employment taxes. Specifically, the NRMA believes that a

small business whose aggregate withheld income taxes, employment taxes and manufacturers' excise taxes do not exceed $1,000 in a calendar quarter should not be required to deposit these taxes more than once each quarter. For the small business whose tax collection obligation is under the dollar limitation suggested, current record-keeping and reporting requirements necessitated by the more frequent depositing of taxes impose a burden out of proportion to the revenue advantage and the business's other record-keeping requirements.

5. Other Comments

In recognition of the numerous other small business tax reform proposals contained in the various bills introduced in the past several Congressional sessions, the NRMA would like to add a brief commentary. In general, we favor reasonable increases in the dollar limitations contained in many of the Code sections, assuming such changes are compatible with revenue needs. The recent increase in the minimum accumulated earnings credit, as part of the Tax Reduction Act of 1975, is a provision on which future changes of this type could be modelled, provided that the specific alterations do not add to the level of complexity in the tax law. In this vein, the NRMA believes it appropriate to strive toward a simpli-

fication of the tax structure and reporting for small business. We favor proposals to study the impact of the Internal Revenue Code on small businesses, such as the creation of an intra-governmental committee on tax simplification for small businesses.

We appreciate this opportunity to comment on small business tax reform legislation, which is of special significance to many of our members, and request that our statement be included in the printed record of the Committee hearings. Representatives of the NRMA would be pleased to render assistance to the Committee in its consideration of these proposals.

Senator NELSON. Thank you very much, gentlemen. We appreciate your very fine statement.

Our next witness will be a panel on estate and inheritance taxes composed of Mr. Dean Treptow, president, Brown Deer Bank, and chairman of the Legislative Committee, Independent Business Association of Wisconsin; Gerald Sherman, attorney and general counsel for the Association for Advanced Life Underwriting; Donald R. Haldeman, president of the Wisconsin State Farm Bureau; John C. Davis, III, president of Davis Brothers, Inc., and a wholesaler from Denver, Colo.; Jared How, publisher of the Free Press, Mankato, Minn.; and Richard B. Covey, attorney, and special counsel to the Trust Division of the American Bankers Association. Those of you who have prepared texts, your statements will be printed in full in the record. You may present them, however you desire. Who is going to lead off?

PANEL DISCUSSION OF THE PANEL ON ESTATE AND INHERITANCE TAXES: DEAN A. TREPTOW, PRESIDENT, BROWN DEER BANK, AND CHAIRMAN, LEGISLATIVE COMMITTEE, INDEPENDENT BUSINESS ASSOCIATION OF WISCONSIN; GERALD SHERMAN, ATTORNEY, SILVERSTEIN & MULLENS, AND GENERAL COUNSEL, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING; DONALD R. HALDEMAN, DAIRY FARMER, AND PRESIDENT, WISCONSIN STATE FARM BUREAU; JOHN C. DAVIS III, PRESIDENT, DAVIS BROS., INC., AND A WHOLESALER, DENVER, COLO.; JARED HOW, PUBLISHER, THE FREE PRESS, MANKATO, MINN.; AND RICHARD B. COVEY, ATTORNEY, CARTER, LEDYARD & MILBURN, AND SPECIAL COUNSEL TO THE TRUST DIVISION OF THE AMERICAN BANKERS ASSOCIATION

Mr. TREPTOW. I was listed first, so I guess I will go first. My name is Dean Treptow and I am president of the Brown Deer Bank of Milwaukee, Wis., and chairman of the Legislative Committee for the Independent Business Association of Wisconsin. It is in that capacity that I am speaking here today representing our Wisconsin small business group.

I appreciate the opportunity to testify before the committee on behalf of our small business group. The subject matter, of course, is Federal estate taxes. I think it is an interesting subject to discuss at this time in view of the numerous proposals offered here today and in prior testimony for tax reform. Estate taxes are probably one of the oldest and most widely accepted forms of taxation in this country. I suspect acceptance of this form of taxation is based upon the fact that the American society has long felt that they were perhaps opposed to the accumulation of large wealth in relatively few hands. We felt we would like to bootstrap our own futures and be responsible for our own economic development. It is the pioneering spirit so to speak. Perhaps this has led to acceptance of estate taxes.

I think there are some unique problems, however, associated with this that were not really intended by the writers of the estate tax laws and the administrato s o' this tax over the years.

Basically we have no quarrel with the concept of estate taxes. As a matter of fact from a study I have done, it appears both estate and gift taxes together aggregate only about 2 percent of the total Federal tax revenues. The real problem in my opinion is that the present administrative structure of the estate taxes tends to motivate a concentration of small business into large corporations or into concentrations of fewer numbers of business firms.

Senator NELSON. What do you mean by "administrative structure?"

Mr. TREPTOW. Well the actual tax structure. I will elaborate on how this tends to happen in the course of my testimony.

The underlying problem or the source of this problem is liquidity of the assets that comprise an estate. And an estate can be comprised of anything from pure cash to actual currency to real estate or even intangible values of patents, royalties, and so forth. Of course there is a great difference in the ability of an estate to pay its taxes, depending upon what is liquidity and a source of cash in that estate. Here is where we get to the problem of the motivation for business concentration or for small businesses to be sold to larger and larger firms.

Now to try to explain this I'm going to use an example. To make it very simple, I will choose my own situation. I don't want anyone to think that I am pleading or looking for tears for bankers. I am not testifying on behalf of bankers in this case, but just giving you my own situation as an owner or a part owner of a bank. This might be viewed as a situation where an individual owns a small business, because in fact the Brown Deer Bank is a suburban bank in the north side of Milwaukee with $25 million in total assets at this time. So in effect I am a small businessman because the Brown Deer Bank is a small business and we serve small business people in the Milwaukee community.

But my situation is this at this point from an estate standpoint. I am 37 years old, married with four children. My financial assets are really amounting to the retention of my earned income from prior years. I have had no great inheritances to myself, nor do I anticipate any inheritances of consequence in the future. So my investment in this bank is what I retain from my own earnings in my lifetime.

The majority of my assets are centered in my investment in this bank. It does not represent a control interest, but it does represent a substantial stockownership in the bank. Now in planning my estate and attempting to prepare for an untimely early death, I am really concerned about the following problems. One, I do not have enough cash in my estate and in my present financial situation to pay the projected estate taxes on my estate. Second, the valuation of my bank stock is highly questionable as to how it might be valued. As the minority stockholder, for example, it might be worth one value, but experience in the Milwaukee area indicates that a small bank, if controlling interest is represented in a sale, that the value can range from 25 to 50 percent greater than if only a minority interest is being sold.

Now as concerns the possibility of my death within the next several years, I am prepared to make certain risk in regard to this liquidity. What I can do to prepare for this is I can buy all the insurance that I can afford or quite frankly I could pray a lot and hope that an early death doesn't come.

But try to project this present situation forward if you will, 25 years from now. Now I have been successful in carrying out my plans and ambitions for this bank, hopefully, and I probably will still remain a substantial minority stockholder of this bank; but if I am typical of most human beings, my ambitions will probably be somewhat dulled and I will be more concerned about preserving for my family and those immediately within my concern about them, then I will be in building a future ahead of me. By that time I would be 62 years old. Now if present tax laws still prevail at that time, I really have these alternatives:

1. I could seek out an ambitious young man who might want to buy my bank stock and start where I started 25 years earlier and he could try to build this stock and his ownership interest to a greater value.
2. I could attempt to—and this is perhaps a better business decision—I could attempt to gain control of my bank.
3. And probably more likely, I could try to find other stockholders who would join with me in aggregating a controlling interest and then I could attempt to sell that for a greater valuation.

Finally, I could simply retire and let my estate worry about the profits of my assets in my Brown Deer Bank stock.

Now let's examine what might happen in each of these instances. First of all, if I were to sell a minority interest to this young man who would like to take off from where I had 25 years earlier, it would probably be for a cash sale. I would have a taxable incident at the time I sold this stock. I will get to the comparisons of this impact in a moment.

Second, I would be selling a minority interest and it would not be worth as much as I could presume to get through majority control.

If I joined forces with other stockholders to try to get majority control, I would immediately have an economic advantage because I could probably get 25 to 50 percent more for my investment. And good tax counsel, CPA's and attorneys, they would recommend that we sell this stock to a firm or a larger bank having a listed security to exchange for equity because then I would not incur a taxable incident at that time. My estate would immediately benefit because it would have liquidity. It might have a New York Stock Exchange listed security as its assets rather than the closely held nonmarketable stock of the Brown Deer Bank. I would gain 25 to 50 percent value in my estate by getting control. I have then solved a tax problem to some degree by eliminating the income tax incident in my lifetime and I have gained liquidity in my estate, which is going to make my administrators' and my wife's job a lot easier at the time of my death.

In the third instance, assuming that I decided to simply retain stock and let my estate worry about the problems, first of all upon my death the administrator of my estate would have to decide how to value the stock. This is commonly done by having your attorneys or CPAs prepare a case for valuation based upon experiences in representative cases, and they would present that to the IRS. This would be open to challenge. And in closely held bank stock, as in any small corporate stock, there are probably 101 ways in which you could establish valuation. It leads to an open-ended situation with a lot of complexity. To provide the cash, ultimately they would have to

find a sale for the stock. It would have to be done under duress because obviously the estate would have to get liquidity and the potential buyers of the stock would know that I would be under some pressure to sell. Therefore the price would be reduced.

Now section 303 redemption is frequently open to businesses and my specific situation a section 303 redemption doesn't work because a State-chartered bank cannot own its own stock, it cannot own Treasury stock. That wipes out a section 303 redemption. For similar types of business corporations it might be a viable entity, but at any rate it seriously reduces working capital. And the testimony I know you heard yesterday and in the June hearings already stresses the shortage of working capital in small businesses, which bears directly on your ability to exercise a section 303 redemption.

But let's assign actual values to this case, this situation. Let's use some round numbers here. Let's assume that the original cost of my bank stock was $100,000 and 25 years from now it would be worth $200,000. So I had a gain in valuation of $100,000, which would be an increase in my estate. If I were to sell the stock for cash and let's say $200,000, and if I qualified for the alternative tax on capital gains, I would incur a $30,000 income tax bill at the time of sale. My motivation again for selling would be to get liquidity into my estate. This would reduce the proceeds of my stock and the net value to my estate to $170,000 from the $200,000 sale. And if I should die shortly thereafter, my estate would have cash, but then it would pay estate taxes. Now let's assume a marginal tax rate of about 40 percent on my estate. That would amount to $68,000, and the net residual of my estate with regard to my bank stock would now be reduced to $102,000.

On the other hand, however, let's assume I accepted the advice of my tax counsel when they said: "Treptow, in anticipation of your death; and you are 62 years old now, why don't you find somebody to join with you to represent control and then sell this out to a large bank that is represented on the New York Stock Exchange. Exchange equity on it." So let's assume I do that. I would incur no income tax during my lifetime.

At the time of my death, I would pay the estate tax. Prior to that I would still be $30,000 ahead because I hadn't paid the income tax. Again, assuming the 40 percent marginal estate tax rate, the estate taxes would amount to $80,000 and my net estate would be reduced to $120,000 after paying taxes, thus realizing a benefit of $18,000 for having sold out to the large corporation or for an exchange of stock.

So I think we can draw two conclusions. First, an almost 20 percent differential in my net estate after payment of estate taxes, that wouldn't really be a substantial motivation to cause me to sell out for the listed security. Certainly, I think any prudent man who has any regard for his family really would not consider leaving the stock in his estate and let them worry about valuation, sale, and all the long-term intanglements that could result if he could benefit to the tune of $18,000 by taking the alternative structure. I think this is the incentive that exists in all small business today. Viable and growing small businesses sell out and force the concentration into larger hands.

Now the situation I described refers, as I mentioned, to my own situation. We think these principles are identical for most rapidly growing small business enterprises, however.

This tendency to concentration is significant and it is widespread. We attempted to research business acquisitions here to date in the State of Wisconsin. Now I am sure we didn't get all of the small firms throughout the State that were sold to other enterprises without public knowledge, but by searching the public records, we became aware of some 11 business acquisitions within Wisconsin so far this year.

Senator NELSON. How many?

Mr. TREPTOW. Eleven of a size that reached public records.

Senator NELSON. Business acquisitions by other corporations?

Mr. TREPTOW. By other corporations. Now 5 of these 11 firms were sold to larger corporations. The principals of these firms or officers of the firms that we interviewed stated specifically that 5 of these 11 firms were sold for estate tax liquidity for the prior stockholders. Now three out of the five, that were sold for estate tax liquidity, were sold to the New York Stock Exchange listed firms. Four of these five firms were sold to an over-the-counter company and the fifth was sold to an international conglomerate. I think this supports the rationale I have been talking about this morning. Now accounts for 5 of the 11. Seven of these firms were sold to the New York Stock Exchange listed firms, but not for estate tax purposes, but for shortages of working capital. They had grown so rapidly they could not get the necessary equity capital or borrow funds to support this growth. I think this bears out the testimony given yesterday by my associate, Mr. Mauer, from the Independent Business Association of Wisconsin. In his testimony on surtax exemptions and accelerated depreciation.

Now the remaining 4 firms out of the 11 were sold for reasons that cannot really be related to taxation as far as we can determine. But here is 7 out of the 11 firms that were sold presumably for tax purposes in accordance with our conversations with the principal stockholders and officers of these companies.

Now in my prepared testimony I have documented the situations in each of these 11 firms and what the type of industry circumstances were surrounding that. I won't go into that in detail today.

But our recommendations are these: First, we don't have a panacea to suggest to you today to solve this rather complex problem. I don't claim to have all of the answers. We have done as much research to date as we can do and we will continue to dig into this matter further and hopefully have the opportunity to make specific recommendations. We think this problem is significant enough that our first recommendation is we would like both the administration and Congress to join with us, as is this committee joining with us today by hearing our arguments, and ask them both to try to find means to solve what we think is a very real problem. Let's apply our creative energies to this problem to avoid concentration of business due to estate taxes.

Second, we recommend that the exemption for estate tax purposes be increased from the present $60,000 to $200,000. A reason for stating this is this. First of all, it would eliminate a lot of small retailers, wholesalers, and probably the vast majority of American family-owned farms from falling into this problem I have been talking

about. I think certainly estates under $200,000 who really represent businesses that are small and the farmers and the like, I think the law really was never intended to catch them—I mean the estate tax laws were never really intended to catch these anyway. We aren't talking about accumulations of huge wealth into big family fortunes when we are talking about estates of this size. Also, and I have not been able to document this, but I think we would all have to agree there would certainly be a reduction to some degree in Government expense in administering and reviewing valuations of these kinds of estates. I think a value could be put on this in conjunction with the Internal Revenue Service.

Next, we would like Congress also to consider further modification of the recently passed Pension Reform Act. Some testimony has been given this morning already on this. I would like to relate our recommendations specifically to employee stock ownership trusts. This is a relatively new item as far as public attention today, although the concept has been available for a number of years. It is a technique that I am hoping to use within our bank to support our capital needs, which are significant. I project them to be $1 million within the next 5 years of capital I am going to have to raise. Now we are going to raise a significant part of this through employee stock ownership trusts, hopefully if we can accomplish it. What this does is place a significant part of the ownership of our bank in the hands of the employees. I think in our situation this is good. I think it is good motivation. My employees are almost unanimously enthusiastic about this concept. It supports the growth that we need in our bank and solves a lot of problems in a relatively easy fashion for a closely held firm.

There is only one big barrier at this point and that is this old valuation problem again. We would have to employ a nationally reputed valuation firm whose validity could always be challenged by someone; it could be challenged by a stockholder, an employee, the IRS, or whatever. This valuation would have to be made every time the trust acquired stock in the bank and every time a disbursal was made on this stock upon retirement or severance from the bank. This is a very knotty problem. I think that with good tax counsel and the help of some of our CPA firms that we could come up with valuation formulas for smaller companies that are not publicly listed. You don't have a market that establishes their value. I'm talking about coming up with some standards for valuation that could really ease the implementation of an employee stock ownership trust, which is a concept that I think has long-run benefit to small business.

I referred to section 303 redemptions in my comments today as being a difficult opportunity for most small businesses to exercise. I would like to make two suggestions in regard to 303 redemptions, however. In current law an estate may qualify for a 303 redemption if the company capital represents 35 percent of the gross estate, or 50 percent of the taxable estate. We would like to recommend a reduction of 20 and 40 percent, respectively, for this. Where the 303 redemptions could possibly be consummated by small business, we think this is important. In my testimony, the largest firm that we analyzed that was acquired by an international conglomerate was acquired because of five stockholders, none of whom had control singly, but had aggregate

control together for the sale, and they did this because they couldn't sell the stock individually and they tried for over 2 years to find buyers for their estate liquidity purposes and could not find a buyer that would accept less than control. So I think by reducing this percentage you might tend to solve this problem. The corporation in this case would have been interested in taking the 303 redemption, but it couldn't because the stock in the company didn't qualify under the 35 percent of gross estate or 50 percent of the taxable estate. I think those reductions could ease the problem.

The other area of 303 redemption we would like to make a recommendation on presently under a hardship case the company can redeem the stock in its company up to the amount of estate taxes due on a 10-year installment plan, but the interest rate recently has gone from 4 to 9 percent.

As a banker, personally I'm in no position to quarrel with the Government wanting to get a higher interest rate. I think you have to get a value there. I'm willing to concede this as an independent businessman as is our independent business association. But I think we need to ease the qualifications for the 10-year installation plan. We would like to see some tax benefit given on the dividends on the corporate stock that is owned by the estate. We would like to see just a small modification like allowing the corporation to treat these dividends as a tax deductible expense and that would ease the cash flow in that estate and I think would ease the whole problem of administration under 303 redemption.

This concludes my formal testimony and I thank you gentlemen for your attention.

[The prepared statement of Mr. Treptow in full follows:]

STATEMENT OF

DEAN A. TREPTON, PRESIDENT

THE BROWN DEER BANK
MILWAUKEE, WISCONSIN

AND

CHAIRMAN OF THE
LEGISLATIVE COMMITTEE

INDEPENDENT BUSINESS ASSOCIATION OF WIS.

HEARING

United States Senate

SENATE SELECT COMMITTEE ON SMALL BUSINESS

Thursday, September 25, 1975

Messrs. Chairmen and Members of the Committee:

I appreciate the opportunity to testify before this Committee on behalf of the Independent Business Association of Wisconsin. The subject on which I have been asked to testify is Federal Estate Taxes. Death taxes are mong the oldest and most accepted forms of taxation in our country. I think this has been particularly true in our American society, as we have always had a great deal of respect for individuals to pull themselves up by their own bootstraps. Estate Taxes are levying revenue for the Federal Government at a time when the creator of the wealth has deceased and the only real cost is to the heirs who probably did not contribute to the development of the wealth. I think this is consistent with the American philosophy that has prevailed for most of our history. We generally oppose the amassing of huge wealth in the hands of relatively few people, particuarly where the inheritors of this wealth have not tehmselves contributed to its creation.

We have no quarrel with this concept. Relative to the total Federal tax structure, estate taxes do not represent a major source of revenue to the Federal government. In fact, in recent years the total of both estate taxes and gift taxes have stabilized at about 2% of total Federal

revenues. Why then should we be concerned enough about this relatively small source of revenue to the point of testifying before this Committee.

While this tax does represent a relatively minor source of revenue to the government, it does have a significant affect in producing a tendency toward realignment of business ownership. This effect I am almost certain was never intended by those drafting our tax laws. I would like to describe for you what I believe is the reason behind this undesirable affect, and then attempt to quantify the impact and offer some suggestions for improvement in the estate tax structure.

The source of the problem lies in the liquidity of the assets that comprise an estate. Stated another way, the vastness of wealth that comprises an estate has absolutely no bearing on the estate's ability to pay taxes when levied. The type of assets represented in an estate of any given size can range from cash, or U. S. Government securities, to real estate, corporate stock or intangible assets such as patents or franchises. Obviously the ability for an estate to write a check for the estate taxes due will vary greatly in proportion to the type of assets that are held. The undesireable effect of the lack of liquidity in an estate is the built in motivation for business concentration, i.e. for small businesses to be sold to larger

corporations, particularly those with listed securities. I can describe a case situation that I think will illustrate the nature of the problem and the likely consequence. My personal situation, I believe, will serve our illustration well.

I grew up on a small dairy farm in Wisconsin and after graduating from college, I worked for two major corporations, prior to buying an interest in a suburban bank in the Milwaukee area, which I now manage as president. I am 37 years old, with a wife and four children. My financial assets are totally the result of retention of earned income. I have had no inheritances nor do I anticipate any inheritances of consequence in the future. By far the majority of my assets are represented by the stock I own in The Brown Deer Bank, a $25,000,000 bank, the stock of which is not publicly traded. My ownership interest in the bank is a substantial percentage of the total shares outstanding, but it does not represent control. In planning my estate and attempting to prepare for an untimely early death, I am concerned about the following problems. 1) I do not have sufficient cash assets to pay the projected estate taxes on my estate. After savings are exhausted, the administrator of my estate would probably be faced with having to sell my Brown Deer Bank stock or selling our personal residence to liquidate the equity that we have in that real estate. 2) Valuation of my bank stock is

difficult. Further, in our region the sale of a controlling interest in a small bank can make a difference of 25 to 50% of the per share value, as compared to a minority interest.

As concerns the possibility of my death within the next several years, I have decided to accept certain risks in estate liquidity. Our bank is growing rapidly and I have every reason to believe that it will be profitable in the years ahead and my investment should be a good one, for my family and ultimately for my estate. I can offset the risk by buying as much life insurance as possible and praying a lot.

Try to project with me, if you will, what my situation might be like 25 years from now. If I have been successful in carrying out my plans and ambitions, the value of my estate will have appreciated substantially due to the increased value of my bank stock. If I am typical of most human beings at that time, my ambitions may be somewhat dulled and I will probably be more concerned about preserving what I have built than in taking risks and building a life ahead of me. Any wealth that I may have created will be largely through my own doing and I would certainly prefer being able to pass on as much of my estate as possible to members of my own family. If present tax laws still prevailed at that time, I would have these alternatives.

1) I could seek an ambitious young man who might want to buy my bank stock and start where I had 25 years earlier.

2) I could attempt to increase my percentage ownership and obtain control of the bank or probably more likely, seek to find several other existing stockholders in the bank to join with me in aggregating control percentages and seek to sell out a controlling interest which can be presumed to be of far greater value than my individual minority interest.

3) I can simply retire, continue to own my Brown Deer Bank stock and permit the stock to become part of my estate.

Now lets examine what might happen in each of these instances. As regards finding someone who might want to buy my interest and follow the same path that I had pursued, I would probably not place a high priority on this possibility. First I would be selling a minority interest which would not have the value thatthe sale of control would represent. Further, such a buyer would probably pay me with cash, or a cash equivalent and I would have to pay income taxes as a result of this sale which would reduce the value of my estate.

If I were able to join forces with other stock holders, an aggregated group that would represent controlling

interest in the bank, we could probably sell our respective interests for a much higher value than we could individually. If we sold to other individual investors for cash, we would incur the same income tax described in the first situation. A far more likely alternative would be for us to seek out a larger bank with securities listed on the New York Stock Exchange and accomplish a tax free exchange of common stock at which time we would have been able to obtain the higher value for our stock, supported by the controlling interest. We would not have incurred an income tax at the time of sale, but yet our estates would have had a marketable security as an asset as opposed to the stock of a closely held corporation.

In the third instance, assuming that I decided to simply retain stock and let my estate worry about the problems of liquidity, I would probably create a very complex situation for the administrators of my estate. First they would be faced with the problem of how to properly evaluate the stock. They would have a minority interest and would not be able to achieve maximum value. They would have to be prepared to come up with a logical evaluation and defend this to the Internal Revenue Service. Secondly they would have to seek the market for the stock and would probably suffer a real discount in value because the sale would be under some durress and the potential buyers would have a preferential position in negotiation. A Section 303 redemption would be out of the question in my situation as banking statutes, for all practical purposes, preclude a Section 303 redemption that

would otherwise be available to other corporations. Assuming that a Section 303 redemption were possible, however it would probably place the corporation in a very difficult position. If I had been successful in meeting my objectives as manager of the bank, we would have had a growth oriented bank that for all of the 25 year history of my management would have been fighting a capital adequacy problem. Redemption of stock by a growth oriented corporation of any type, bank or non-bank, is a difficult proposition. The Section 303 redemption diverts funds for estate tax purposes that are almost always desperately needed to support the on-going operations of the corporate business.

Lets assign some actual values to this case situation, and look at what the actual tax impact would be. For the purpose of simplicity I will use round numbers. Let us say that the original cost on my bank stock was $100,000 and 25 years from now it would be worth $200,000. This represents a gain in valuation of $100,000. If I were to sell the stock for cash, for $200,000 and if I qualified for the alternative tax on capital gains, I would incur a $30,000 income tax bill at the time of sale. This would reduce the proceeds of my stock to $170,000. I would at that time, have cash, or cash equilavent which would provide me with a potentially liquid estate. If I were to die shortly after this sale for cash, the estate taxes on $170,000 might be assumed to have a marginal rate of 40% or $68,000 and the net residual of

my estate with regard to my bank stock would now be reduced to $102,000.

On the other hand, if at age 62 I were to sell this stock by exchanging it for the securities of a large bank that was listed on the New York Stock Exchange, and realized $200,000 in value on the listed security, I would incur no income tax and I would still have a liquid asset to forward to my estate but I would be $30,000 further ahead. Assuming again that I died shortly after this transaction, and assuming a 40% marginal estate tax rate, the estate taxes would amount to $80,000 and my net estate would be reduced to $120,000, thus realizing a benefit of $18,000 for having exchanged my stock for the listed security as opposed to selling for cash. I think we can draw two conclusions from this comparison. First, an almost 20% differential in my net estate after a payment of estate taxes, is a substantial motivation to cause me to sell out for the listed security as opposed to cash. Certainly I think any prudent man who has any regard for his family would not consider holding the closely held bank stock up to the point of his death, in subjecting his estate to the complexities described above, if he had the alternative to exchange his stock for a listed security as described. The situation I have described refers to my own situation in a bank, the principals involved however are identical to any small business man in any type of business venture. I am sure you will agree that the present tax

structure does build in a strong incentive for the business man to seek out a publicly traded corporation and exchange his company stock for a listed security. Thus the tax structure tends to shift business ownership from a wide number of independent owners into fewer and fewer larger entities.

This tendency to concentration, we are convinced, is a significant and wide-spread problem. We have attempted to research the business acquisitions of Wisconsin corporations that have occurred thus far in 1975. To the best of our knowledge, 11 business acquisitions have taken place in Wisconsin to date this year. Interviews with the officers or former stockholders of the corporations that were sold, revealed the following information:

Five of the 11 were sold to the larger corporations specifically for an estate liquidity of the prior stockholders. Three of these firms were sold to New York Stock Exchange listed firms, one was sold to an over the counter company and the fifth was sold to an international conglomerate. Two of the 11 firms sold were sold to New York Stock Exchange listed firms of national reputation because they had grown so rapidly that they could no longer obtain the working capital to support their growth. This is no direct bearing on estate tax problems, but it certainly lends support to the testimony given by my associate Mr. Bruno Maurer on the importance of the surtax exemption and accelerated deprecia-

tion. The remaining four firms were sold for reasons that cannot really be related to taxation. The important point is that seven out of the 11 firms sold were stated to have been sold specifically for reasons of tax impact; five out of the 11 specifically for estate liquidity. A brief synopsis of the firms sold for estate liquidity is as follows:

1) A large financial institution which had several large private stockholders who felt that they were locked in. Their stock ownership ranged from 2% to 11% each of the total stock outstanding, despite the fact that the stock of this corporation was traded over the counter there was no market from individuals who wanted to acquire blocks unless they were gaining control. It was five stockholders who were concerned with their liquidity problem and they were all over 65. In order to find a market for their stock at an acceptable price, they worked to aggregate a number of stockholders that could represent a controlling interest and the sale was consummated. In the opinion of management of the corporation concerned, this sale would not have taken place if these five large stockholders had not been seriously concerned with the liquidity of their estate.

2) A packaging container company was sold to an over the counter traded corporation of a larger size as the company was closely held and family owned. Members of the family were seriously concerned with how to meet the taxes upon their death and none of the individuals involved, nor the corporation, had sufficient cash assets to meet the

estate tax obligations.

3) A technically oriented metal working company was sold to a New York Stock Exchange listed firm. A majority owner of the firm who had recently retired as Executive Officer had built the firm to a net worth of close to $2,000,000. His interest in this non-public company, represented most of his net worth, and his estate taxes would have been in a magnitude where the company could not possibly have afforded a Section 303 redemption. As a result, he sold his company.

4) An engineering firm which was a manufacturer in the metal workings trade was sold to a New York Stock Exchange listed firm. The company had been founded 49 years ago and was totally owned up to the date of sale by a husband and wife who had founded the firm and they had determined, in their opinion, that the sale to a New York Stock Exchange listed company was the most prudent action that they could take.

5) A substantial printing company was sold to a New York Stock Exchange listed firm. One individual who managed the company for much of its history was now over 75 and owned over 50% of thecorporation. It was reported to us that this individual's interest in selling to a larger corporation was almost totally motivated by estate liquidity prior to death.

We are aware of no panacea for this complex problem created by estate taxes. We do feel however, the problem is significant not only to small business men, but the type of business structure and economy that the majority of Americans seem to desire. Accordingly we would like Congress to consider the following:

1) We would like both the administration and Congress to join with us seeking out the most effective means by which we could solve the problems described without significant impact on flow of revenues to government. We have some suggestions which we will outline here, but we really think the whole area needs some extensive research, which is a very worthwhile undertaking for government as well as our small business sector.

2) We recommend that the exemption for estate tax purposes be increased from the present $60,000 to $200,000. We believe that this is important because it would remove hundreds of small firms from the estate tax planning problem entirely. We would be interested in receiving a revenue impact study from the Treasury Department on this proposal. If the revenue impact could be justified it would largely solve the estate liquidity problem for all of the smallest firms that are least capable of retaining the professional counsel that is necessary for adequate tax planning. This would include small retailers, wholesalers and probably a vast portion of America's owner-operated farms.

3) We would like Congress to consider modification of the recently passed Pension Reform Act to simplify the establishment of Employee Stock Ownership Trusts. This special form of a qualified profit sharing plan has recently received a lot of attention. It has many virtues such as spreading ownership of a corporation among numerous employees providing a vehicle by which existing stockholders ownership can be acquired and redistributed with the people who have a vested interest in the success and perpetuation of the corporation- the employees themselves. Valuation requirements for acquisition of the company stock by an Employee Stock Ownership Trust and valuation for purposes of distribution to employees upon termination of employment and/or retirement is very complex. Revision of existing statutes to ease the implementation and operation of the E.S.O.T. would be a very significant step toward solving the problems that I have discussed today.

4) Section 303 redemptions reflected an effort by the writers of the tax codes to give a partial solution to the problem we have described here. It has given some relief. We do believe, however, that Section 303 can be amended so as to make it a viable alternative to far more companies. Two suggestions would be (a) in current law an estate may qualify for a Section 303 redemption if the company capital represents 35% of the gross estate, or 50% of the taxable estate. We would like to recommend a reduction of 20% and 40% respectively. We believe that there is a great incidence of minority stockholders who can have great impact on the sale of a controlling interest in a company, when they themselves do not presently qualify for a Section 303, liberalizing the qualifications would be beneficial. Presently under a Section 303 redemption, the estate tax obligation may be paid off on a ten year instalment payment program. The interest rate on these instalment payments have recently increased from 4% to 9%. This has made the redemption more costly. We can justify the increase in the interest cost as something that is properly due the government for waiting for its tax payment. A very significant improvement of Section 303 redemptions could be made if the dividends on the corporate stock paid to the estate were to be made tax deductible to the corporation as an expense. This would significantly reduce the after tax cash flow required to pay the estate tax levy.

Thank you for this opportunity to testify before your Committee today. We welcome this opportunity to communicate directly with our Legislative leaders and certainly desire to maintain this communication in the future.

Senator NELSON. On the same issue you addressed yourself to respecting the sale of stock to another conglomerate corporation, one of the witnesses was arguing for the following proposition for the small businessman with a family business, who had to sell for cash and had to pay a capital gains tax. He argued for the proposition that he ought to be able to sell it for cash to an independent buyer who wanted to maintain the business; and that if he reinvested that money with *x* period of time, that that would postpone the incidence of the capital gains tax until he either dies or sold the stock in which he invested, arguing that there would be no loss to the Treasury in the long pull.

Mr. TREPTOW. Right, I understand.

Senator NELSON. And that would be true whether he exchanged stock with a corporation or not?

Mr. TREPTOW. Yes.

Senator NELSON. That was the first time in our hearings, as far as I can recall, that that particular proposal was made. It sounds like an interesting concept. What do you think of it?

Mr. TREPTOW. I personally subscribe to that theory for the small businesses that I have had experience with because it really relates to the problem of who is going to be the most productive user or administrator of that capital; either the business where it is employed or funneling it back into the economy. I like the concept of leaving that capital untaxed, maybe declared perhaps, but unpaid as long as it is employed in the small business. Perhaps you could tax it only when the owner of that capital or that estate achieves liquidity by sale for cash or marketable securities at a later date. I don't know what the impact of that would be or if we could properly restrict that and assign it to just those situations. But I certainly endorse the concept of leaving the capital untaxed as long as it is productively employed to support sales, employment, and support manufactured goods in the economy.

Senator NELSON. It would not only leave the money in the marketplace in one way or the other working, but it also might help avoid the problem of the absorption of independent businesses by conglomerate corporations.

Mr. TREPTOW. It would directly and favorably affect that situation no doubt. I think it is an excellent concept.

Senator NELSON. Thank you very much for your very thoughtful contributions to the hearing.

I will call next on Mr. How, publisher of the Free Press, Mankato, Minn.

Mr. HOW. My testimony is going to be repetitious of the testimony immediately given before in many instances, but perhaps will serve to emphasize the points that have been made.

I am Jared How, principal owner of the Free Press Co. which publishes daily newspapers at Mankato and Owatonna in Minnesota. When I inherited the majority interest in the company about 19 years ago, the value of the company was modest. The estate taxes payable were tolerable. The specific exemption of $60,000 covered a substantial part of the company's value and the remainder of the value fell into the low and middle end of the graduated rate.

Today, partly as a result of inflation and partly as a result of the

great growth of group newspaper operations and very impressive advances in technology, market value of our company, as determined by formula used by the IRS has increased tremendously. The same situation, of course, faces the owner of any enterprise where availability is in short supply.

The trouble is my business, which, like farming, involves a very valuable asset, does not throw off enough income to pay estate taxes on top of the cost of operating and modernizing the business. The value in the marketplace is far greater than the value to my heirs.

While my company's profits over the last decade have, to some extent, kept pace with inflation, market value has increased about seven times. Stock in the company valued at $800 a share when inherited would, on the basis of prices paid for a comparable newspaper property today, be worth close to $6,000 a share. On this kind of a value estate taxes would run over $1 million.

It is difficult to see how the company could generate enough cash to allow my heirs to handle this amount of tax.

It would be helpful if the present provisions permitting payment of estate taxes over a period of years in installments were liberalized, but these proposals assume that the deferred tax will be based on a value equal to the price a buyer might be willing to pay at the time of the owner's death, and, of course, the recently enacted 9 percent interest charge on unpaid balances, pretty well negates the value of the installment method to an estate. The trouble with this is that it makes it very difficult for me to pass ownership of my business on to my family.

If I can't lay up enough cash during my lifetime to pay my estate taxes, what should I do? I am better off to sell out to a large, publicly owned company in a tax-free reorganization. This will give me my marketable stock that can be sold to pay my estate taxes; however, this means that there is no guarantee of family continuance in the operation of the company.

Senator NELSON. You are talking about a sale in which he receives the stock of a company listed on a stock exchange?

Mr. HOW. Yes sir, a merger.

Senator NELSON. So even if you wanted to sell it to an independent, you couldn't afford to do so because you have to pay immediately a capital gains tax, whereas if you exchanged the stock, you wouldn't?

Mr. HOW. I guess the capital gains problem, which I will be coming to a little later Senator, is not that important to me. I think in my particular case, and I am arguing in the statement against consolidation, is that there is nobody to sell it to except those already in business because of the value.

My responsibility, as a publisher of a privately held newspaper, is to myself. Group management's responsibility is to public stockholders. Their primary responsibility is to maximize profits.

I feel that individual or family ownership of a business or farm is a good thing. From a market value viewpoint some small businesses and farms may not necessarily be small business any more, but they are businesses with close personal ties to their communities and are apt to have a continuing interest in and commitment to that community's future.

As family-owned businesses and farms pass into ownership of publicly owned corporations or are consolidated into larger holdings, the concentration of wealth is enhanced.

I am concerned about this increasing concentration, at least some of which is brought about by estate taxes. In my own field I am concerned about the decreasing number of real decisionmakers. I think the managers of today's newspapers are, generally, public-spirited, concerned citizens who are doing a good job, but I do feel that the communications industry could do a better job if there were more decisionmakers, more competitors for America's attention. In short, I think there is a public interest to be served in making it possible for people like myself to pass ownership of their businesses on to their families.

It seems an anomaly to me that while the recent thrust of business and social legislation in this country has been directed at a redistribution of wealth and the maintenance of a healthy, competitive market, our inheritance laws, designed to further these objectives, are bringing about exactly the opposite result.

What can be done to achieve the goal of passing on family business ownership?

First, the specific exemption must be increased to a level that reflects the enormous increases in the value of business assets brought on by technology, inflation, and lack of availability. I think the present $60,000 exemption should be increased to at least $150,000.

Second, estate tax rates should be reduced, especially at the upper end of the bracket where they are almost confiscatory. An owner may sell his farm or business during his lifetime at capital gain rates which are less than half of the top inheritance tax rates. The property received in that sale can then be disbursed among a number of family members so as to greatly reduce the estate tax that will be payable on the seller's death. This fact creates an enormous pressure to sell out rather than pass the business on to one's family.

Third, and perhaps most important, it seems to me that the estate tax on a family-owned business ought to be more closely related to what that business has earned historically in the years preceding the owner's death. In other words, my widow should pay a tax based upon the value of the property to her—what it can provide her in dividends, salary, or other forms of compensation rather than the price she can get for the business if she sells it.

If she should sell it at a later time for a higher value, she would pay tax on the difference either in the form of a capital gains tax, or in the form of a deferred estate tax.

I recognize that fixing the value at which the property should be initially taxed to the family poses some difficult problems, but I don't think the solution of those problems is beyond the ingenuity of this country's tax experts.

I would like to depart, if I may, from my written testimony to say that I think this is really the crux of the matter. There are a good many reasons why a newspaper group operation, and I think these reasons pertain to many hundreds of small businesses, can pay more for a property than the value of that property to an individual. These can be summarized very briefly. There is the in-house expertise that can be spread over many properties and reduce overhead very considerably. In my particular case, for instance, because of the propensity of people filing libel suits today, we need good sound legal counsel. Also because of the complexities of the tax laws and de-

preciation schedules, we need good accounting counsel, and because of this our accounting and legal fees run around $25,000 a year. As one more unit in a group operation, that $25,000 in a group operation which has centralized accounting and which has adequate legal counsel, well that portion of our overhead then disappears. And this is also true of our mechanical expertise and other expertise. And it seems to me that if privately owned business could be taxed on the basis of its profits, on the basis of its book value or its asset value or something like that, at least the owner would be protected from the great surge in market value which comes about from inflation. So I think some formula could be worked out. I think it would be important to plan it carefully. I have consulted with tax people about my own estate. One of the problems which we face or I face personally in trying to plan to keep the business in the family is that nobody can be sure at this point in time what valuation would be acceptable to the IRS at this moment. Now this is kind of a rough situation, Senator. And the variation between what my accountants and my attorneys feel, that variation between the minimum and the maximum is so great that it is really impossible to plan with any degree of safety.

Now getting back to my testimony, in summary, I believe our tax policies should be aimed at diffusing ownership of American business throughout the widest group possible. Our present estate tax system works the other way and tends to concentrate the ownership of our farms and businesses into ever larger units—concentrations which bring problems arising from lack of competition, problems such as public suspicion of administered prices and other monopolistic practices. I believe in family ownership of small American business. I hope this committee can be instrumental in making changes in the estate tax system that will help us keep the ownership of American business in as many hands as possible.

Senator NELSON. Thank you very much. As you know, Senator Mondale has introduced a bill in the estate tax area.

Mr. HOW. Yes, I learned it just this morning.

Senator NELSON. Well thank you very much, Mr. How.

[The prepared statement of Mr. How in full follows:]

STATEMENT BY

JARED HOW, PRESIDENT, FREE PRESS COMPANY
418 South Second Street, Mankato, Minnesota

BEFORE THE
SUB-COMMITTTEE ON FINANCIAL MARKETS
OF THE SENATE FINANCIAL COMMITTEE

AND THE

SENATE SELECT COMMITTEE ON SMALL BUSINESS

September 25, 1975

I am Jared How, principal owner of the Free Press Company which publishes daily newspapers at Mankato and Owatonna in Minnesota. When I inherited the majority interest in the company about nineteen years ago, the value of the company was modest. The estate taxes payable were tolerable. The specific exemption of $60,000 covered a substantial part of the company's value and the remainder of the value fell into the low and middle end of the graduated rate.

Today, partly as a result of inflation and partly as a result of the great growth of group newspaper operations and very impressive advances in technology, market value of our company, as determined by formulae used by the I.R.S. has increased tremendously. The same situation, of course, faces the owner of any enterprise where availability is in short supply.

The trouble is my business, which, like farming, involves a very valuable asset, does not throw off enough income to pay estate taxes on top of the cost of operating and modernizing the business. The value in the marketplace is far greater than the value to my heirs.

While my company's profits over the last decade have, to some extent, kept pace with inflation, market value has increased about seven times. Stock in the company valued at $800 a share when inherited would, on the basis of prices paid for a comparable newspaper property today, be worth close to $6,000 a share. On this kind of a value estate taxes would run over a million dollars.

It is difficult to see how the company could generate enough cash to allow my heirs to handle this amount of tax.

It would be helpful if the present provisions permitting payment of estate taxes over a period of years in installments were liberalized, but these proposals assume that the deferred tax will be based on a value equal to the price a buyer might be willing to pay at the time of the owner's death, and, of course, the recently enacted nine percent interest charge on unpaid balances, pretty well negates the value of the installment method to an estate. The trouble with this is that it makes it very difficult for me to pass ownership of my business on to my family.

If I can't lay up enough cash during my lifetime to pay my estate taxes, what should I do? I am better off to sell out to a large, publicly owned company in a tax-free reorganization. This will give me marketable stock that can be sold to pay my estate taxes: however, this means that there is no guarantee of family continuance in the operation of the company.

My responsibility, as a publisher of a privately held newspaper, is to myself. Group management's responsibility is to public stockholders. Their primary responsibility is to maximize profits.

I feel that individual or family ownership of a business or farm is a good thing. From a market value viewpoint some small businesses and farms may not necessarily be small business anymore, but they are businesses with close personal ties to their communities and are apt to have a continuing interest in and commitment to that community's future.

As family owned businesses and farms pass into ownership of publicly owned corporations or are consolidated into larger holdings, the concentration of wealth is enhanced.

I am concerned about this increasing concentration, at least some of which is brought about by estate taxes. In my own field I am concerned about the decreasing number of real decision makers. I think the managers of today's newspapers are, generally, public spirited, concerned citizens who are doing

a good job, but I do feel that the communications industry could do a better job if there were more decision makers, more competitors for America's attention. In short, I think there is a public interest to be served in making it possible for people like myself to pass ownership of their businesses on to their families.

It seems an anomaly to me that while the recent thrust of business and social legislation in this country has been directed at a redistribution of wealth and the maintenance of a healthy, competative market, our inheritance laws, designed to further these objectives, are bringing about exactly the opposite result.

What can be done to achieve the goal of passing on family business ownership?

First, the specific exemption must be increased to a level that reflects the enormous increases in the value of business assets brought on by technology, inflation and lack of availability. I think the present $60,000 exemption should be increased to at least $150,000.

Second, estate tax rates should be reduced, especially at the upper end of the bracket where they are almost confiscatory. An owner may sell his farm or business during his lifetime at capital gain rates which are less than half of the top inheritance tax rates. The property received in that sale can then be disbursed among a number of family members so as to greatly reduce the estate tax that will be payable on the seller's death. This fact creates an enormous pressure to sell out rather than pass the business on to one's family.

Thirdly, and perhaps most important, it seems to me that the estate tax on a family owned business ought to be more closely related to what that business has earned historically in the years preceding the owner's death. In other words, my widow should pay a tax based upon the value of the property to her -- what it can provide her in dividents, salary or other forms of compensation rather than the price she can get for the business if she sells it.

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I recognize that fixing the value at which the property should be initially taxed to the family poses some difficult problems, but I don't think the solution of those problems is beyond the ingenuity of this country's tax experts.

In summary, I believe our tax policies should be aimed at difusing ownership of American business throughout the widest group possible. Our present estate tax system works the other way and tends to concentrate the ownership of our farms and businesses into ever larger units -- concentrations which brings problems arising from lack of competition, problems such as public suspicion of administered prices and other monopolistic practices. I believe in family ownership of small American business. I hope this committee can be instrumental in making changes in the estate tax system that will help us keep the ownership of American business in as many hands as possible.

Senator NELSON. Our next witness will be Mr. Gerald Sherman, attorney, Silverstein & Mullens, general counsel of the Association for Advanced Life Underwriting.

Mr. SHERMAN. Thank you, sir. As you say, I am general counsel of the Association for Advanced Life Underwriting, a national association of life insurance agents who specialize in one or more fields of advanced life underwriting. Collectively our members are responsible for annual sales of life insurance in excess of $2 billion.

If I may, I will paraphrase selected portions of the introductory materials in my written statement and then go on to summarize briefly some of the substantive aspects on which the statement touches.

Our members are familiar with many of the problems of small businessmen and farmers because these individuals comprise a substantial portion of our clientele. Indeed, our membership is itself composed of small businessmen. The life underwriter is frequently asked to counsel small businessmen on many matters connected with the Federal tax system, particularly those matters dealing with the achievement of sufficient liquidity to pay Federal and State death taxes, the preservation within the family structure of an interest in a small business—or farming operation—after the death of its principal owner, and the implementation of cross-purchase or stock redemption agreements in closely held corporations.

I should emphasize that the life insurance industry as a whole might transitorily profit in a narrow and selfish way if the tax rules affecting small businesses, particularly the transmittal of interest in small businesses at death, were made harsher. Presumably, if estate tax rates were increased or exemptions decreased or if death was held to become the occasion for the realization of capital gains on agricultural or business property and the stock of small, closely held corporations, then the more insurance might be sold—for a while. We believe, however, that adding to the tax burdens of the small businessman and family farmer will ultimately serve to decrease their numbers; we feel that this would be bad for the country and bad for our membership. Accordingly, my testimony will be based on the premise that the preservation and encouragement of small business in the United States is in the public interest.

In my written statement, I touch on a broad range of tax matters of an income, estate, and gift tax nature which arise on the occasion of the lifetime and after-death transfers of business. I will not here try to address each one of these points, many of which have been spoken to by other witnesses, but will focus primarily on those issues on which the life underwriter is particularly familiar because of his professional work.

I refer you to our written statement for specifics of our comments on the other issues. The issues about which I speak now may not necessarily be as intellectually stimulating as matters such as integrating the estate and gift taxes, but they are of immense importance because they concern the direct involuntary cash costs of the transfer of business interests among family members and among groups of employees. If this cash cost becomes too severe, such transfers cannot easily take place and the stage is set unfortunately for sales of controlling blocks of stock in small businesses to outside conglomerates

and large businesses since this may be the only means, as other witnesses have said, of raising the necessary cash. We urge this panel to put its weight behind substantive tax measures which will insure that the tax burden of lifetime transfers and after-death transfers are reasonable ones and ones that are consistent with the preservation of the small business entrepreneurship group in this country.

Now, on the occasion of after-death transfers there are in our experience three normal ways in which cash is made available for the kinds of taxes and administrative costs that arise. One way is, of course, through the availability of life insurance; another way is through the utilization of cash which has been accumulated over time by the small business—and I am contrasting here the small business with the small businessman whose estate may indeed be lacking in cash and cash equivalents—a third method is the extension of credit or time over which to pay the expenses and the taxes.

Our Federal tax system, that is, the income, estate and gift tax system, provides comfort to varying degrees in the raising of cash in these ways. One of the problems, or perhaps the prime problem in terms of its effect on small business, is that the different degrees of comfort which are given can often act in a highly capricious fashion. One small business can find relief in the Revenue Code and the other small business can find death in the same Code. Typical aspects of the Code which tend to provide this relief are those provisions which permit capital gain treatment where ordinary income dividend treatment might otherwise be applicable in the case of distributions from the small business corporation or, indeed, from any corporation. It is the standard rule under the IRS Code that a corporate distribution will generate dividend ordinary income treatment unless a special exception applies, for example, a complete termination of interest of the stockholder whose stock is being redeemed. That exception is itself encumbered by an exception which says that if there are certain family attributions, that is, if certain family members own stock, you can't have the capital gain treatment unless you waive certain aspects of the family attribution rules.

Another capital gain kind of generating event is the section 303 situation to which other witnesses have spoken and which covers expenses and taxes of the estate. The installment payment of estate taxes, to which Senator Mondale spoke this morning, is a means of providing credit terms for the payment of taxes. Section 101 of the Internal Revenue Code provides some comfort in the utilization of life insurance proceeds so that those proceeds can be fully utilized to fund buy-out provisions among natural recipients of small businesses, that is, members of the family of the small businessman and his other business associates.

Unfortunately, although each one of these methods can sometimes be extremely useful to the small businessman, they can likewise be very detrimental in a totally capricious way.

I thought that what I might usefully do in the oral portion of my testimony today is present an illustration of what we consider a prototype situation—a situation which involves the death of a small businessman and which illustrates a number of ways in which we fail to achieve tax results that are available to others without there seemingly being rational differences. The illustration I have developed for this

purpose relies on the presentation of numbers. It is rather specific. It seems to me the most useful way to dramatically illustrate the point to be made. I hope it is followable.

Let's take the case of Mr. Abel. Mr. Abel died on June 30, 1975. At his death, he owned 36 percent of the outstanding stock of King Machine Co. and approximately 29 percent of the outstanding capital stock of Queen Machine Co. He was active in the management of both companies. The value of his stock in King was $180,000 and the value of his stock in Queen was $100,000. These are not overpowering figures and I think they are reasonable for small businessmen. Mr. Abel's son owned $165,000 in value of King stock and Mr. Baker, an unrelated person, owned the remaining $155,000 in value of King stock and the remaining $250,000 of Queen stock. There were no other shareholders in either corporation. Mr. Baker, like Mr. Abel, was active in the management of both corporations.

The remainder of Mr. Abel's estate at his death consisted of $35,000 in cash, marketable securities and other liquid assets, and $600,000 in value of real estate. That real estate was purchased at a relatively low cost by Mr. Abel in 1968 for long-term investment purposes. It is undeveloped; there is no relationship between that real estate and the King and Queen businesses and it is simply being held by Mr. Abel in anticipation of long-term growth. Because of current market conditions, there would be substantial difficulty in arranging a prompt sale of the assets. In effect, the real estate is, for all practical purposes, illiquid. It seems to me this kind of fact development is not at all unusual with regard to the small businessman who has accumulated in his business a certain amount of net worth over the years and wants to place that net worth, which is no longer needed in the business, in growth potential assets which are generally related to the economy.

Mr. Abel's estate is also subject to short-term liabilities of $50,000 and can anticipate expenses and State death taxes of $40,000, or a total of between 4 and 5 percent of the gross estate. Mr. Abel's will provides for a marital deduction trust for the benefit of his wife, a highly typical provision, with the remainder of his estate going to his children. Federal estate taxes can be computed as approximately $92,000. The gross estate is in the nature of $850,000 to $900,000.

Senator NELSON. Pardon?

Mr. SHERMAN. The gross estate is in the nature of $850,000 to $900,000, and the Federal estate taxes are $92,000, 10 percent of the gross estate. I don't think that is a particularly unfair amount to pay with regard to estate taxes.

However, you have to note that the estate has cash needs for $90,000 in Federal estate taxes plus $40,000 in State death taxes and expenses and $50,000 in long-term liabilities or $182,000 of reasonably immediate need. The estate has cash and other liquid assets of $35,000 and it is in trouble. Now, how can we be assured here that the estate will be able to take care of its cash needs?

Mr. Abel and Mr. Baker had entered into a written agreement by which, upon Mr. Abel's death, Mr. Baker would purchase Mr. Abel's interest in Queen for its then fair market value. With respect to King, it was understood that on Mr. Abel's death, John Abel, his son, would continue to own his shares and control the company and Mr.

Abel's shares would be redeemed by the company for cash. Mr. Baker was, in effect, willing to say, "I will go along with King and your estate can pull cash down out of the company. With regard to Queen, I will buy all your stock from your estate."

In 1965, before Mr. Abel and Mr. Baker had entered into their understanding with respect to the disposition of the stock, Mr. Abel had taken out a $100,000 policy on his life. In 1970, when the parties entered into the stockholder agreement, Mr. Abel was no longer insurable. Therefore, Mr. Baker purchased the policy from Mr. Abel for its then cash value, $10,000. He has since paid an additional $8,000 in premiums. It is his anticipation to use the insurance proceeds to fund the purchase price of the Queen stock, which we have assumed to be $100,000.

I should state that in my assumption as to the value of the stock in small businesses I am obviously taking liberties. The difficulties of that evaluation are pointed out in our written testimony and have been described by other witnesses today.

Now as I said, we consider this a prototypical situation. It is a combination of circumstances which is repeated day in and day out. The inability of the Internal Revenue Code to operate equitably in all cases respecting small businesses will cause the following detrimental tax consequences, which will substantially impede the parties' plans for an orderly after-death transfer of Mr. Abel's stock. What they had anticipated with respect to the use of the cash in King Co. and the use of the insurance proceeds will be interfered with capriciously by the operation of the Internal Revenue Code.

First. A redemption of Mr. Abel's stock in King by that corporation in the amount of the value of the stock, $180,000, will generate a like amount of ordinary dividend income rather than capital gain simply because Mrs. Abel is a beneficiary of Mr. Abel's estate through the marital deduction trust. Such a distribution would have qualified for capital gain treatment if Mrs. Abel had owned the stock directly. I can't see the relevance of that distinction. Economically, Mrs. Abel is in the same position. However, it is the Internal Revenue Service's position that if there is an intervening trust, ordinary income is the result. We would urge that this result be changed through the legislative process.

Second. No part of a redemption of Mrs. Abel's King stock qualifies for capital gain treatment under section 303 as being referable to Federal estate tax, State death tax, administrative expense and liabilities, since the value of neither the King stock nor the Queen stock in Mr. Abel's estate is at least as great as 50 percent of the net estate nor is it at least as great as 35 percent of the gross estate; figures that approximate $300,000 to $400,000. His total interest in this stock is $280,000 even if you could aggregate the two companies—an aggregation which section 303 will not permit. If Mr. Abel had a greater value in King or Queen stock and, thus, had been a substantially wealthier man, he could have obtained a capital gains benefit. This seems to me to be an irrational result since the poorer Mr. Abel is in total net worth and the poorer he is in cash, then the worse is his income tax result.

Third. Not having been able to effect a capital gains redemption, Mr. Abel's estate is also not able to utilize the 10-year installment

spread forward in the payment of the estate tax obligation otherwise available under section 6166. However, as with respect to conclusion No. 2 above, this deferral of tax would have been available if Mr. Abel owned a greater value in King or Queen and had been a substantially wealthier man.

Fourth. In terms of the kinds of difficulties this example is intended to illustrate, upon the receipt by Mr. Baker of the $100,000 insurance proceeds, he will have taxable income in the amount of $82,000—$100,000 minus his total acquisition and premium cost of $18,000—and, thus, assuming a 50-percent income tax bracket, which may be modest considering the fact he is going to be burdened with an additional $82,000 in income in 1 year, he will be responsible for income taxes of $41,000 and will have only $59,000 of the proceeds available for the agreed buyout at $100,000. If Mr. Baker had taken out the policy on Mr. Abel's life directly—that is, if Mr. Abel had been insurable at the time of the stockholders' agreement—Mr. Baker would not have been charged with taxable income and the full $100,000 in proceeds would have been available for the stock purchase. The merits of this distinction avoid me. There may be some merit to it, but I can't find it.

Rather than repeat what we have said in our written statement, we will terminate our testimony. We won't burden the time of the committee any further except to urge correction of the problems which we have described. Thank you.

[The prepared statement of Mr. Sherman in full follows:]

STATEMENT OF

GERALD H. SHERMAN, ESQUIRE

COUNSEL

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING
(AALU)

TO THE

SELECT COMMITTEE ON SMALL BUSINESS
AND THE
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE FINANCE COMMITTEE
UNITED STATES SENATE

ON

THE BUSINESS TAX STRUCTURE AND ITS EFFECTS ON SMALL BUSINESS

Matters Primarily Relating to Lifetime
and After Death Transfers of Business Interests

September 25, 1975
Washington, D.C.

TABLE OF CONTENTS

	Page
SUMMARY	i
STATEMENT OF GERALD H. SHERMAN	1
THE ROLE OF LIFE INSURANCE	3
TRANSFER FOR VALUE	6
SPLIT-DOLLAR LIFE INSURANCE	9
REDEMPTIONS UNDER CODE SECTION 303	11
EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX	13
VALUATION OF SMALL BUSINESSES	16
INCREASING ESTATE AND GIFT TAX EXEMPTIONS	21
OTHER ESTATE AND GIFT TAX CHANGES	22
1. The Marital Deduction	22
2. Integrating Estate and Gift Taxes	23
3. The Gift Tax Anomaly	24
PROPOSED CAPITAL GAINS TAX AT DEATH	26
OTHER TAX MATTERS	28
1. Increase in Corporate Surtax Exemption	28
2. The Accumulated Earnings Tax	29
3. Subchapter S Reform and Simplification	31
4. The Family Attribution Rules	32

STATEMENT OF GERALD H. SHERMAN

SUMMARY

The Role of Life Insurance. The major role of life insurance in the small business context is to provide the liquidity which will enable the business to continue to function despite the death of a proprietor, partner or shareholder.

Transfers of Life Insurance. Present Internal Revenue Code provisions which allow the transfer of existing insurance policies for valuable consideration without the imposition of income tax on the proceeds when received by a beneficiary should be broadened to include transfers between shareholders in closely-held corporations.

Split-Dollar Life Insurance. Legislation is needed to make clear that the proceeds of "split-dollar" life insurance policies on the life of a controlling shareholder are not subject to the estate tax when the insured has relinquished all incidents of ownership in the policies prior to his death. The present treatment of this type of life insurance by the Revenue Service discriminates in favor of executives of publicly-held corporations.

Stock Redemptions Under Code Section 303. Section 303 of the Internal Revenue Code should be liberalized in the interest of preserving small businesses from the necessity for liquidation or merger.

<u>Extension of Time For Payment of Estate Tax</u>. Provisions of the Internal Revenue Code allowing payment of the estate tax in installments when a substantial part of the estate consists of an interest in a closely-held business are believed to be under-utilized for a variety of reasons. It is suggested that a return of the interest rate on installment payments to prior levels and liberalization of the eligibility requirements might make the use of Code Section 6166 a viable alternative to liquidation or merger.

<u>Valuation Problems of Small Businesses</u>. One of the most difficult problems facing a shareholder in a small corporation is the necessity for valuing his interest in the business upon death. A "rule of thumb" or balance sheet approach to the valuation of a closely-held corporation after the death of a principal shareholder ignores subjective factors and may often be invalid. Some suggestions are made which might ameliorate this problem.

<u>Increasing Estate and Gift Tax Exemptions</u>. The impact of estate and gift taxes on the transfer of interests in small businesses could be substantially lessened by a realignment of estate and gift tax exemptions and tax rate tables to compensate for the effects of inflation.

<u>Other Estate and Gift Tax Changes</u>

1. <u>The Marital Deduction</u>. Adoption of a 100 percent

estate tax marital deduction is appropriate if the family is considered as a single economic unit.

2. Integrating Estate and Gift Taxes. A brief summary is made of considerations involved in the full or partial integration of the estate and gift taxes.

3. The Gift Tax Anomaly. Mention is made of certain circumstances under which the full benefits of the annual gift tax exclusion and the gift tax marital deduction become unavailable.

Imposition of a Capital Gains Tax at Death. Recent proposals to impose a capital gains tax on the unrealized appreciation of capital assets at death are shown to be very inhibiting to the continued welfare of small business. The AALU strongly recommends against the adoption of any such changes.

Other Tax Matters Reviewed Briefly

1. Corporate Surtax Exemption. The enlargement of the corporate surtax exemption to $50,000 for 1975 only should be made permanent and increased to compensate for the effects of inflation.

2. The Accumulated Earnings Tax. The mere existence of the accumulated earnings tax substantially inhibits the achievement of adequate liquidity, self-financing of business expansion and the amassing of funds for the redemption of stock in closely-held corporations. Consideration should be given to a further increase in the accumulated

earnings credit.

3. <u>Subchapter S Simplification and Reform</u>. The extreme complexity of provisions of Subchapter S of the Internal Revenue Code have often caused this form of elective business taxation to be characterized as a trap for the unwary. Reform and simplification of Subchapter S would be of substantial benefit to small businessmen and could be accomplished with little or no revenue loss.

4. <u>Stock Ownership Attribution Rules</u>. Redemptions of stock without ordinary income dividend consequences by shareholders of closely-held corporations are strictly circumscribed by statute. Action is urged to clarify the intent of Congress with respect to the filing of waivers of the family attribution rules under Code Section 302(c) in view of the position of the Internal Revenue Service on these matters.

STATEMENT OF

GERALD H. SHERMAN, ESQUIRE

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS
AND THE
SUBCOMMITTEE ON FINANCIAL MARKETS
OF THE FINANCE COMMITTEE,
UNITED STATES SENATE

Washington, D.C.

September 25, 1975

MR. CHAIRMAN:

My name is Gerald H. Sherman. I am a member of the Washington, D.C. law firm of Silverstein and Mullens and counsel to the Association for Advanced Life Underwriting (AALU). The AALU is a national association of approximately a thousand members who specialize in one or more fields of advanced life underwriting. Collectively, they are responsible for annual sales of life insurance in excess of $2 billion, mostly in circumstances involving complex factual situations and often dealing with business planning considerations. AALU is affiliated with the National Association of Life Underwriters (NALU), the largest life insurance industry field force organization in the United States. NALU has a membership of approximately 120,000 life insurance agents.

I am most appreciative of the opportunity to present our views on several aspects of the Federal tax system affecting small business.

Our members are familiar with many of the problems of small businessmen and farmers because these individuals comprise a substantial portion of our clients. Indeed, our membership is itself composed of small businessmen. The life underwriter is frequently asked to counsel small businessmen on many matters connected with the Federal tax system, particularly those matters dealing with the achievement of sufficient liquidity to pay Federal and state death taxes, the preservation within the family structure of an interest in a small business (or farming operation) after the death of its principal owner, and the implementation of cross-purchase or stock redemption agreements in closely-held corporations.

The life insurance industry as a whole and some of the members of our organization might transitorily profit in a narrow and selfish way if the tax rules affecting small businesses, particularly the transmittal of interests in small businesses at death, were made harsher. Presumably, if estate tax rates were increased or exemptions decreased or if death was held to become the occasion for the realization of capital gains on agricultural or business property and the stock of small, closely-held corporations, then more insurance might be sold -- for a while. We believe, however, that adding to the tax burdens of the small businessman and family farmer will ultimately serve to decrease their numbers; we feel that this would be bad for the country and bad

for our membership. Accordingly, my testimony will be based on the premise often enunciated by the Select Committee and by the Congress as a whole that the preservation and encouragement of small business in the United States is in the public interest.

I will first address myself to the kind of problems which are repeatedly encountered and observed by our membership in their roles as life underwriters and insurance counselors, i.e., those tax and related problems affecting the preservation and encouragement of small businesses and the transmission of interests in small businesses during life and at death. Appropriate emphasis will be given to tax considerations involving the use of life insurance by the small businessman. I shall conclude my remarks with a brief word on a few other tax matters affecting small businessmen which are not frequently called to the attention of our membership, but which the AALU believes worthy of mention. Your Committees have probably received testimony on most of these items. The AALU would simply like to commend such subjects to your attention and add our voice to those of others expressing opinions on these subjects.

THE ROLE OF LIFE INSURANCE

A major role of life insurance in the small business context is to provide liquidity which will enable the business

62-209 O - 76 - 38

to continue to function despite the death of a proprietor, partner or shareholder. Without sufficient liquidity, the business may have to be partially dismantled or sold to pay debts, expenses and taxes. The effect of estate and inheritance taxes on a small business after the death of one of its principals depends in large part, of course, upon both the overall size of the business and the portion of the decedent's estate which it constitutes.

The 50 percent marital deduction and the $60,000 exemption provided by Sections 2056 and 2052 of the Internal Revenue Code allow passage of a net estate of $120,000 free from any Federal estate tax liability.*/ Even in such a case, however, there may be several thousand dollars of state death taxes payable. The small businessman's principal asset is usually his business and because of lack of easy access to capital from outside sources his savings must usually be reinvested in his business if it is to grow and to meet competition. As the value of the business increases, the amount of liquidity needed to pay Federal and state death taxes increases sharply due to the progressive nature of these taxes. For example, if a decedent's net estate is $1 million and he is able to take advantage of the maximum marital deduction, the Federal estate tax is $126,500 (if he

*/ Hereinafter, all statutory references are to sections of the Internal Revenue Code of 1954 unless otherwise indicated.

were not survived by a spouse the Federal estate tax would be $303,500).

Insurance on the life of a principal shareholder may be purchased by the corporation to facilitate a redemption of stock by his estate under Section 303 to pay administrative expenses, debts and taxes. Insurance funding is also frequently used in connection with shareholder cross-purchase or buy-sell agreements in closely held corporations where the remaining shareholder or shareholders need a source of funds to purchase the stock of a deceased shareholder.

In sum, life insurance often plays a significant role in ensuring the continued existence of a small business after the death of its owner or a substantial shareholder by providing the liquidity necessary to meet the cash needs occasioned by death and/or to facilitate the orderly transfer of the decedent's interest in the business to other active shareholders or partners. For the sake of brevity, I will refer in my subsequent remarks principally to small businesses organized in corporate form. Naturally, similar problems are usually faced by small businessmen operating as proprietors or in partnerships.

There are certain aspects of the tax laws dealing with life insurance which, if changed, would facilitate the preservation and continuance of small businesses after the death of a principal owner. One of these is the so-called

"transfer for value" rule contained in Section 101(a)(2).

TRANSFER FOR VALUE

In a small business organized in corporate form there are not infrequently two or more unrelated shareholder-employees for whom the business provides the principal source of livelihood. As the business matures and the shareholders grow older, it becomes necessary to plan for the contingency of a shareholder's death. If the wives of the shareholders have not been active participants in the business, the shareholders may be unwilling to have stock ownership (with its attendant voting rights) and a proportionate share of the profits go to a non-employee. Or, even if this is not unacceptable, the surviving spouse of a shareholder may have substantial cash needs upon death which can only be satisfied from a disposition of the decedent's interest in the business. Typically, the market for such an interest is limited to the remaining shareholders who may not themselves have the cash necessary to purchase a fellow shareholder's interest.

This problem is frequently resolved by shareholder buy-sell agreements funded with life insurance. Unfortunately, however, by the time the shareholders reach the age where the establishment of such arrangements becomes of vital concern to them, they may be uninsurable, or because of age

or health problems, insurance may be available only at a very high premium. If such a shareholder has an existing insurance policy or policies, he might wish to transfer them (for adequate consideration) to a fellow shareholder who would commence paying the premiums and, thus, be able to use the proceeds to purchase the stock of the insured from his estate.

Section 101(a) provides that the proceeds of life insurance received upon the death of an insured are not considered taxable income to the recipient unless the policy was transferred for valuable consideration. In such case, the insurance proceeds in excess of the sum of the consideration paid for the policy and the premiums paid subsequent to transfer are taxable income to the recipient. The purpose of the "transfer for value" rule has been stated as one of preventing speculation on the death of the insured.*/ In enacting Section 101, Congress recognized that there were situations involving the transfer of insurance policies for valuable consideration where it need not be concerned with such speculation. Exceptions were provided in the case of transfers of policies to the insured, to his partner, to a partnership in which he is a partner, or to a corporation in which he is a shareholder or officer. These transfers have

*/ S. Rept. No. 1622, 83rd Cong., 2d Sess., p. 14.

been recognized as being made for "legitimate business reasons."*/

In establishing these exceptions, the legislature omitted any provision exempting shareholder-to-shareholder transfers. We feel that the omission of shareholder-to-shareholder transfers from the excepted categories for the purpose of funding a buy-sell agreement is an oversight which would aid the orderly continuation and continuity of ownership of small, closely-held corporations if remedied. It should not be difficult to set up a few simple criteria which would prevent abuses in circumstances where there was no legitimate business purpose. A suggested approach to curative legislation may be found in H.R. 11450, introduced in the 89th Congress by former Chairman Mills at the request of the American Bar Association.**/

*/ Id.

**/ H.R. 11450 contains the recommendations of the American Bar Association for a wide variety of changes in the Internal Revenue Code. Section 3 of that Bill would also extend the exception from the transfer for value rule to spouses, former spouses, parents, lineal descendants and adopted children. The explanation of H.R. 11450 published by the ABA concludes that these persons, as well as shareholders of closely-held corporations, have an insurable interest in the life of an insured and, thus, could initially purchase from an insurance company a policy covering the insured and receive the proceeds without undesirable income tax consequences.

SPLIT-DOLLAR LIFE INSURANCE

The proceeds of a life insurance policy receivable by someone other than the executor or administrator of an insured are not included in the taxable estate, providing the decedent possessed at death no "incidents of ownership" in the policy.*/ The Revenue Service, however, through the issuance of regulations of questionable validity under the statute, has asserted that the proceeds of "split-dollar" policies on the life of a sole or controlling shareholder payable to a person other than the corporation are includable in the insured's estate.**/ The position of the Revenue Service in this matter results in a serious discrimination against small businessmen in favor of executives of large, publicly-owned corporations.

A split-dollar life insurance policy is one in which both an employer and an employee participate in the benefits and share the premium payments of the policy.***/ In such an arrangement, the employer pays that part of the annual premium

*/ Section 2042(2).

**/ Treas. Regs. §20.2042-1(c)(6). The regulations do not refer specifically to split-dollar insurance, but can easily be read as including such insurance within their grasp. Discussion with representatives of the Revenue Service at the time of the issuance of the final regulations confirmed this reading.

***/ In some cases the employer may pay all of the premiums. If so, the employee is deemed to have received additional taxable compensation in an amount equal to his share of the premium payment.

equal to the increase in the cash surrender value of the policy and the employee pays the balance. Upon the death of the employee the employer is the beneficiary of the policy proceeds to the extent of its cash value at death or the total of premiums paid. The designated beneficiary receives the balance of the proceeds.

Such an arrangement enables an employee to carry substantial amounts of insurance on his life at relatively low cost. This is especially useful to small businesses because it allows the business to build up a reserve against the unfavorable consequences of the death of a principal employee or for purposes of redeeming the employee's stock. At the same time, the beneficiary will receive funds enabling him or her to pay Federal and state death taxes and the costs of administration of the employee's estate.

In the case of a shareholder owning more than 50 percent of the corporation's stock, however, the Revenue Service has taken the position in Treas. Regs. §20.2042-1(c)(6) that the incidents of ownership of the employer in the policy are to be attributed to the deceased shareholder-employee, thus causing that portion of the proceeds received by the individual beneficiary to be included in the decedent's taxable estate, whether or not the decedent has given away his incidents of ownership in the policy. The executives of large corporations where stock ownership is more widely

distributed may easily cause their portion of the policy proceeds to be excluded from their taxable estates by transferring all incidents of ownership to the intended beneficiary, notwithstanding the fact that such executives may effectively "control" such large or publicly-held corporations. The resultant discrimination against small businesses can easily be said to be another factor which may encourage the absorption of small businesses by larger ones. It also clearly inhibits the use of insurance to provide the liquidity needed to ensure the continuance of a small business upon the death of a principal shareholder. This form of discrimination against the continued existence of a small business after the death of a principal shareholder can be eliminated through a clarifying amendment to Section 2042.

REDEMPTIONS UNDER CODE SECTION 303

Section 303 of the Code allows the estate of a deceased shareholder to receive capital gains treatment (rather than ordinary income or dividend characterization) of amounts received in redemption of the stock of a deceased shareholder which do not exceed the amount of the federal and state death taxes payable plus administrative expenses. However, to be eligible under this section, the stock owned by the decedent must comprise more than 35 percent of the value of his gross estate or more than 50 percent of his taxable

estate. If the decedent owned stock in two or more corporations, such stock may be treated as the stock of a single corporation for purposes of Section 303, providing the estate owns more than 75 percent in value of the stock of these corporations. It is submitted that a lowering of these limitations would facilitate the preservation of small businesses from liquidation or mergers, particularly in the case of the 75 percent rule applicable to stock in two or more corporations. It would seem difficult to justify the retention of these rather arbitrary limits.

All that Section 303 accomplishes is to provide that amounts received from the redemption of the stock shall not be treated as ordinary income -- a capital gains tax is payable on any increase in value of the stock over its taxable value in the estate of the decedent. Moreover, if the stock owned by the decedent consisted of readily salable shares of a publicly-held corporation, the sale of such publicly-held stock would always result in capital gain treatment to the extent the proceeds of sale exceeded the stock's value in the decedent's estate. In effect, Section 303 is an implicit recognition of, and a partial attempt to ameliorate, the numerous discriminations against small business built into the Internal Revenue Code.

EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX

Where a decedent's estate consists in substantial part of an interest in a closely-held business, i.e., where such interest comprises 35 percent of the value of the gross estate or 50 percent of the taxable estate, the executor may elect, under Section 6166, to pay all or part of the Federal estate tax attributable to the value of the interest in not more than ten equal installments. For purposes of that Section, a "closely-held business" is defined as: (1) a proprietorship; (2) a partnership having no more than ten partners or one in which the decedent had a capital interest of at least 20 percent included in his gross estate; or (3) a corporation having no more than ten shareholders or one in which 20 percent or more in value of the voting stock was included in the decedent's gross estate. Interests in two or more closely-held businesses are considered as a single business for purposes of this section, provided the decedent owned more than 50 percent of the total value of each business. Other provisions of Section 6166 provide for acceleration of payment in the case of the failure to pay any installment on time, and in other defined circumstances.

It is understood that very few taxpayers take advantage of Section 6166 because of the various limitations contained therein and for the very practical reasons that the executor remains personally liable for the tax until it

is paid in full and because the Treasury may require the posting of bond for payment. Inquiry in the Washington, D. C. area has found that bonding is probably unavailable unless the executor is able to pledge liquid assets to the surety company. It was also learned that the premium for such a bond would be substantially higher than for the normal executor's bond. A further practical difficulty is that if payment of the installments is to be made out of the earnings of the business, and given that the executor remains personally liable until the tax is paid in full, the executor's own personal assets remain at the hazards of the business for a protracted period of time -- if the business fails or is unable to generate sufficient funds to pay the tax, the executor will be liable either to the government or to the surety.

Related Section 6161 allows the Commissioner to extend the time for payment of the estate tax for a period not in excess of ten years if he makes a determination that "undue hardship" would be imposed on the estate by requiring prompt payment. Under Section 6161, the determination of "undue hardship to the estate" is a matter of administrative discretion rather than a matter of right. Even if the required degree of hardship is found and an extension granted, the problems of prolonged personal liability and bonding discussed above are also present. Further, effective July 1,

1975, the interest rate on deferred payments of estate tax was raised to nine percent. It was formerly six percent under Section 6161(a)(1)*/ and four percent on that portion of the estate tax attributable to a qualifying interest in a closely-held business (i.e., under Section 6166) or in case of "undue hardship" under Section 6161(a)(2).

Although Section 6621 provides for adjustment of the statutory rate of interest at intervals of two or more years based on the level of the commercial prime rate, it seems doubtful that the favorable four percent and six percent interest rates under Sections 6166 and 6161 will be approached in the foreseeable future. Thus, because of the high interest rates and the other factors discussed above, it would appear that these sections of the Code are of very little help in preserving small businesses intact upon the death of a substantial shareholder.

Because of the fact of prolonged personal responsibility which may tie the executor's personal finances to the prosperity of the small business and because bonding may not be available, it seems doubtful that any lowering of interest rates or a liberalization of the eligibility criteria for Section 6166 would make installment payments of estate tax more attractive. However, because it would be a step in the direction of protecting small business, we recommend that the interest rate for installment payments under Section 6161(a)(2) and

*/ Section 6161(a)(1) allows the Commissioner to grant a 12 month extension of time to pay the estate tax for "hardship." The interest rate under Section 6161(a)(1) was formerly six percent.

under Section 6166 be returned to the 4 percent level, and that the 35 percent of gross estate/50 percent of taxable estate eligibility rule*/ and the 50 percent of the total value of each of multiple businesses rule**/ be substantially relaxed or eliminated. An alternative might be provided whereby the entire estate tax could be paid in installments, as a matter of right, if a specified percentage of value of the gross or taxable estate was comprised of an interest in a closely-held business. Sufficient liberalization of Section 6166, together with a low interest rate on installment payments, might tend to make the use of Section 6166 a viable alternative to liquidation or merger.

VALUATION OF SMALL BUSINESSES

One of the weightiest tax-related problems which inevitably must face the small businessman who does not sell or terminate his business during his lifetime is valuation of the business at his death for estate tax purposes. Particularly troublesome is the valuation of stock in closely-held corporations for which there is no market. Usually the only potential buyer is another shareholder (if there are any). In most circumstances, however, what another shareholder might be willing to pay will probably not constitute a value usable for estate tax purposes.

*/ Section 6166(a).

**/ Section 6166(d).

There are no truly objective standards for the valuation of the small, closely-held business. Further, the typical revenue agent is not an expert in business valuation nor does he have the time to spend in an exhaustive investigation and analysis of a business. Accordingly, a rule of thumb using some multiple of earnings averaged over the last few years prior to the death of the shareholder, or other mathematical approach based on balance sheets and income statements, is usually employed. The computed value using such rule of thumb methods may be highly unrealistic simply because it ignores the intangible factors which play such a large part in the earnings capability of a small business. In many small businesses the going concern value is heavily dependent upon the competence, reputation and energy of the proprietor or principal partner or shareholder. Small businesses often have no depth in management. The death of the principal guiding force of the business may reduce its value to a liquidation value overnight, even if there has been an impressive earnings record in the past. Further, even though there may be one or more competent adult shareholders or partners surviving, the ability of the business to generate earnings may be greatly diminished because it now lacks the earning power of the services contributed by the decedent.

Accordingly, because of these and other factors, the post-death value of a small business cannot be determined solely by a formula approach.

Even though the executor is provided with the option of valuing the decedent's property on the alternate valuation date (six months after death), the diminution in value caused by the death of a principal may not be fully manifested within such a short time. If the formula approach is used in conjunction with the alternate valuation date, the pre-death earnings will over-weight the formula. Another approach to valuation endorsed by the Treasury Regulations is to assess the small business on the basis of comparisons with publicly-held companies for which published financial data is available. Again, this approach ignores the subjective and personal factors which figure so importantly in the worth of a small business. Further, it is unrealistic to assume that an investor will pay as high a multiple of earnings for unmarketable stock in a small, closely-held business as for stock in a larger business which is publicly traded.

The fact that there is at present no real solution to the valuation issue for many small businesses is undoubtedly a factor contributing to liquidations and mergers during the lifetime of the principal owner. One possible solution

for businesses organized in a corporate form*/ might be to change the tax laws to permit estates holding stock of businesses qualifying under prescribed criteria as "small businesses" to elect the use of a "carry-over" tax basis for such stock rather than being subject to a formal determination of fair market value at death.**/ Upon the subsequent sale of the stock, a capital gain or loss would be realized. Thus, an estate tax could be traded for an income tax. Since in some cases the estate tax rate would be higher than the capital gains tax rate, provision would have to be made to achieve some approximate measure of equity. One way this could be accomplished would be to add the stockholder's prorata share of the corporation's accumulated earnings and profits (roughly, his share of retained earnings) to his tax basis to arrive at a figure which would be used both for estate tax valuation purposes and for computing gain or loss on a subsequent sale of the stock. There are some practical difficulties with this

*/ This approach would probably pose too many complications if applied to unincorporated businesses, particularly if fractional interests or multiple beneficiaries were involved.

**/ This would cause the stock to be valued in the deceased shareholder's estate at its tax basis, i.e., its basis for determining the amount of taxable gain or loss upon the sale by the shareholder during his lifetime. This would be the cost of the stock in most cases.

62-300 O - 76 - 39

approach, however, and substantial revisions of the Internal Revenue Code would be required.

Another possible solution might be establishment of special valuation teams composed of independent skilled appraisers in the various Internal Revenue Service Regions. The members of these teams (who would be independent consultants rather than civil servants) would make a detailed and subjective investigation of interests in closely-held businesses when a dispute arose between an estate and the examining revenue agent. Such valuation teams might also be established under the aegis of the United States Tax Court if the valuation dispute ended in litigation. Unfortunately, the chilling effect of potential litigation on valuation after the death of a small businessman is with us at present as a factor encouraging pre-death liquidations and mergers. The fact that a fair valuation might be arrived at if the Tax Court were to utilize a valuation task force composed of independent skilled appraisers often might not outweigh the delay, inconvenience and considerable expense of resorting to litigation. Another variation would be to allow some type of binding arbitration by a valuation board composed of members selected by the Revenue Service and the estate. This would seem to be a costly and somewhat cumbersome approach, however.

INCREASING ESTATE AND GIFT TAX EXEMPTIONS

The impact of estate and gift taxes on the transfer of interests in small businesses could be substantially lessened by a realignment of estate and gift tax exemptions and brackets to compensate for the effects of inflation. */ The current $60,000 estate tax exemption, the $30,000 gift tax exemption, the $3,000 gift tax annual exclusion and the present estate and gift tax rate tables were enacted by the Revenue Act of 1942. In the interval between 1942 and July of this year the consumer price index has risen from 48.8 to 162.3. **/ This represents an increase of approximately 232.6 percent. Applying this increase to the $60,000 estate tax exemption would produce an exemption of about $140,000 currently. The $30,000 gift tax lifetime exemption would become approximately $70,000 and the $3,000 gift tax annual exclusion would be now about $7,000. To compensate for the effects of inflation the brackets in the estate and gift tax tables would have to be correspondingly widened. The combined effect of these adjustments would be to remove many small businesses or interests therein from being subject to significant amounts of estate and gift taxes.

*/ A number of bills have been introduced to increase the Federal estate tax exemption in an attempt to compensate for the effects of inflation. Recently, Senator Curtis (R-Neb.), ranking minority member of the Finance Committee, has introduced a bill (S. 1173) to increase the estate tax exemption to $200,000. The estimated Revenue loss is about $2 billion.

**/ Bureau of Labor Statistics Consumer Price Index for Urban Wager Earners and Clerical Workers, U.S. City Average, all items -- Series A (1967 equals 100).

upon transmission. Presuming the 50 percent marital deduction applied, a net estate of approximately $280,000 could be passed without incurring Federal estate tax. About 81 percent of the estate tax returns filed in 1972 on which some tax was payable involved gross estates under $300,000. */ The revenue loss from an increase in the estate tax exemption to $140,000 in 1972 would have been approximately $806 million, or about 19.4 percent of the more than $4.1 Billion in estate taxes levied in that year. Quite naturally, an expansion of the estate tax brackets to allow for inflation would have an additional effect on revenues but would also assist in the preservation of small businesses from liquidation or sale upon the death of the principal owner.

OTHER ESTATE AND GIFT TAX CHANGES

1. The Marital Deduction. A frequently recommended estate tax revision is to allow a 100 percent marital deduction rather than the current 50 percent deduction. If a husband and wife are considered one economic unit, and often in small businesses the wife may be significantly responsible for the operation and success of the business, then there would seem to be no logical reason to levy death taxes on this economic unit in two stages. At present, if the first spouse to die leaves his entire estate to the survivor, half of the estate is subject to tax at the time of the first death.

*/ Internal Revenue Service; Statistics of Income - 1972, "Estate Tax Returns."

Upon the death of the surviving spouse 100 percent of the estate existing at the time of the death of the first spouse (less any amounts consumed) is taxed again, thus causing the economic unit to be in effect taxed one and a half times. With the 100 percent marital deduction only one tax would be imposed on the transmission of property by the economic unit. */

2. Integrating Estate and Gift Taxes. An unknown but probably large number of persons who die leaving taxable estates never make a taxable gift during life and thus lose the benefit of the $30,000 lifetime gift tax exemption. Many such persons are undoubtedly small businessmen who were unable or unwilling to give away part of their business during their lifetime. Suggestions for change in this area range from an overall integration of the estate and gift tax (both rates and exemptions) to merely allowing the estate of a decedent to utilize whatever portion remains unused of his lifetime gift tax exemption. The latter approach would provide a greater degree of equality between those persons who made intervivos gifts and those who did not. However, since there is a decided tax advantage in passing property by gift rather than by will or intestate succession, true

*/ It is realized that these comparisons are crude because no allowance can be made for consumption in the estate of the second spouse or of the effect of the $60,000 estate tax exemption on the absolute amount of taxes paid in each spouse's estate. It is clear, however, that the overall amount of the estate tax paid by a family unit would be somewhat less if a 100 percent marital deduction were in effect.

equality would not be achieved. Full integration of estate and gift taxes is too complex and time consuming a subject (and perhaps too tenuously related to small businessmen) to be discussed at any length here. In general, such an integrated tax would make no distinction between lifetime giving and the passage of property at death. For computational purposes, each successive transfer would be added to prior transfers and the additional increment would be taxed at the higher rate for the bracket in which the increment found itself. It would operate essentially in the same manner as our present system of gift taxation except that lifetime gifts would be "grossed up," i.e., the amount of the gift would be considered to be the value of the property transferred plus the amount of the tax.

3. The Gift Tax Anomaly. We would like to invite your attention to a gift tax anomaly which, although having no specific connection with small businessmen, certainly could affect any of them who make gifts to their spouses. Prior to the amendments effective in 1971 which provided for quarterly rather than annual filing of gift tax returns, a husband or wife could give a total of $6,000 per year to the other spouse without incurring any gift tax liability or using any part of their lifetime exemption because half of one spouse's gift to the other is exempt from tax, and because of the $3,000 per person annual gift tax exclusion. However, upon the change to quarterly filing of gift tax

returns (which was intended solely to speed up gift tax collections), the making of gifts to one's spouse in more than one quarter of any calendar year totaling in excess of $3,000 will always occasion some additional and unintended tax liability unless the first gift is at least $6,000. This is because of a method of computation of the gift tax prescribed by the Treasury Regulations promulgated in conjunction with the switch to quarterly filing.

These Regulations provide that the $3,000 annual exclusion is to be deducted from the amount of the gift prior to the application of the marital deduction. Thus, on the making of two $3,000 gifts to a spouse in the same year in different quarters, the $3,000 annual exclusion would be used up upon the making of the first gift and the marital deduction applicable to that gift would be zero. When a second $3,000 gift was made there would be nothing left of the annual exclusion and since the marital deduction applied to only one-half ($1,500) of the second gift, the remaining $1,500 would be taxable. Contrast this with a single gift of $6,000 in one calendar quarter. The $3,000 annual exclusion is first subtracted from the amount of the gift, leaving $3,000. Then a marital deduction of one-half ($3,000) of the amount of the gift is subtracted from the $3,000 remaining after the deduction of the annual exclusion; the

result is a zero taxable gift. */ A similar result occurs in all interspousal transfers in excess of $3,000 in any calendar year where two or more gifts are made in different quarters and the first gift is less than $6,000. It would appear to be an example of legislation by regulation which should be corrected.

PROPOSED CAPITAL GAINS TAX AT DEATH

Under present law, the assets of a decedent receive a fair market value tax basis upon the former owner's death and no gain or loss is realized by the estate because of this change in basis. This rule is generally quite advantgeous to the small businessman who died owning highly depreciated real property or stock in a closely-held corporation. The fair market value basis which attaches at death generally means that there will be little or no gain by the estate or beneficiaries on a sale within a short time after the date of death.

Persons interested in tax reform have for many years been advancing the proposition that this adjustment to basis constitutes a tax loophole and tends to discourage frequent alienation of property (thus immobilizing amounts of capital for long periods). Typically, the taxpayer's shares in a small business corporation laboriously built up over many years

*/ Treas. Regs. §25.2523(a)-1(c), examples 1 and 2.

will have a very low tax basis, often representing only the original capital contributed to the firm. Proposals have been made to treat death as a sale of capital assets thus triggering capital gains and losses in a decedent's final taxable year.

Whatever the merits of such a system in promoting tax equity, it is clear that the taxation of unrealized capital gains at death would have a very adverse effect on small businesses. It would make tax-free mergers during a shareholder's life resulting in the receipt of stock of a publicly traded company even more attractive and would tend to force the liquidation of some small businesses in order to obtain funds to pay the tax.

If the property could not be sold because of a desire of the heirs to continue the business or because no buyer could be found, the additional liquidity requirements inherent in such a tax would be extremely burdensome. Proposals have been made to ameliorate this by providing for installment payment of taxes on capital gains deemed to have occured at death. Any such installment payments would be subject to the same disadvantages outlined earlier in my discussion of Section 6166. They would also constitute an additional burden on small businesses.

We strongly recommend against the adoption of any income tax changes which would result in imposing a

tax upon unrealized appreciation in property passing at death. Virtually the same objectives could be met by providing that property passing at death would have a carry-over basis, i.e., that it would retain the basis it had in the hands of the decedent. Thus a capital gain would be realized only when the property was disposed of by the beneficiary. Even this system would have an indirect unfavorable effect on small business, however, since the present system of giving capital assets a fair market value basis at death might be deemed to constitute an incentive or "reward" to the business entrepreneur for having successfully built up a profitable business. It would also discourage transfers of stock in small businesses from beneficiaries who were inactive in the business to remaining active shareholders under stock redemption and cross-purchase agreements.

OTHER TAX MATTERS

1. Increase in Corporate Surtax Exemption. The Tax Reduction Act of 1975 provided for an enlargement of the corporate surtax exemption for 1975 from $25,000 to $50,000. This has the effect of reducing the tax rate on corporate earnings between $25,000 and $50,000 from 48 percent to 20 percent; the maximum tax reduction which can be achieved is $7,000 for one year. We believe that

this surtax exemption should be retained after 1975 and, perhaps, enlarged to take into account the effect of inflation on small business corporations. Since the present tax benefit applies to all corporations having taxable income in excess of $25,000, it may be deemed desirable to provide for the phasing-out of the surtax exemption after corporate income reaches a specific amount. Such a rule would limit the tax benefit to small corporations.

2. The Accumulated Earnings Tax. Sections 531 through 537 of the Code limit the amount of earnings which can be retained without risk of the imposition of a punitive accumulated earnings tax to those amounts which a corporation can prove to have been retained for the "reasonably anticipated needs of the business."*/ For taxable years beginning after December 31, 1974, a corporation is allowed a buffer in the form of a minimum credit of $150,000, regardless of size.**/ Accumulated earnings in excess of the minimum credit may be taxed at the rate of 27-1/2 percent of the first $100,000 and 38-1/2 percent on amounts exceeding $100,000 unless their retention can be justified.***/

*/ Section 537(a).

**/ Section 535(c), as amended by the Tax Reduction Act of 1975. The minimum credit for 1974 and prior years is $100,000.

***/ Section 531. When added to the ordinary corporate tax rate of 48 percent, the accumulated earnings tax produces total rates ranging from 75-1/2 percent to 86-1/2 percent.

Although the law does not restrict the application of the tax to closely-held corporations, with minor exceptions only relatively small, closely-held corporations have been subject to challenge by the Revenue Service in this regard.*/ In the only meaningful court test to date of the applicability of the accumulated earnings tax to publicly-held corporations, the U.S. Court of Appeals for the Ninth Circuit decided, on the basis of the legislative history, that Congress did not intend for Section 531 et seq. to be applicable to publicly-held corporations.**/

In the face of an assertion by the Revenue Service that a corporation is liable for the accumulated earnings tax, the taxpayer must prove that the accumulations do not exceed the reasonably anticipated needs of the business and that the purpose of the accumulations was not to avoid the imposition of the individual income tax on shareholders.***/ It is a tremendously difficult burden of

*/ The official position of the Revenue Service is that the accumulated earnings tax is applicable, "in the appropriate case," to publicly-held corporations. Revenue Ruling 75-305, 30 IRB 12. As far as can be determined, the Service has only pressed this position once in recent years.

**/ Golconda Mining Corp. v. Commissioner, 507 F.2d 594 (1974).

***/ Although Section 534 would appear to shift the burden of proof to the Revenue Service in cases before the U.S. Tax Court providing certain requirements are met, in practice it would seem that the corporation must always be prepared to shoulder the burden of proof.

proof and defense of an accumulated earnings case is complicated and costly. The problem is that what is "reasonable" is an almost entirely subjective matter in the majority of instances.

Because of difficulties of proof and the expense of litigation, not to mention the financial consequences, the mere possibility of an imposition of this punitive tax inhibits the achievement of liquidity, self-financed business expansion, and the amassing of funds for the redemption of the stock of deceased or retiring shareholders. The Tax Reduction Act of 1975 increased the accumulated earnings credit from $100,000 to $150,000. It is suggested that small business would be helped in a substantial manner by a further reasonable increase in the credit.

3. Subchapter S Reform and Simplification. A large number of small businesses (in 1972 more than 280,000 (about 28 percent) of the U.S. corporations with total assets of less than $1.0 million) elect to be taxed under Subchapter S of the Internal Revenue Code of 1954.*/ Under the provisions of Subchapter S, a corporation's income is taxed directly to the shareholders, whether or not distributed and no tax is imposed at the corporate level.**/ Although

*/ Sections 1371-1379.

**/ Except on certain capital gains under Section 1378.

Subchapter S is utilized mainly by small businessmen with restricted access to sophisticated tax advisors, it is one of the most complex and poorly understood parts of the Internal Revenue Code. Because a failure to understand and comply with all of the rules governing Subchapter S corporations can trigger extremely severe and often retroactive tax consequences, Subchapter S has been the cause of a large amount of tax litigation and is frequently characterized by the courts as "a trap for the unwary." While the subject of overall reform and simplification of Subchapter S is too complex a matter to dwell on at this time, we would like to commend it to your attention as an area of the tax law where substantial benefits could be achieved for small businessmen (and small business thereby encouraged) with little or no revenue loss. A few of the more important and widely recommended changes were included in the stillborn Tax Reform Act of 1974. It is to be hoped that these and other needed changes will be incorporated in current tax reform legislation.

4. The Family Attribution Rules. The final item I would like to mention in conjunction with the effect of tax laws on small businesses is the matter of the family attribution rules regarding "constructive ownership" of stock in closely-held corporations. Absent the exception provided by Section 303 in the closely defined circumstances

mentioned earlier, the redemption of stock in closely-held or "family" corporations is subject to characterization as a dividend rather than as a sale of stock unless there is full compliance with the rules set out in Section 302. These rules are complicated and subject to being misunderstood by small businessmen not sophisticated in tax law. Section 302 provides that a redemption shall not be treated as a dividend if it is substantially disproportionate with respect to the shareholder redeeming the stock, or if it results in a complete redemption of all the stock of the corporation owned by the shareholder.

The constructive ownership rules of Section 318, however, state that an individual is to be considered as owning the stock owned directly or indirectly by or for members of his family, and by partnerships, estates, trusts and corporations in which he has an interest. Correct interpretation of these stock ownership attribution rules is difficult, but absolutely essential if ordinary income treatment of a redemption of stock in a closely-held corporation is to be avoided. This is because stock legally or beneficially owned by other persons or entities may be deemed under these rules to belong to the individual disposing of his stock and, thus, prevent the shareholder from achieving a substantially disproportionate redemption or a complete termination of interest in the corporation.

Provision has been made in Section 302 for a waiver of the family attribution rules provided that: (1) immediately after the redemption the former shareholder has no interest in the corporation (including an interest as officer, director or employee) other than as a creditor; (2) the shareholder does not acquire any such interest, other than by inheritance, within ten years; and (3) proper notification is made to the Revenue Service by such shareholder.

While the rules regarding stock redemptions in closely-held corporations constitute a heavy burden for small businessmen doing business in this form, we agree that objective standards in this area have merit because they prevent abuses. We feel, however, that changes should be brought about in the extremely rigid interpretation of the attribution rules by the Internal Revenue Service, particularly with regard to the waiver of the application of these rules provided for in Section 302(c) of the Code. The Service has taken the position, unsanctioned by the statute, that estates and trusts holding stock in closely-held family corporations may not file waivers of the family attribution rules provided by Section 302(c). Accordingly, estates and family trusts are effectively prohibited by the Revenue Service from redeeming stock in family corporations no matter how necessitous the circumstances since such redemptions

would be treated as an ordinary income dividend.[*/] We urge that appropriate corrective action be taken to clarify the intent of Congress in this regard.

Mr. Chairman and Members of the Committees, on behalf of the Association for Advanced Life Underwriting, I would like to thank you for the opportunity given me to express the Association's views today on these subjects.

*/ One taxpayer has successfully challenged in the Tax Court the Revenue Service's contention that an estate cannot file a waiver of the family attribution rules. Lillian M. Crawford v. Commissioner, 59 T.C. 830 (1973). The case may be subject to being distinguished on its facts, however, and there is no indication that the Revenue Service will not continue to litigate the issue. There has been no determinative litigation concerning a waiver of the family attribution rules by a trust.

62-309 O - 76 - 40

Senator NELSON. Thank you very much for your presentation.

Our next witness will be Mr. Donald Haldeman, president of the Wisconsin State Farm Bureau.

Mr. HALDEMAN. Thank you. I am a dairy farmer from west-central Wisconsin. I don't come here with any special expertise in the area of tax except an observation from the standpoint of a dairy farmer as to what is happening to us. I would like to present the written testimony on behalf of the American Farm Bureau Federation and the Wisconsin Farm Bureau Federation. I will just kind of skip over it in view of the time constraints.

Senator NELSON. Would you pull the microphone up closer?

Mr. HALDEMAN. I will just skip over the portions relating to the fact that we are largest of the general farm organizations with 2,393,000 member-families.

Farming and ranching are predominantly family enterprises so farmers and ranchers are deeply interested in the orderly transfer of their businesses to succeeding generations. Currently, upon the death of a farmer or rancher, many families find themselves faced with such high estate taxes that they are forced to sell the farm or ranch regardless of their desire to keep it in the family.

The hardships caused by estate taxes have grown increasingly more common and more severe in recent years. Unfortunately, many families are not aware of their Federal estate tax liability until after an unexpected death. Consequently, a ground swell of public pressure has not developed as rapidly on this issue as on other issues where the effects are more immediate and better understood.

I was visiting with a farmer this past week in a neighboring State. You may be interested in some of the observations I would make from his case as to what a family farmer may be faced with. You are in a business where the profit levels aren't as high as maybe they ought to be. But in 1968, he purchased some land at about $650 an acre. Due to the inflated values of land today, that land is worth about $2,000 an acre.

Senator NELSON. For a farmer?

Mr. HALDEMAN. Well, this is in a farming community where there aren't any outside pressures necessarily. It is just a demand for land. If a farmer wants to stay in business, he has to pay in order to stay in business.

Senator NELSON. What I meant to say was I meant to raise the question as to whether or not at $2,000 an acre, whether he could make a living dairying on a farm.

Mr. HALDEMAN. I have a feeling that what he is doing here is that he has a unit he wants to add to and he is amortizing across all of it. He is also taking a look at the fact he figures it is going to appreciate in value more in the future. This is in the State of Iowa, of course, where land values are higher than in the State of Wisconsin. I am in agreement with you that at $2,000 an acre, to try to raise corn on that kind of value, you would have to be quite enthusiastic about the possibilities of the future. But I would state and carry this thing through an example. Say that a family farmer purchased 200 acres in 1968, and the last land purchased before that was $650 an acre. This would give him a cost of $130,000. If he just had a mortgage at that time of 70 percent, which would be about a $91,000 mortgage. If the

mortgage was just continued at the $91,000 with only the interest payments made and he was able to maintain and farm his land until now, upon death this would give a value on his land of only $309,000 for estate tax purposes. Now that land, if he has a youngster that wants to farm, now using those figures, that land in all possibility will be sold because that youngster at such an early age is not going to be able to handle that tax because the income isn't there in order to pay the tax. He would probably farm it through an outside interest. This is why the farmer is aware of what is happening. In my State of Wisconsin we aren't up to the $2,000 figure, but we didn't start out with the $650 figure. I'm sure you are familiar with the area I am from.

The Federal Government's estate tax is essentially the same today as it was more than 25 years ago. The present rates and schedules were adopted in 1941. The last significant change, the addition of the marital deduction, was made in 1948. Since that time, the purchasing power of the dollar has been eroded by inflation and the size and the value of an economically sound farming unit have undergone drastic changes. Urban development also has pushed land values up, and farms located in populous areas are threatened with extinction by rising assessed values based on nonfarm uses.

To offset the cumulative effect of more than 30 years of inflation and to help check the adverse effect of urban sprawl on farm production, Farm Bureau has three recommendations for changes in our present Federal estate tax laws. These are:

1. To raise the specific estate tax exemption from $60,000 to $200,000. This would adjust the estate exemption for the inflation which has occurred since 1942, when the $60,000 exemption went into effect. This should apply to all estates, not just to farm estates.

2. To raise the marital deduction from 50 percent of the value of the adjusted gross estate to $100,000 plus 50 percent of the total value of the adjusted gross estate. This would recognize the importance of partnerships between husbands and wives. Again, it would apply to all estates.

As a matter of equity, we do not think the transfer of property between spouses should be taxable—particularly on the death of a husband or wife—however, the proposed increase in the marital deduction would provide considerable relief for the estates that most need it.

3. To establish a procedure which would permit the executor of an estate to elect to have its property assessed for extate tax purposes on the basis of current use rather than higher potential uses. Presently land is assessed for estate tax purposes on the basis of its market value. This policy often forces an estate to sell farm property for a nonfarm use in order to provide funds for the payment of estate taxes. Under the proposed change, if the executor elects to have the estate assessed at its value for farming purposes, the land in the estate should be required to remain in farming or ranching for a period of 5 years. If it did not, an additional tax based on the higher use value should be assessed and collected. A period in excess of 5 years would create a hardship by clouding title to the land in an estate and thereby impairing its collateral value.

Bills encompassing these recommended changes in the Federal estate tax laws are now pending in both bodies of the Congress. In the Senate, S. 1173, introduced by Senator Curtis and other Senators, is now pending before the Senate Finance Committee. In the House, H.R. 1793, introduced by Representative Burleson and cosponsored by over 50 other Representatives, is pending before the House Ways and Means Committee.

We recommend that you urge the Senate Finance Committee to consider this legislation favorably in the 94th Congress.

We appreciate the opportunity to present our views on this matter.

Senator NELSON. I can assure you it will be considered because there are six members of the Small Business Committee who are on the Finance Committee and Senator Curtis is also a member of the Finance Committee and so is Senator Talmadge. What we will come out with I am not certain, but there is a very real interest in doing something about this problem. Where did you say you were from?

Mr. HALDEMAN. Southern Monroe County just out of Sparta.

Senator NELSON. Just out of Sparta?

Mr. HALDEMAN. Yes.

Senator NELSON. In the Sparta area what would be the average appraised, and I don't mean appraised for tax purposes, but the average value of a 200-acre farm with 40 or 50 milking cows?

Mr. HALDEMAN. It would be pretty easy to figure out. Just for real estate alone, the buildings, you are talking about $105,000.

Senator NELSON. And personal property would be another $50,000 I take it?

Mr. HALDEMAN. Yes, and probably better than that today because we have seen some extremely high increases in the past 24 months as far as evaluation of farm machinery.

Senator NELSON. Just as an aside, has that constitutional amendment that was adopted to allow the appraisal of land for tax purposes to be distinguished from for agricultural purposes, has that been put into operation?

Mr. HALDEMAN. No it hasn't. There has been quite a discussion in the State legislature as to what it is going to be. I don't think it will be passed in the very near future because we had land controls that are getting tied in with the issue of taxation. This is going to be a very sensitive issue.

Senator NELSON. Thank you very much for your presentation. We deeply appreciate that. Where is Bill Kasakaitas?

Mr. HALDEMAN. Well he is busy in the State house.

Senator NELSON. Tell him I said to say hello.

[The prepared statement of Mr. Haldeman in full follows:]

Farm Bureau is a free, independent, non-governmental, voluntary organization of farm and ranch families united for the purpose of analyzing their problems and formulating action to achieve educational improvement, economic opportunity, and social advancement and, thereby, to promote the national well-being. Farm Bureau is local, statewide, national, and international in its scope and influence and is non-partisan, non-sectarian and non-secret in character.

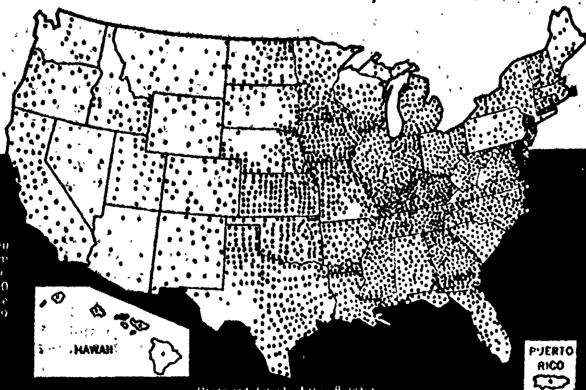
FEDERAL ESTATE TAX LAWS

Presented to
SENATE SELECT COMMITTEE ON SMALL BUSINESS
SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS

by
Donald Haldeman, President
Wisconsin Farm Bureau Federation

September 25, 1975

The American Farm Bureau Federation is a general farm organization with a membership of more than 2,000,000 member families in more than 2,800 counties in 49 States and Puerto Rico.



Organized County Farm Bureaus

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SENATE SELECT COMMITTEE ON SMALL BUSINESS
AND THE SENATE FINANCE SUBCOMMITTEE ON FINANCIAL MARKETS
WITH REGARD TO FEDERAL ESTATE TAX LAWS

Presented by
Donald Haldeman, President
Wisconsin Farm Bureau Federation

September 25, 1975

I appreciate the opportunity to present the recommendations of the American Farm Bureau Federation with respect to federal estate taxes. These recommendations are strongly supported by my own state organization, the Wisconsin Farm Bureau Federation.

We commend the Senate Select Committee on Small Business and the Senate Finance Subcommittee on Financial Markets for holding these hearings. We hope that your efforts will highlight some needed changes in the federal estate tax laws.

Farm Bureau is the largest general farm organization in the United States with a membership of 2,393,731 families in forty-nine states and Puerto Rico. It is a voluntary, non-governmental organization, representing farmers who produce virtually every agricultural commodity that is produced on a commercial basis in this country. As a consequence, we have a deep interest in all aspects of taxation, including estate taxes, that affect our members.

Farming and ranching are predominantly family enterprises so farmers and ranchers are deeply interested in the orderly transfer of their businesses to succeeding generations. Currently, upon the death of a farmer or rancher, many families find themselves faced with such high estate taxes that they are forced to sell the farm or ranch regardless of their desire to keep it in the family.

The hardships caused by estate taxes have grown increasingly more common and more severe in recent years. Unfortunately, many families are not aware of their federal estate tax liability until after an unexpected death. Consequently, a groundswell of public pressure has not developed as rapidly on this issue as on other issues where the effects are more immediate and better understood. However, for several years Farm Bureau members have adopted policies which recognize the problems emanating from federal estate taxes and Farm Bureau has been seeking reforms in these tax laws.

The federal government's estate tax is essentially the same today as it was more than twenty-five years ago. The present rates and schedules were adopted in 1941. The last significant change, the addition of the marital deduction, was made in 1948. Since that time, the purchasing power of the dollar has been eroded by inflation and the size and the value of an economically sound farming unit have undergone drastic changes. Urban development also has pushed land values up, and farms located in populous areas are threatened with extinction by rising assessed values based on non-farm uses.

To offset the cumulative effect of more than thirty years of inflation and to help check the adverse effect of urban sprawl on farm production, Farm Bureau has three recommendations for changes in our present federal estate tax laws. These are:

(1) To raise the specific estate tax exemption from $60,000 to $200,000. This would adjust the estate exemption for the inflation which has occurred since 1942, when the $60,000 exemption went into effect. This should apply to all estates, not just to farm estates.

(2) To raise the marital deduction from 50 percent of the value of the adjusted gross estate to $100,000 plus 50 percent of the total value of the adjusted gross estate. This would recognize the importance of partnerships between husbands and wives. Again, it would apply to all estates.

As a matter of equity, we do not think the transfer of property between spouses should be taxable--particularly on the death of a husband or wife--however, the proposed increase in the marital deduction would provide considerable relief for the estates that most need it.

(3) To establish a procedure which would permit the executor of an estate to elect to have its property assessed for estate tax purposes on the basis of current use rather than higher potential uses. Presently, land is assessed for estate tax purposes on the basis of its market value. This policy often forces an estate to sell farm property for a nonfarm use in order to provide funds for the payment of estate taxes. Under the proposed change, if the executor elects to have the estate assessed at its value for farming purposes, the land in the estate should be required to remain in farming or ranching for a period of five years. If it did not, an additional tax based on the higher use value should be assessed and collected. A period in excess of five years would create a hardship by clouding title to the land in an estate and thereby impairing its collateral value.

Bills encompassing these recommended changes in the federal estate tax laws are now pending in both bodies of the Congress. In the Senate S. 1173, introduced by Senator Curtis and other Senators, is now pending before the Senate Finance Committee. In the House H.R. 1793, introduced by Representative Burleson and cosponsored by over fifty other Representatives, is pending before the House Ways and Means Committee.

We recommend that you urge the Senate Finance Committee to consider this legislation favorably in the 94th Congress.

We appreciate the opportunity to present our views on this matter.

American Farm Bureau Federation

OVER A HALF CENTURY OF SERVICE TO AMERICAN AGRICULTURE

GENERAL OFFICES
225 TOUHY AVENUE
PARK RIDGE, ILLINOIS 60068
PHONE: (312) 696-2020
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September 4, 1975

Senator Gaylord Nelson, Chairman
Select Committee on Small Business
United States Senate
Washington, DC 20510

Dear Senator Nelson:

We appreciate the invitation conveyed by your letter of June 16, 1975 for us to contribute to your current study of the business tax system with specific reference to small business.

Farm Bureau Policies for 1975 include the following recommendations with respect to the taxation of business-related income, including the income of farmers and farm cooperatives:

Income Taxes

Tax policy should be designed to encourage private initiative, help stabilize the dollar, promote employment and economic growth, and distribute the tax burden equitably.

* * * * *

Taxpayers should be given the option to treat investment in capital equipment for the abatement of air, water, and soil pollution as a current expense for federal income tax purposes since such investments generally increase costs without increasing production.

We recommend that farmers continue to have the option of filing income tax returns on either the cash or the accrual basis.

* * * * *

Investment Credit

We favor the investment credit as a permanent feature of our tax system. This credit should apply to both domestic and imported equipment.

Capital Gains

The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property.

The present law results in the taxation of "gains" which reflect in part a decline in the value of the dollar. This penalizes property owners and discourages the sale of property. As a partial answer to this inequity we recommend that the rate of tax on capital gains be reduced as the length of the holding period increases. We favor retention of the present minimum holding period.

Where farmland is acquired for public use by eminent domain or private treaty, the owners should be permitted to reinvest in farming or another business with the same tax treatment. In addition, we recommend that persons whose property is taken for public use be allowed to invest the proceeds in government or municipal bonds without paying the capital gains tax.

We oppose proposals to apply the capital gains tax to the appreciated value of property transferred by reason of the death of the owner.

We support the present law with respect to capital gains treatment for sales of breeding livestock.

Depletion Allowances

We favor the use of depletion allowances as an encouragement for the investment of capital in the extraction of exhaustible resources.

Tax Loss Farming

We recommend an amendment to the Tax Reform Act of 1969 to limit further the opportunity of a taxpayer to offset farm losses against nonfarm income.

We recommend that the cost of developing all orchards, groves, and vineyards be capitalized on the same basis as developmental expenses for citrus and almond groves.

Taxation of Cooperatives and Other Corporations

We oppose any effort to tax cooperatives on disbursements or credits taxable in the hands of their patrons.

The net savings and income of farm cooperatives should be subject to a single federal income tax to be paid either by the cooperative or the patron as earned.

Any legislation affecting the tax status of the Cooperative Farm Credit institutions should include an exemption for income used to build legally required reserves or returned to the members of the institutions.

Corporations should be permitted a deduction for earnings distributed to stockholders as dividends and taxable in the hands of stockholders.

Senator Gaylord Nelson, Chairman
Select Committee on Small Business

Sales and Excise Taxes

* * * * *

...The highway use tax should be amended to provide an exemption for farm trucks.

We oppose the use of taxes as a method of implementing EPA standards.

Recent legislation provides for additional taxes on aircraft fuels to help finance new and improved services and facilities for the nation's airway system. We oppose the use of these funds for the operational expenses of other federal agencies.

We oppose the adoption of a federal value added tax.

Your consideration of these recommendations will be appreciated.

Sincerely,

William J. Kuhfuss, President

WJK:ljb

cc: Roger Fleming, Director
Washington Office

Senator NELSON. Our next witness is John Davis III, president of Davis Bros., Inc., Denver, Colo.

Mr. DAVIS. Thank you, Mr. Chairman. I am delighted to be here. I would like to say at the outset that I wish the wholesale industry had done as good a job as apparently the Mankato Free Press has done in the growth of its assets value over the last 17 years.

I am appearing here today as a past president of the National Association of Wholesaler-Distributors. I am also president of Davis Bros., a wholesale drug company located in Denver, Colo.

Our members, consisting preponderantly of small business, have a vital interest in the impact of taxes on the continuation of smaller business enterprises. We are particularly concerned with the matter of estate and gift taxation, which already poses a serious problem for many small wholesale-distribution firms.

As table 1 below indicates, the wholesale trade is characterized by small, closely held, family-owned businesses. Ninety percent of all wholesaling corporations had assets of less than $1 million in 1970, and such firms accounted for approximately two-thirds of the total sales by wholesale-distribution corporations. The industry, nonetheless, is a significant factor in the economy, with sales by merchant wholesalers of $448.1 billion in 1974.

First, I would like to address the impact of current estate taxes on the perpetuation of smaller wholesale corporations.

At the present time, the first $60,000 of net personal worth of a deceased is exempt from the Federal estate tax. That exemption level was established in 1942. No change has been made in this level of exemption despite the change in the purchasing power of the dollar. The fact that Congress has made no change in the estate tax law does not mean that no change has occurred. Indeed, a very significant change has occurred for the heirs of the deceased and for the future of the business.

The effects of inflation on estates have been dramatic, and have resulted in huge tax liabilities which the business must pay when faced with the death of a principal owner.

What would have happened if the estate tax exemption had been increased with the changes in the value of the dollar? To illustrate this change, we have used the implicit price deflator for the gross national product for the years 1940 to 1974—table 2.

The following table indicates what would have been the result.

We can see from the table that based on the decreased purchasing power of the dollar, the exemption in 1976 would have equalled $192,000 if the same amount of purchasing power was exempted from Federal estate taxes. It should be noted that the current tax on the $192,000 estate is now $30,300, but no Federal estate tax would have been due on the same amount of purchasing power in 1942.

Inasmuch as there has been a further decline in the purchasing power of the dollar, we recommend that the Congress recognize this situation by increasing the estate tax exemption to $200,000.

We are very much concerned with the problems of perpetuating small business enterprise in our industry

The level of estate taxes will have a great effect on whether this business can be perpetuated. There is no question but that because

no change has been made in the Federal estate tax exemption for over 30 years, the tax bite is more severe than it was in 1942, and that a smaller portion of these businesses will be able to continue past one generation.

For example, the estate tax on a total estate of $350,000 is $78,500. If the exemption has been "indexed" with the implicit price deflator, the taxable estate would now equal $158,000, and the tax due would be $38,100. This would have permitted the retention of an additional $40,400 for the continuation of the business. It is an illustration of the typical situation that smaller business—the closely held corporation—faces—what is in reality a constant effective increase in the rate of taxing estates. The change is brought about by a constant in the dollar value of the estate tax exemption and a continuing decline in the value of the dollar.

What is the intent of the Congress? Does it intend to continue the increase in the effective rate of taxing estates? Congress has never so stated, but the result is as real as if it had.

In my written testimony I go through some examples of what is happening in smaller estates.

Clearly, the effect of a constant exemption and a declining dollar is felt more by the heirs of smaller estates than the heirs of very large estates. The problem of small business perpetuation is therefore increasingly more difficult for them.

Another measure of how the estate tax is now applied to more estates due to inflation is indicated in table 5 of my written remarks.

In 1941, less than 1 estate out of 100 required a Federal estate tax, compared to over 6 out of every 100 estates in 1973. That is an increase in the rate of estates taxed of over 600 percent. As stated earlier, the estate tax is dipping down into smaller estates—measured by purchasing power—than it did in 1941.

Now let us take a couple of minutes to examine the options available to the small business in order to pay the estate tax and still perpetuate the business.

As has been indicated, the bulk of the deceased's assets are in the closely held corporation, and stock in such businesses is not easily saleable, as there is not a ready market compared to stock traded on an exchange.

We should also examine the capability of the heirs to borrow to pay the estate taxes. In 1969, wholesalers already had current liabilities equal to 1.15 times net worth, and total liabilities equal to 1.53 times net worth. For firms in the $1 to $5 million asset size class, the ratios were 1.29 times and 1.59 times, respectively.

This means that the debt is already at a rather high figure and financial sources, mainly commercial banks, are unlikely to extend additional credit. Indeed, the contrary is likely to happen as the principal owner is also the chief executive officer, the one looked to by the bank to manage the business in such a way that the bank will be repaid its already outstanding loans to the small business. When the small business loses its chief executive officer—usually the president—the bank is very likely to recall a portion of the loan or decline to extend additional time or renew current loans until the future of the business is more certain. The bank knows that cash must be generated

to pay existing high estate taxes, and if this capital is somehow taken out of the business by the heirs, it would increase the debt-to-net-worth ratio to the detriment of the bank's position. Bankers are required to protect the money they loan. We can validly conclude that banks are not a likely source of capital upon the death of a small business owner.

The problem of maintaining the viability of these small enterprises with average debt to equity ratios, which regularly exceed 100 percent, is often insurmountable without the added burden of a huge estate tax. The addition of a large tax liability to the already high debt structure of the typical wholesaling corporation would surely mean the sale or liquidation of a majority of these corporations.

In view of the increasing difficulty of smaller business enterprises to continue due to the delay in reforming and updating estate taxation, we believe this committee should give serious consideration to our recommendation to increase the estate tax exemption to $200,000.

I have attempted briefly to outline some of the difficulties currently encountered by smaller wholesaler-distributors in the area of estate taxation and business perpetuation. We note that some tax reform proposals introduced in the Congress do not contemplate any increase in the estate tax exemption, but rather propose another change—the imposition of a capital gains tax on assets transferred at death. Such a tax would sound the death knell for small businessses such as those engaged in wholesale-distribution.

I urge the committee to update the estate tax exemption from $60,000 to $200,000, to account for the effects of inflation since 1942. We believe that the adoption of this proposal would, on balance, have a minimal effect on total tax revenues, and would be an important step toward preservation of a viable small business sector in our economy.

We also urge the committee not to apply a capital gains tax to an imaginary gain. Taxation of an action founded only on the assumption that it has in fact occurred is not a realistic basis for taxation.

In my written remarks I have skipped over some tables. I have done my best to save you time. I would appreciate it if they would go in the record. I appreciate the opportunity to appear here.

Senator NELSON. Thank you very much for your presentation. Your statement with all the tables will be printed in full in the record.

[The prepared statement of Mr. Davis in full follows:]

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

STATEMENT OF

JOHN C. DAVIS, III, PRESIDENT
DAVIS BROTHERS, INC.
DENVER, COLORADO

BEFORE THE

SELECT COMMITTEE ON SMALL BUSINESS
AND
SUBCOMMITTEE ON FINANCIAL MARKETS,
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

ON

THE EFFECTS OF ESTATE TAXATION
ON SMALL BUSINESS PERPETUATION

SEPTEMBER 25, 1975

1725 K Street, N.W. · Washington, D.C. 20006 · 202/872-0885

Mr. Chairman, Members of the Small Business Committee and the Financial Markets Subcommittee of the Finance Committee:

My name is John C. Davis, III. I appear here today as a past president of the National Association of Wholesaler-Distributors (NAW). I am also president of Davis Bros., a wholesale drug company located in Denver, Colorado.

NAW is a federation of 95 national commodity-line wholesale-distribution associations with approximately 30,000 member firms representing merchant wholesaler establishments or warehouse operations in the 50 states.

Our members, consisting preponderantly of small business, have a vital interest in the impact of taxes on the continuation of smaller business enterprises. We are particularly concerned with the matter of estate and gift taxation, which already poses a serious problem for many small wholesale-distribution firms.

As Table 1 below indicates, the wholesale trade is characterized by small, closely-held, family-owned businesses. 93 percent of all wholesaling corporations had assets of less than $1 million in 1970, and such firms accounted for approximately two-thirds of total sales by wholesale-distribution corporations. We are nonetheless a significant factor in the economy, with sales by merchant wholesalers of $448.1 billion in 1974.

Table 1

Distribution of Merchant Wholesaler-Distributor Corporations by Size of Total Assets, 1970

Asset Size Class	Number of Returns	Percent
Under $250,000	115,509	69.8
$250,000 under 500,000	24,387	14.7
$500,000 under 1,000,000	14,009	8.5
$1,000,000 under 10,000,000	10,959	6.6
$10,000,000 under 50,000,000	608	0.4
$50,000,000 under 100,000,000	53	*
$100,000,000 and over	50	*
Total	165,575	100.0

*Less than 1/2 of 1 percent

Source: U.S. Treasury Department, Internal Revenue Service, Statistics of Income - Corporation Income Tax Returns

First, I would like to address the impact of current estate taxes on the perpetuation of smaller wholesale corporations.

At the present time, the first $60,000 of net personal worth of a deceased is exempt from the Federal estate tax. That exemption level was established in 1942. No change has been made in this level of exemption despite the change in the purchasing power of the dollar. In 1942, milk cost 13¢ a quart, a pair of men's leather shoes $6.00 and a white shirt $3.50. The fact that Congress has made no change in the estate tax law does not mean that no change has occurred. Indeed, a very significant change has occurred for the heirs of the deceased and for the future of the business.

The effects of inflation on estates have been dramatic, and have resulted in huge tax liabilities which the business must pay when faced with the death of a principal owner.

What would have happened if the estate tax exemption had been increased with the changes in the value of the dollar? To illustrate this change, we have used the Implicit Price Deflator for the Gross National Product for the years 1940 to 1974. (Table 2)

Table 2

Implicit Price Deflator for Gross National Product
Selected Years, 1940-1974

Year	Implicit Price Deflator (1958=100)	Annual Rate of % Change From Preceding Period
1940	43.87	---
1942	53.03	10.0
1945	59.66	6.3
1950	80.16	6.1
1955	90.86	2.5
1960	103.29	2.6
1961	104.62	1.3
1962	105.78	1.1
1963	107.17	1.3
1964	108.85	1.6
1965	110.86	1.8
1966	113.94	2.8
1967	117.59	3.2
1968	122.30	4.0
1969	128.20	4.8
1970	135.23	5.5
1971	141.61	4.7
1972	146.12	3.2
1973	154.31	5.6
1974	170.18	10.3

Percent Change:

1940-74	+287.9%
1942-74	+220.9%

Source: Economic Report of the President, February, 1975

62-209 O - 76 - 41

The following table indicates what would have been the result:

Estate Tax Exemption Adjusted for Change In Implicit Price Deflator Since 1942

Year	Exemption
1942	$ 60,000
1950	90,720
1960	116,880
1970	153,000
1974	192,000

We can see from the table that based on the decreased purchasing power of the dollar, the exemption in 1974 would have equalled $192,000 if the same amount of purchasing power was exempted from Federal estate taxes. It should be noted that the current tax on the $192,000 estate is now $30,300, but no Federal estate tax would have been due on the same amount of purchasing power in 1942.

Inasmuch as there has been a further decline in the purchasing power of the dollar, we recommend that the Congress recognize this situation by increasing the estate tax exemption to $200,000.

We are very much concerned with the problems of perpetuating small business enterprise in our industry. For this purpose, a special study was conducted of the members of our industry.

From a universe of 18,000 firms asked to participate in the survey, over 5,000 responded.

Among wholesale-distribution firms which are closely-held corporations, we now know that this is the most typical ownership profile:

A) The firm has a net worth of between $250,000 and $499,000.

B) The Chief Executive Officer (CEO) himself owns from 51 to 74 percent of the firm's outstanding stock.

C) The CEO himself is between 50 and 59 years of age.

D) The CEO's <u>personal</u> maximum federal tax bracket is in the range of 35 to 49 percent.

E) His ownership in the company represents from 51 to 74 percent of the CEO's <u>personal</u> net worth.

F) <u>Less</u> than $100,000 in life insurance on the CEO is owned by the corporation, and payable to it upon the death of the CEO.

The level of estate taxes will have a great effect on whether this business can be perpetuated. There is no question but that because no change has been made in the Federal estate tax exemption for over 30 years, the tax bite is more severe than it was in 1942, and that a smaller portion of these businesses will be able to continue past one generation.

For example, the estate tax on a total estate of $350,000 is $78,500. If the exemption had been "indexed" with the Implicit Price Deflator, the taxable estate would now equal $158,000, and the tax due would be $38,100. This would have permitted the

retention of an additional $40,400 for the continuation of the business. It is an illustration of the typical situation that smaller business (the closely-held corporation) faces -- what is in reality a constant effective increase in the rate of taxing estates. The change is brought about by a constant in the dollar value of the estate tax exemption and a continuing decline in the value of the dollar.

What is the intent of the Congress? Does it intend to continue the increase in the effective rate of taxing estates? Congress has never so stated, but the result is as real as if it had.

What has been the result? The true rate of estate taxes has increased, and at a greater rate on the smaller estates than it has on the very large estates. For example, what has happened to the taxes due on a estate worth $10 million? The current tax on a total estate of $10 million (assuming a taxable estate of $9,940,000) is $6,042,600. By applying the GNP Implicit Price Deflator and indexing the exemption, we can calculate that the estate would have been valued at $3,125,000 in 1942 and taxed $1,299,600, or 41.5% of the total estate. In 1974, the estate tax would take 60.4% of the total estate, an increase of 45.5%. However, the estate valued at $350,000 was taxed in 1942 at 6.3% of the total estate. (The value of the estate in 1942 assumed to be $109,375.) In 1974, the same estate would be taxed at 22.4% of the total estate, an increase of 255.5%. (Table 3) Clearly, the effect of a constant exemption

Table 3

Comparison of Estate Tax Rates, 1942/1974

Estate Tax Under Present Statute:		
Total Estate	$350,000	$10,000,000
Exemption	60,000	60,000
Taxable Estate	$290,000	$ 9,940,000
Estate Tax	78,500	6,042,600
Average Estate Tax Rate:		
Total Estate	22.4%	60.4%
Taxable Estate	27.1%	60.7%

Estate Tax Based on 1942 Value (Implicit Price Deflator Applied):		
Total Estate, 1974	$350,000	$10,000,000
Total Estate, 1942	109,375	3,125,000
Exemption	60,000	60,000
	$ 49,375	$ 3,065,000
Estate Tax	6,862	1,299,600
Average Estate Tax Rate:		
Total Estate	6.3%	41.5%
Taxable Estate	13.9%	42.4%

Source: Derived from Table 4 and Implicit Price Deflator

Table 4

EQUIVALVENT ESTATE TAX STRUCTURES, 1942 and 1974

	1942	1974 equivalent
Basic Exemption	$60,000	$192,000

Rate Table for Taxable Estate

(A) Taxable Estate Equal to More Than --		(B) Taxable Estate Less Than		Tax on Amount in Column (A)		Rate of Tax On Excess Over Amount In Column A
1942	1974 equivalent	1942	1974 equivalent	1942	1974 equivalent	(percent)
-0-	-0-	5,000	16,000	-0-	-0-	3
5,000	16,000	10,000	32,000	150	480	7
10,000	32,000	20,000	64,000	500	1,600	11
20,000	64,000	30,000	96,000	1,600	5,120	14
30,000	96,000	40,000	128,000	3,000	9,600	18
40,000	128,000	50,000	160,000	4,800	15,360	22
50,000	160,000	60,000	192,000	7,000	22,400	25
60,000	192,000	100,000	320,000	9,500	30,400	28
100,000	320,000	250,000	800,000	20,700	66,240	30
250,000	800,000	500,000	1,600,000	65,700	210,240	32
500,000	1,600,000	750,000	2,400,000	145,700	466,240	35
750,000	2,400,000	1,000,000	3,200,000	233,200	746,240	37
1,000,000	3,200,000	1,250,000	4,000,000	325,700	1,042,240	39
1,250,000	4,000,000	1,500,000	4,800,000	423,200	1,354,240	42
1,500,000	4,800,000	2,000,000	6,400,000	528,200	1,690,240	45
2,000,000	6,400,000	2,500,000	8,000,000	753,200	2,410,240	49
2,500,000	8,000,000	3,000,000	9,600,000	998,200	3,194,240	53
3,000,000	9,600,000	3,500,000	11,200,000	1,263,200	4,042,240	56
3,500,000	11,200,000	4,000,000	12,800,000	1,543,200	4,938,240	59
4,000,000	12,800,000	5,000,000	16,000,000	1,838,200	5,882,240	63
5,000,000	16,000,000	6,000,000	19,200,000	2,468,200	7,898,240	67
6,000,000	19,200,000	7,000,000	22,400,000	3,138,200	10,042,240	70
7,000,000	22,400,000	8,000,000	25,600,000	3,838,200	12,282,240	73
8,000,000	25,600,000	10,000,000	32,000,000	4,568,200	14,618,240	76
10,000,000	32,000,000			6,088,200	19,482,240	77

Source: A Guide to Federal Estate and Gift Taxation, Internal Revenue Service, 1971, and 1974 equivalents are derived from implicit price deflator shown in Table 2.

and a declining dollar is felt more by the heirs of smaller estates than the heirs of very large estates. The problem of small business perpetuation is therefore increasingly more difficult for them.

Another measure of how the estate tax is now applied to more estates due to inflation is indicated in Table 5. This indicates that in 1941, there were 1,432,000 deaths with 13,336 taxable returns filed, or 0.9 percent. In 1973, there were 1,962,000 deaths, with 120,761 taxable returns filed, or 6.2 percent.

Table 5

Number of Estate Tax Returns Filed By Citizens and Resident Aliens In Relation To Total Deaths

Year of Filing	Total Number of Returns Filed	Taxable Returns Filed	Deaths 1/	Ratio of Total Returns to Deaths	Ratio of Total Returns to Deaths
1941	15,977	13,336	1,432,000	1.1	0.9
1951	27,958	18,941	1,468,000	1.9	1.3
1961	64,538	45,439	1,708,000	3.8	2.7
1970	133,944	93,424	1,926,000	7.0	4.9
1973	174,889	120,761	1,962,000	8.9	6.2

1/ In preceding year.

SOURCE: Statistics of Income. Estate Tax Returns, 1965, 1969, 1972, Statistical Abstract of The United States; 1974

Expressed in other terms, in 1941, less than one estate out of 100 required a federal estate tax, compared to over 6 out of every 100 estates in 1973. That is an increase in the rate of estates taxed of over 600 percent. As stated earlier, the estate tax is dipping down into smaller estates (measured by purchasing power) than it did in 1941.

Now let us examine the options available to the small business in order to pay the estate tax and still perpetuate the business.

As has been indicated, the bulk of the deceased's assets are in the closely-held corporation, and stock in such businesses is not easily saleable, as there is not a ready market compared to stock traded on an exchange.

We should also examine the capability of the heirs to borrow to pay the estate taxes. Table 6 presents IRS data with respect to the ratio of liabilities to net worth. In 1969, wholesalers already had current liabilities equal to 1.15 times net worth, and total liabilities equal to 1.53 times net worth. For firms in the $1 to $5 million asset size class, the ratios were 1.29 times and 1.59 times, respectively.

This means that the debt is already at a rather high figure and financial sources, mainly commercial banks, are unlikely to extend additional credit. Indeed, the contrary is likely to happen as the principal owner is also the chief executive officer, the one looked to by the bank to manage the business in such a way that the bank will be repaid its already outstanding

Table 6

Wholesale Trade: Ratios of Current Liabilities and Total Liabilities to Net Worth By Asset Size Class, 1969

Asset Class (Thousands)	Current Liabilities (Millions)	Total Liabilities (Millions)	Net Worth (Millions)	Ratio of Current Liabilities to Net Worth (Times)	Ratio of Total Liabilities to Net Worth (Times)
Zero					
Over 0, under 50	480	775	249	1.93	3.11
50, under 100	793	1,119	815	.97	1.37
100, under 250	2,524	3,446	2,822	.89	1.22
250, under 500	3,511	4,570	3,763	.93	1.21
500, under 1,000	4,414	5,577	4,145	1.06	1.35
1,000, under 5,000	9,676	11,943	7,505	1.29	1.59
5,000, under 10,000	3,687	4,684	2,479	1.49	1.89
10,000, under 25,000	3,065	3,972	2,376	1.29	1.67
25,000, under 50,000	1,925	2,606	1,621	1.19	1.61
50,000, under 100,000	1,373	1,901	1,103	1.24	1.72
100,000, under 250,000	1,880	2,967	1,728	1.09	1.72
250,000 or more	3,410	5,595	3,455	.99	1.62
Total All Sizes	36,738	49,155	32,061	1.15	1.53

Source: Internal Revenue Service, Corporation Source Book of Statistics of Income, 1969.

loans to the small business. When the small business loses its CEO (usually the president), the bank is very likely to recall a portion of the loan or decline to extend additional time or renew current loans until the future of the business is more certain. The bank knows that cash must be generated to pay existing high estate taxes, and if this capital is somehow taken out of the business by the heirs, it would increase the debt-to net worth ratio to the detriment of the bank's position. Bankers are required to protect the money they loan. We can validly conclude that banks are not a likely source of capital upon the death of a small business owner.

The problem of maintaining the viability of these small enterprises with average debt to equity ratios, which regularly exceed 100 percent, is often insurmountable without the added burden of a huge estate tax. The addition of a large tax liability to the already high debt structure of the typical wholesaling corporation would surely mean the sale or liquidation of a majority of these corporations.

In most cases, some life insurance proceeds are available. However, in our business perpetuation survey, information was requested to determine to what extent small companies hold life insurance on the life of the principal. Such insurance is used to facilitate the small corporation to buy out the interest or a large part of the interest from the heirs. This is particularly useful when the continuation of the business management will fall on others than the heirs. Typically,

it is the case of younger employees who have minority stock interests. Out of the 5,000 firms which participated in the survey, only 1,800 firms responded to the question on life insurance. (Table 7) The survey concluded that relatively few owners, regardless of corporate net worth, have initiated substantial amounts of corporate-owned insurance on their own lives. For example, the table indicates that 59.76% of the respondents hold insurance payable to the corporation valued at less than $100,000. Such amounts would rarely be sufficient to purchase a departed CEO's interest from his heirs.

Table 7

Corporation-Owned Insurance on CEO

Amount of Insurance	% of Respondents Holding
Under $100,000	59.76
100,000 - 249,000	30.13
250 - 499,000	8.43
Over $500,000	3.15

Source: Small Business Perpetuation Study

In view of the increasing difficulty of smaller business enterprises to continue due to the delay in reforming and updating estate taxation, we believe this Committee should give serious consideration to our recommendation to increase the

estate tax exemption to $200,000.

I have attempted to outline some of the difficulties currently encountered by smaller wholesaler-distributors in the area of estate taxation and business perpetuation. We note that some tax reform proposals introduced in the Congress do not contemplate any increase in the estate tax exemption, but rather propose another change -- the imposition of a capital gains tax on assets transferred at death. Such a tax would sound the death knell for small businesses such as those engaged in wholesale-distribution.

Those who favor such a tax argue that unrealized appreciation of capital assets, regardless of kind, is income which currently escapes taxation when held until death. They maintain that this unrealized capital gain should be taxed as if it had been sold the day before death, as if it had been realized.

To the typical small wholesale-distribution firm, a tax on capital gains transferred at death, coupled with estate taxes due, would most probably preclude the business being transferred to the next generation. Our association has attempted to analyze the impact of the proposed legislation on specific firms in the wholesale-distribution industry. Let me give you an example of the operation of proposed tax legislation on one such firm -- typical according to IRS data and also a typical small wholesaler of refrigeration equipment. This firm was founded in 1948 with invested capital of $13,000. The firm has been continuously profitable throughout its existence, though its profits have

never been large either in relation to sales or net worth. The continuously growing capital requirements of the business necessitated that every dollar of profit be reinvested in the business. As a result of this pattern of reinvestment, the net worth of the business increased to $495,000 at the end of 1974.

In Table 8, we attempt to portray the tax consequences for this firm under existing estate tax legislation, as well as those under one of the frequently mentioned proposals for tax change -- a capital gains tax on assets transferred at death. The principal owner, whose spouse died in 1971, has three prospective heirs, a son who is active in the business and two married daughters. Because the growing business has absorbed all of the firm's profits, the firm comprises virtually all of the owner's estate. For simplicity of illustration, we will therefore assume that the firm comprises the entire estate. You will note that, based on the existing estate tax structure, the heir would owe an estate tax of $124,900. Assuming that this estate were granted an extended period (i.e. ten years) in which to pay the estate tax due based upon a hardship finding, the first annual payment of estate tax and interest would amount to $23,731, or $6,131 more than the average annual after-tax profits of the firm over the past seven years. (I might observe that if the estate tax exemption and rate structure were adjusted to establish an "inflation-adjusted parity" with the tax structure legislated in 1942, the total

Table 8

Tax Consequences of Death of Present Owner

	Based on Present Tax Rates	Based on Equivalent 1974 Rates 1/
Net Worth, December 31, 1974	$495,000	$495,000
Basic Exemption	60,000	192,000
Taxable Estate	435,000	303,000
Estate Tax	124,900	61,480
Minimum Annual Tax Payment Due	23,731	11,681
Average Annual Profit (1968-74)	17,600	17,600
Net Profit after Payment to Estate	- 6,131	5,919

	Present Estate Tax Rates Plus Capital Gains Tax
Net Worth, December 31, 1974	$495,000
Original Investment, 1948	13,000
Capital Gains Subject to Tax	482,000
Capital Gains Tax (25% Rate)	120,500
Taxable Estate after Capital Gains Tax Deduction	374,500
Exemption	60,000
	314,500
Estate Tax	86,340
Total Tax Liability	206,840
Minimum Annual Tax Payment 2/	39,230
Average Annual Profit	17,600
Net Deficit After Payment To Estate	-21,630

1/ Table 4

2/ Assumes hardship finding. Includes 9 percent interest rate plus 10 percent of principal. Tax is for first year.

Source: Actual case study. Interview and analysis of corporate financial records. Tax consequences based on estate tax tax structure and revised rates set forth in Table 4. Capital gains proposals based on stated assumptions.

estate tax liability would be only $61,480 and the firm would be able to generate a small annual profit, $5,919, after satisfying the minimum allowable payment towards the estate tax liability.)

Now let us consider the consequences of superimposing capital gains taxes over the existing estate tax structure, for our sample firm. You will recall that virtually the entire net worth of the firm would be considered a capital gain and the capital gains tax liability alone would be $120,500. This amount combined with an estate tax liability of $86,340 would result in a total tax liability of $206,840. The minimum annual tax payment -- again assuming a hardship finding -- due on this liability the first year would be $33,094, or nearly double the average annual after-tax profit of the firm during the last seven years. Under this tax burden, the mounting deficits of the firm would certainly force an early liquidation of the enterprise. Our analysis indicates that the experience of this firm is not unique. Corporations in the $1 to $5 million asset size category simply cannot generate sufficient income to pay their yearly income taxes, plus the capital gains tax, plus a minimum of 10% of the total estate tax, plus the interest payment for the outstanding estate tax.

Finally, the liquidity crisis noted in Table 9 does not take into account a critical element in the survival of the family-owned enterprise -- the need for new investment capital to sustain corporate growth. Assuming the heirs were able in

some way to scrape up the capital to cover the deficit shown in Table 8, they would still be lacking the capital needed to maintain a viable competitive position for their firm.

It is important to understand that, for the typical wholesale-distribution firm, growth is not a mere luxury but an absolute economic necessity. A wholesale-distribution business cannot stand still. It either grows or it fails. Since 1940, the typical firm would have had to increase its sales by an average of close to 4 percent annually merely to keep up with the general rate of inflation in our economy. Moreover, our suppliers are steadily expanding their range of products, and we must expand our inventories and services accordingly if we are to retain the confidence and goodwill of our customers and our suppliers. To achieve the sales growth necessitated by inflationary and competitive factors, the typical wholesaler-distributor must generate a proportionate increase in assets. Here it is particularly important to understand the peculiar character of the wholesale-distribution industry, as discussed earlier today by Mr. McCamant and Dr. Ture. Virtually all of our assets consist of current assets, largely inventories and accounts receivable. For the family-owned wholesaler-distributor, the sources of capital needed to increase assets, which must be expanded in rough proportion to sales, are effectively limited to retained earnings. That is why the typical wholesale-distribution corporation distributed only 25.2 percent of its after-tax earnings in 1971 compared with

Table 9

Pretax Net Income, Income Taxes, Dividends, and Cash Flow, Merchant Wholesaler-Distributor and All Corporations, 1971

(dollar amounts in billions)

	Merchant Wholesaler-Distributors	All Corporations
Pretax net income*	4.5	78.7
Corporate profits tax	2.2	37.5
(Percent of pretax net income)	(50.5)	(47.6)
Net income after tax	2.2	41.2
(Percent of pretax net income)	(49.5)	(52.4)
Dividends	.6	25.0
(Percent of net income after tax)	(25.2)	(60.7)
Retained earnings	1.7	16.2
(percent of net income after tax)	(74.8)	(39.3)
Capital recovery allowances	1.9	60.4
Net cash flow	3.6	76.8
(Percent:		
Retained earnings	(46.2)	(21.1)
Capital recovery allowances	(53.8)	(78.9)

*Profits after inventory valuation adjustment.

Source: U.S. Department of Commerce, Survey of Current Business.

Note: Percentages calculated from unrounded numbers.

62-209 O - 76 - 42

60.7 percent for the average corporation. (Table 9) The remainder, or almost three-quarters of total earnings, were retained to provide the capital needed for expansion. Without that expansion, the business would be doomed to failure.

I am confident that this Committee will recognize the dangers of such a form of taxation to the small, closely-held business enterprise. Unfortunately, such legislation would precipitate the demise of such businesses unless special consideration is granted to the unique problems they face.

I urge the Committee to update the estate tax exemption from $60,000 to $200,000, to account for the effects of inflation since 1942. We believe that the adoption of this proposal would, on balance, have a minimal effect on total tax revenues, and would be an important step towards preservation of a viable small business sector in our economy.

We also urge the Committee not to apply a capital gains tax to an imaginary gain. Taxation of an action founded only on the assumption that it has in fact occurred is not a realistic basis for taxation.

Senator NELSON. Senator Hansen, who is also a member of the Finance Committee, has joined us. I know he has an interest in this subject, and also represents lots of farmers and ranchers in Wyoming.

Mr. DAVIS. He is a good neighbor.

Senator HANSEN. Tell that to the people to the north, Mr. Davis.

Mr. DAVIS. I will work at it, Senator.

Senator NELSON. Our final witness is Richard Covey, special counsel to the trust division, of the American Bankers Association.

I wonder, Senator Hansen, if you would chair the hearings from this point on. I regret I have to leave. There is a Democratic conference luncheon, in which we are taking up some business that I have to attend. I appreciate very much for your taking the time to come here today. I think all these witnesses have given most valuable testimony for our consideration.

Oh, and I did want my prepared statement placed in the record.

Senator HANSEN. Mr. Covey, as I am certain you have heard other witnesses being similarly instructed, your entire statement will be included in the record as though it were read. You may summarize it or present it, as you like.

[The prepared statement of Mr. Covey in full follows:]

STATEMENT BY RICHARD B. COVEY, ATTORNEY,
CARTER, LEDYARD & MILBURN, 2 WALL STREET,
NEW YORK, NEW YORK 10005
BEFORE JOINT HEARINGS OF THE SENATE SELECT
COMMITTEE ON SMALL BUSINESS AND THE SUBCOMMITTEE
ON FINANCIAL MARKETS OF THE SENATE COMMITTEE ON
FINANCE ON SEPTEMBER 25, 1975

PANEL ON ESTATE AND INHERITANCE TAXES

My name is Richard B. Covey. I am an attorney practicing in New York City. A considerable part of my practice involves the application of the federal tax laws to trusts and estates. I appeared by invitation before the Committee on Ways and Means of the House of Representatives during 1973 at the panel discussion on estate and gift tax revision. Since 1970 I have acted as special counsel to the American Bankers Association on trusts and estates tax matters. However, the views that I express here today are my own and not those of the Association.

Small Business and Estate Tax Revenues

At the outset it is useful to have some general idea regarding what percentage of the federal estate tax revenues is attributable to small business. This percentage is difficult to estimate and depends on how the term "small business" is defined. The figure of 5% was suggested to the House Ways and Means Committee during the 1973 hearings on general tax reform. See, *e.g.*, Small Business Tax Reform, 1970-74, Select Committee on Small Business, United States

Senate, July 25, 1974, at 139 and 175. I believe that this estimate is low and suggest that a range of 9-11% would be more accurate. The supporting data for using this range is set forth in Appendix A.

The estate tax collections for the year ending June 30, 1975 were $4.6 billion. Using a 10% small business estiamte, the total estate tax on all small businesses could be eliminated at a revenue loss of $460 million. Thus, in determining whether changes should be made in the estate tax laws relative to small business, revenue considerations do not loom large.

Major Policy Decisions - Reducing Estate Taxes On Small Business and Imposition of Capital Gains Tax At Death

Other members of this panel have greater knowledge of the effect of the estate tax on the continuation of small businesses. It is, however, clear to me that the current level of estate taxation is making the continuation of family businesses and family farms by different generations difficult in many cases. The testimony of the National Livestock Tax Committee and the National Association of Wholesaler-Distributors before the Committee on Ways and Means of the House of Representatives during the 1973 public hearings on General Tax Reform (4008-043, 4079-4126) on this subject

is convincing and confirmed by testimony given on June 17, 18 and 19, 1975 on Small Business Tax Reform at the joint hearings before the Committee and the Subcommittee holding these hearings. See pages 4, 471, 544, 628. In my view the major policy decision is whether the desirability of continuing small businesses is such that an estate tax incentive should be created to encourage such action.* This is not an easy decision to make. Today's tax incentive often becomes labeled tomorrow as a tax loophole.

While reasonable men may differ concerning the desirability of reducing estate taxes on small business, there should be no dispute about the devastating effect the imposition of a capital gains tax at death would have in this area unless the new tax were accompanied by a reduction in estate tax rates. In commenting upon such a tax during the 1973 public hearings on General Tax Reform before the House Committee on Ways and Means the National Livestock Tax Committee stated

> "It has been suggested that if we give farmers and ranchers estates enough time to pay this tax that this will solve the problem. However, we think this is no solution because if you have to sell the business to pay the tax, we feel that nothing has been accomplished. In fact, a great detriment has been caused." (page 4011).

*It should be recognized that in many, if not most, cases of small business assets, estate taxes cannot be reduced significantly by the transfer of these assets during lifetime by gift because the owner must retain control over the assets.

Using current estate tax and capital gains tax rates, the combined effect of the two taxes could be in the 40-50% range for an estate of $500,000 with substantial unrealized appreciation. Even those who favor the imposition of a capital gains tax at death recognize the difficulty of applying this tax to small business assets. See Small Business Tax Reform, 1970-74, Select Committee on Small Business, United States Senate, July 25, 1974, at page 175.

Proposed Legislative Solutions

A. Introduction

A substantial number of bills have been introduced in Congress during recent years with the stated purpose of reducing estate taxes on small business, and particularly family farms. So far during this year eleven such bills (S.568, S.678, S.679, S.702, S.1164, S.1173, S.1803, S.2038, S.2187, S.2267, S.2272) have been introduced by ten different senators, including Senators Bartlett and Dole. In past years three other current members of the Select Committee on Small Business, Senators McIntyre, Mondale and Javits, have supported such legislation.

B. Types of Approaches

The "relief" provisions of the bills generally fall into three categories (1) increasing the estate tax exemption from the current $60,000 to a larger figure,*

*A bill recently introduced by Representative Rousch would create an exemption of $200,000 for a family farm. Congressional Record, September 17, 1975, H.8783.

(2) increasing the marital deduction from the current one-half of a decedent's adjusted gross estate to a higher figure of $100,000 plus one-half of the adjusted gross estate and (3) permitting an alternate method to be used to value one or more types of small business assets provided the business is operated by the decedent for a stated period before his death and by his beneficiaries for a stated period after his death.

C. Revenue Effects

The revenue effects of these three approaches vary significantly. Any increase in the estate tax exemption will be of benefit to all decedents who would pay an estate tax under the current law and not merely to those with small business assets. This approach would maximize the revenue loss when compared with the other two approaches. An exemption of $200,000, which is the figure most frequently suggested, bears approximately the same relationship to the present $60,000 exemption as the cost-of-living index bears to the index in effect when the $60,000 exemption became a part of the estate tax law in 1942. Thus, viewed in terms of purchasing power in the smaller estates, there is some basis for the increase. Based upon statistics for decedents dying during 1973, the last year for which published figures are available, the revenue loss for that year from an increase

in the exemption to $200,000 would be more than $1.37 billion,* which is approximately 30% of the total estate tax before credits (see Table 17, Statistics of Income, 1972 Estate Tax Returns, Internal Revenue Service Publication 764 (4-75)).

The second approach of increasing the marital deduction would result in a short term revenue loss, but little or no revenue loss over the long term. The reason for this is that, in general, the marital deduction merely postpones the imposition of estate tax until the death of a surviving spouse. There would be revenue loss from the third approach of creating an election to value a business by a "use" approach rather than a fair market value approach, but the loss should be small.

D. Critique

1. Increased Exemption

In my view a general increase in the exemption is the wrong approach to the small business estate tax problem for three reasons:

(i) This approach is likely to run into considerable opposition, particularly if the increase is substantial. Some members of Congress have in recent years proposed or supported legislation to lower the estate tax rates and to impose a capital gains tax at death. See, e.g., S.512 introduced by

*All tax generated at rates below 30% and 40/150 of tax generated at 30% rate. The actual revenue loss would be higher because the increased exemption would operate as a deduction in computing the tax at the estate's highest rather than lowest estate tax rates.

Senator Haskell. I fail to see how these persons could support a general increase in the exemption.*

(ii) Any approach which does not create an incentive for the continued operation of the small business is in my judgment defective. An increase in the exemption bears no relationship to the continued operation of the business after the decedent's death. If an estate disposes of a small business shortly after the decedent's death and receives cash, I see no reason to grant any type of tax preference to that estate.

(iii) An increase in the exemption has the effect of granting the estate a deduction in computing the estate tax owed. The benefit to the estate would be the increase in the exemption times the estate's highest estate tax rate or rates. For example, if a decedent has a taxable estate in excess of $10,000,000 an increase in the exemption would benefit him in an amount equal to the highest estate tax rate (77%) times the amount of the increase. If the exemption is to be "increased", a more satisfactory approach would be to have the exemption operate as a credit against the tax at the lowest estate tax rate or rates. The credit approach would minimize the estate tax revenue loss.

2. Increased Marital Deduction

An increase in the marital deduction is of limited

*For a criticism of S.1173 proposing an increase of the exemption to $200,000, see Tax Notes, Tax Analysts and Advocates, September 22, 1975, at pages 10-12.

utility and is in large part misdirected because the liquidity problem for small businesses is most severe when the business passes from one generation to another rather than when it passes from husband to wife or vice versa. My feelings in this regard are similar to those expressed by the National Association of Wholesale-Distributors in testimony before the Committee on Ways and Means of the House of Representatives during 1973 on General Tax Reform when that organization stated

> "While NAW heartily endorses the 100 percent marital deduction we would like to emphasize that it in no way solves the long-term problem of perpetuating a family-type business from one generation to the next. Our support for the 100 percent marital deduction is therefore tempered by reality--the harsh reality that the exemption while needed in no way solves the basic problem of continuing family-type enterprises under a highly progressive estate tax system." (page 4094)

3. Alternate Valuation Based Upon Use

The third approach, which is essentially one of creating an optional method of valuation based upon use (capitalization of earnings), has the virtue of being limited in its effect to one or more types of small businesses. There are, however, drawbacks to this approach. Two different valuations would have to be made. An estate might agree with one of the values arrived at by the Service under either the fair market value approach or the use-capitalization of earnings approach but would not agree with the valuations under both approaches. The estate would then be required to

litigate the result under an approach which because of later events might become moot. Further, in the closely held stock area, I am not sure that the capitalization of earnings method will be of significant economic benefit to estates. An approach which merely establishes more certainty of valuation does not meet the liquidity problem.

My Suggestions

A. Improvement of Existing Valuation Procedure

While I believe the alternate "use" (capitalization of earnings) valuation approach is deficient, it focuses upon a problem which concerns many lawyers and accountants representing estates. A belief exists that agents auditing estate tax returns with assets which are not susceptible of precise valuation are with some frequency proposing inflated valuations. A possible solution to this problem, which I believe is real, would be for an estate to be able to compel production by the auditing agent of a valuation report on any asset whose value cannot be easily ascertained.* When the Service has used the services of an appraiser, the agent would be required to disclose the name of the appraiser and give the estate a copy of the appraisal report. Similarly, in the case of closely held stock, the agent would have to give detailed information regarding the valuation method which was used and any comparable companies. The present

*The estate probably cannot compel production of the Service's material under the Freedom of Information Act. See NLRB v. Sears Roebuck & Co., 421 U.S. 132 (1975).

practice of not giving the estate this type of material should be changed.

B. A Method for Creating Small Business Estate Tax Relief

If this Committee determines that legislation is desirable to reduce the impact of estate taxes on small businesses in order to encourage continued family control of such businesses after a decedent's death, I suggest for consideration the creation of a tax incentive which increases as the period of time from the decedent's death increases. Section 6166 permits an extension of time for a period of up to ten years for paying the estate tax attributable to a closely held business. My proposal would grant a forgiveness of tax on each annual installment due under this section (and interest on the unpaid balance of the tax) and the forgiveness would increase at the rate of 10% per year as each installment payment is made. To illustrate, if the estate tax deferred under section 6166 were $100,000 with annual installments of $10,000 there would be a forgiveness of 10% on the first installment, of 20% on the installment and interest for the second year, of 30% on the third installment, and so on until there would be a total forgiveness of the installment and interest for the 10th year. The tax previously forgiven on prior installments would not be affected by acceleration

of the remaining installments under section 6166(h) but no forgiveness would be available with respect to any unpaid tax or interest after this provision becomes operative. The maximum tax forgiveness for all ten installments would be 55% of the tax attributable to the closely held business, with the greatest part of the forgiveness concentrated in the sixth through tenth years.

A slightly different approach to forgiveness which would produce a smaller revenue loss would be to apply increasing percentages of forgiveness to the unpaid balance of the tax immediately before the payment rather than to the amount of each installment. The forgiveness would commence at 1% and increase by 1% per year. If this were done the total forgiveness would be 40% of the tax attributable to the closely held business. Interest would be forgiven as discussed in the preceding paragraph.

While my proposal is keyed to section 6166 forgiveness of tax could be granted to a more limited group of small business assets than those described in section 6166(c). In this regard, it might be concluded that one of the two qualification requirements for stock - 20% of the voting stock of the corporation being included in gross estate - is too broad. If further restrictions on tax forgiveness are deemed advisable in the stock area

there are many ways to restrict this benefit. One possibility would be that the number of shareholders be set at a higher figure but made a dual rather than an alternate requirement. Also, a dollar limit could be imposed on the value of a closely-held business as to which tax forgiveness would be available.

C. Interest on Deferred Estate Tax

All estate tax extensions are now subject to an interest charge at a "floating rate" based upon the prime rate, and the current rate is 9%. The special 4% interest rate for extensions under section 6161(a)(2) or 6166 was eliminated effective July 1, 1975. This represents an increase of more than 100% in interest payments under these sections and will create a cash flow problem for many business assets. Inquiries that I have made suggest that adequate consideration was not given to this problem. The elimination of a special rate was ill-advised, at least in terms of section 6166. The reduced rate was designed to enable estates to pay the deferred tax out of earnings of the closely-held business. The House Committee Report says:

> "This provision is primarily designed to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax. Where the decedent had a substantial proprotion of his estate invested in the business enterprise, under existing law this may confront the heirs with the necessity of either breaking up the business or selling it to some larger business enterprise, in order to obtain funds to pay the Federal estate tax. Your

committee believes that this result has an especially unfortunate result in the case of small businesses, which traditionally also are closely held businesses. Therefore, although not removing any Federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system." (emphasis added)

See H.R. Rep. No. 2198, 85th Cong., 2d Sess. 7 (1958).

I suggest that interest on amounts deferred under section 6166 be set at two-thirds of the regular interest rate from time to time in effect.* I would not make this change for section 6161(a)(2) permissive extensions since such a change would make it more likely that the Service would apply a restrictive policy in granting such extensions.

D. Technical Changes

There are a number of changes which should be made in various sections of the Code that are generally concerned with the liquidity problem and the payment of estate taxes.

1. Section 6165 - Bond

This section authorizes the Service when an extension of time is granted to pay the estate tax to require the estate to furnish a bond in an amount not to exceed twice the amount

*If the forgiveness proposal (which includes a forgiveness of interest suggested above) were adopted, I would make no further change in the interest payable.

covered by the extension. The cost of a bond is no different from the payment of additional estate tax. The bond requirement should be eliminated unless the Service can demonstrate that it is needed.* If the bond requirement is not eliminated, alternate security devices to a bond should be provided as recommended by the 1968 Treasury Studies and there should be a uniform practice followed by all District Directors in requiring bonds. No such practice now exists.

2. Section 2204 - Executor's Personal Liability for Tax

When payment of estate tax is extended the executor remains personally liable for the payment of the tax. This potential liability, when coupled with the bonding requirement of section 6165 and the estate tax lien of section 6321, seems like legislative overkill. The continuing personal liability of the executor has restricted the use of section 6166. Consideration should be given to eliminating the personal liability of the executor after the estate tax has been finally determined and all estate tax has been paid except amounts as to which an extension has been granted, particularly if the bonding requirement is retained.

3. Section 303 - Stock Redemptions and Avoiding Dividend Treatment

Section 303 permits redemptions of stock included

*The estate tax lien provided by section 6321 remains in effect until ten years after a decedent's death.

in a decedent's gross estate to be treated as an exchange of property and not as the receipt of a dividend to the extent of death taxes and funeral and administration expenses if certain requirements are met. Imposition of dividend treatment would present a serious liquidity problem for a decedent's estate in need of cash tc pay estate taxes. Thus, sections 303 and 6166 are each aimed at providing relief for an estate's liquidity problem. The percentage requirement of section 303 - 50% of the taxable estate or 35% of the gross estate - is the same as that applicable under section 6166. The time periods under the two sections are, however, different. The estate tax may be deferred for ten years under section 6166 but a qualified redemption under section 303 must in general be accomplished within three years after the estate tax return is filed. Since the redemption proceeds may be used to make the installment payments under section 6166, the time requirement of section 303 should be extended to ten years to conform with section 6166.

Sections 303 and 6166 also differ regarding their application to stock of two or more corporations. Section 303 has a 75% multiple corporation rule - the decedent's gross estate must include 75% of the value of the oustanding stock - while section 6166 has a 50% multiple corporation rule. The percentage should be the same for each section. Further, a 50% requirement is too high and should be lowered to 33 1/3%.

63-209 O - 76 - 43

4. Section 6161(a)(2) - Permissive Extensions

This provision permits the Service to grant an extension of time to pay the estate tax for up to ten years if payment of the tax would result in "undue hardship" to the estate. The word "undue" should be eliminated since no one is sure what it means but it suggests that something more than "hardship" is needed. "Hardship" alone should be a sufficient ground for a permissive extension.

5. Section 6166 - Ten Year Extension

This provision contains alternate requirements in the case of stock - 20% or more of the voting stock or 10 or less shareholders. The 10 or less shareholder test is too restrictive and should be broadened to include at least 25 shareholders.

A problem exists concerning the application of section 6161(h) to trust property. Under this provision certain events may cause an acceleration of the deferred payments. One of these events occurs if 50% or more of the interest in the closely held business "is distributed, sold, exchanged or otherwise disposed of". Treas. Reg. §20.6166-3(e)(1) states:

> "A transfer by the executor of an interest in a closely held business to a beneficiary or trustee named in the decedent's will or to an heir who is entitled to receive it under the applicable intestacy law does not constitute a distribution thereof for purposes of determining whether 50 percent or more

of an interest in a closely held business has been distributed, sold, exchanged, or otherwise disposed of."

This result appears to be inconsistent with the result when the distribution is made from trust property which is included in a decedent's gross estate. Treas. Reg. §20.6166-3(e)(3) provides:

"An interest in a closely held business may be 'distributed' by either a trustee who recevied it from the executor, or a trustee of an interest which is included in the gross estate under sections 2035 through 2038, or section 2041."

There is no rational basis for any such distinction. Why should a distribution by an executor be "clean" and a distribution by a trustee of a revocable trust used as a will substitute be "tainted"? This trap for the unwary should be eliminated. Section 6166(h) should be revised to make clear that a distribution of property by a trustee will not cause an acceleration of the payment of deferred estate tax.

The Service has recently issued three rulings involving whether section 6166 applies to certain businesses operated by a decedent at his death. Revenue Rulings 75-365, 75-366 and 75-367, IRB 1974-34 at 24-47. Revenue Ruling 75-365 states in part:

"What amounts to a 'trade or business carried on' within the meaning of the statutory language of section 6166(c)(1) of the Code ('an interest as a proprietor in a trade or business carried on as a proprietorship'), should not

> be determined merely by reference to a broad definition of what 'business' is or to a case-law definition of the term for purposes of some other section of the Code such as section 162, but should be found in keeping with the intent of the legislature in enacting section 6166. Although the management of rental property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship, section 6166 was intended to apply only with regard to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets."

The Service's restrictive interpretation of section 6166(c) is not supported by the legislative history of section 6166. Congress should refine the meaning of the term "trade or business" as used in this section.

APPENDIX A

Estimate of Estate Taxes On Small Businesses

The Internal Revenue Service periodically publishes statistics from federal estate tax returns. The most recent such statistics are for returns filed during 1973 and are found in Statistics of Income, 1972 Estate Tax Returns, Publication 764 (4-75). Unfortunately, they do not give detailed information regarding what portion of decedents' property consists of small business assets except to state that "non-corporate business assets" comprised $890,025,000 of which $754,259,000 was included on taxable returns. These figures do not include real estate. The total gross estate figure for 1973 returns was $38,868,676,000, of which $33,293,565,000 was included on taxable returns.

The most recent information made available by the Service regarding closely-held stock is in Statistics of Income, 1965 Fiduciary, Gift and Estate Tax Returns for returns filed during 1966. Corporate stock is classified into three categories - traded, closed corporation and unidentified. "Closed corporation" refers to "a family owned closely-held corporation". The breakdown for these three categories is as follows:

Traded	$7,188,969,000
Closed Corporation	978,004,000
Unidentified	1,047,577,000
	$9,214,550,000

$924,234, or 94.5%, of the total closed corporation figure covered taxable returns. This percentage is somewhat higher than the percentage of the total gross estate figure included in taxable estates. The ratio of closed corporation stock to the total gross estate figure of $21,936,000 is 4.5%. The statistics for returns filed during 1966 also include "non-corporate business assets". This category showed a gross figure of $549,426,000, or 2.5% of the total gross estate figure.

Small business would also include real estate used in farming or livestock businesses. The statistics for 1966 returns make a differentiation in real estate between "primary residence" and "other". The "other" category shows a gross figure of $3,328,589,000, of which $2,677,883,000 is included in taxable returns. There is, of course, no way to determine how much of the "other" category is real estate used in farming and livestock operations. An estimate of $550,000,000, the same figure as non-corporate business assets, seems like a minimum figure.

In summary, based upon the statistics for the

returns filed during 1966 it seems reasonable to assume that small business assets comprised at least 9% of the total gross estate figure. This percentage should not vary significantly from 1966 to 1975. While the stock percentage may now be somewhat lower the real estate percentage should have increased as a result of substantial increases in the value of farm land.

STATEMENT OF RICHARD B. COVEY, ATTORNEY, CARTER, LEDYARD & MILBURN, SPECIAL COUNSEL TO TRUST DIVISION, AMERICAN BANKERS ASSOCIATION

Mr. COVEY. I would like to stay away from my statement and look at some of the things that have been said here today, and come up with some alternatives to what has been suggested.

I think what we end up with here, as we look over this whole area, is we've got four separate considerations that have to be taken into account.

No. 1, we've got the social policy of preventing corporate mergers and maintaining the free enterprise system. That certainly speaks for trying to do something to help out the small businessman. If there was ever a case for estate tax relief that is a compelling case, it is the small businessman's case. There is no question about that.

No. 2, we've got the fairness concept that taxpayers with the same estates should pay the same estate taxes. To give an illustration, if the small businessman sells out 1 month after the date of death for cash, I don't really feel very sympathetic for him. I see no reason why he shouldn't pay the same estate tax as somebody who has listed securities. This is an important consideration you've got to keep in mind.

No. 3 is revenue considerations. This I will get to in a minute when we start talking about the specific exemption. If the exemption is increased across the board, a scatter gun or spray gun approach to the problems of small businessmen, I don't think it would be wise.

No. 4 is the hardship case. Here, again, we come back to the small businessman and his liquidity problem.

Now, a lot of bills have been introduced that have suggested increasing the estate tax exemption to between $150,000 to $200,000. I really think that is a scatter gun approach to the question of the small businessman. It has nothing whatever to do with whether he continues in that business after date of death. Not only that, it is not an exemption. It is a deduction which operates at the highest estate tax rates. So the effect of going from $60,000 to $200,000 is that you are giving an increased deduction, not an exemption. To a person in a 77 percent bracket, multiply 140,000 times 77 percent, and you get the benefit to his estate.

It would seem to me that if you are talking about increasing the exemption, you would be much better off to do it in terms of a credit against the estate tax; in other words, permit a tax credit at the lowest estate tax rate. You will still be able to get a lot of people off the estate tax rolls. If you have a credit against taxes down below, the benefit is the same to the big businessman as it is to the small man. This, essentially, is the same problem that is presented in the income tax, that is, should there be an exemption—deduction—or should there be a tax credit? This has generated a considerable amount of controversy.

Now, let's look at revenue. As best as I can figure out, the estate tax attributable to small business is probably about 10 percent of the estate tax revenues. Maybe somebody can come up with a better estimate. How I get to this figure is set out in the appendix to my statement and is based on statistics published in past years.

Our estate and gift tax revenues are roughly $4.6 billion. Let's assume we exempted all small business from the estate tax. The net result would be a revenue loss of about roughly $450 million. If we increase the exemption to $200,000, we are talking about a revenue loss of somewhere between $1.4 billion and $2 billion. It seems to me this points up that if we are talking solely about small business, to raise that exemption is a very expensive way to solve the problem. You could solve the problem by exempting all small business from estate tax entirely at something less than half the cost.

So, it seems to me what we essentially have got to do is to get this thing into proper focus. If you think there is an estate tax problem, and to me there is a demonstrable problem in many cases, then let's see what we can do to focus on the problem and then give some relief to the people that you think should get some relief but let's not do it by means of increasing the exemption.

Second, on increasing the marital deduction, that doesn't really help you, because the problem here is not from the husband to the wife or from the wife to the husband; the problem is between generations. We already have a marital deduction which solves the problem on one-half the estate being exempted from taxes. So, I view this solution as not really addressing itself to the problem.

The third solution that has been suggested is valuation. It has been suggested we are valuing the property in the wrong manner. If the property stays as a farm, it ought to be valued as a farm. The difficulty I have with changing the method of valuation is that it opens up a can of worms. We file the estate tax return 9 months after death. The auditing agent walks in and what are you going to do? Are you going to establish a double valuation procedure?

Let's say we value it on its fair market value and we value it on its farm value and let's say we get two different figures. If the property is sold within 5 years a tax is paid at the higher figure; if it is retained after 5 years, the tax is finalized at the lower figure. That means we have a valuation for two purposes, and this seems to me kind of foolish, because you may be going through a valuation process that is moot later on. You may agree on the farm use, but disagree on the fair market value use, or are you going to wait for 5 years to see what occurs and then try to value it 4 or 5 years later? This has problems.

All right, essentially what I would say that if we think there is a compelling case for relief here, then let's focus on it. Well, what have we got in the code today? We've got provisions in 6166 to give an extension of time to pay the estate tax. This was put in the last major bill that dealt with relief for small business. It permits him to pay the estate tax over a 10-year period.

Well, suppose you took this approach to it and said the way we ought to do this is to give the estate tax reduction based upon the amount that he can defer under 6166. Then it seems to me that if you are thinking of an incentive to keep the small business operating, you want an incentive which increases with the passage of time. The longer the small business is retained, the longer his heirs stay in with it, the more the incentive should be.

So, in my paper, what I have suggested is an approach that might be like this. The estate has to make its first payment 9 months after date of death on the first installment when the estate tax is due. Let's

assume we have an estate tax of $100,000 attributable to the closely held business, and therefore the estate would pay one-tenth, or $10,000, 9 months after date of death. I would say at that point in time, give him a reduction in tax of 10 percent. So, instead of paying $10,000, the estate would pay $9,000.

Then we come to 1 year and 9 months after date of death, when the second installment is due, and I would say, at that point in time, give a 20-percent reduction in tax. So, instead of paying $10,000, the estate would pay $8,000. The estate also gets a forgiveness of 20 percent of the interest that is due at that time. The forgiveness of interest parallels exactly what forgiveness of principal is.

You would continue on that same schedule until the 10th payment, at which time the entire payment is forgiven and all interest on the unpaid balance is forgiven.

The result of this would be that you would have a forgiveness of 55 percent of the tax attributable to the closely held business. The incentive to continue the business is not based on a single event. Each year the incentive to continue increases. It seems to me that is the proper approach, if you are going to try to create incentives.

All right, if you think that is a little too rich for your blood, because you say 55 percent is too high, then how could we scale it down a little?

One way of scaling it down would be to have the forgiveness based on the unpaid amount of indebtedness. So that the first year the indebtedness would be $100,000 and I would give him a 1-percent forgiveness, or $1,000.

The second year, on the $90,000 that is left, I would give him a 2 percent, or $1,800. The third year, again, would be 3 percent of $80,000. The end result would be a foregiveness of $40,000, or 40 percent, rather than the 55 percent under the previous method.

I would point out that at these figures, you attack the problem much more directly at a lower revenue cost than by increasing the exemption.

If my figures are right, we've got about $450 million estate tax on small business. Under my approach there is a 55-percent reduction in tax. Now, what does that mean? The revenue loss is roughly $250,000. Contrast this with increasing the exemption in terms of revenue loss. So, it just seems to me that we ought to stop horsing around and pretending that we should solve the problem indirectly.

Now, what is the difficulty with my approach?

Well, the difficulty is obviously that something that is labeled "a tax incentive" today, even with a good purpose behind it, becomes tomorrow's "loophole." That is the problem. This is why, I suspect, many people, who have testified here, have taken the way out of increasing the exemption, which applies across the board and gets everybody relief, and not just the small businessman. I think that is the wrong way to go. I think it also raises some very difficult value judgments as to the relative weight of the estate tax and the income tax. A lot of people, including some members of this committee, favor increasing estate taxes. For example, Senator Haskell has a bill in which it would reduce the exemption from $60,000 to $20,000, or $25,000, and start the tax in at 20 percent. That would kill off the small businessman. Senator Haskell would add a capital gains tax at death on top of it, which would kill him off twice.

Very frankly, I don't view the function of the Select Small Business Committee as being to set general policy for what the estate tax exemption should be. I think that is more within the province of the Finance Committee and the House Ways and Means Committee in the first instance. Rather, I would view it as saying, "We think there is a problem in the small business area, and we think this solves our problem."

Now, maybe my proposal will get no place. Maybe it stinks. But, at least, it has the virtue of being addressed specifically to what people say the problem is.

One of the difficulties with my proposal is that the requirements of section 6166 are not limited to a small businessman. It could apply to a multimillion-dollar corporation. I could conceivably see where you might want to place some restrictions on tax forgiveness, if you go this route. You might want to cut back some.

There are obvious ways to handle this. You can restrict the amount of forgiveness or you can restrict the number of shareholders. There are a lot of ways to tinker with it.

It seems to me that the function of this committee is to decide the following: No. 1, is there a problem; and No. 2, how do we try to solve this problem.

Thank you.

Senator HANSEN. Well, gentlemen, thank you very much for your appearance here today. I think you have been, as far as I can gather of what I have heard of the testimony this morning, real contributors towards a better understanding by the members of the Finance Committee and the Committee on Small Business.

We appreciate your appearance here today.

The committee stands in recess.

[Whereupon, at 12:30 p.m., the committee recessed, subject to the call of the Chair.]

SMALL BUSINESS TAX REFORM

THURSDAY, NOVEMBER 13, 1975

U.S. Senate,
Select Committee on Small Business
and the Subcommittee on Financial Markets
of the Committee on Finance,
Washington, D.C.

The Committees met at 9:30 a.m., pursuant to call, in room 2221, Dirksen Senate Office Building, Senator Gaylord Nelson (Chairman of the Select Committee on Small Business) presiding.

Present: Senators Nelson, Haskell, Brock, and Roth.

Also present: Herbert L. Spira, tax counsel, Senate Small Business Committee; Judah C. Sommer, minority counsel, Senate Small Business Committee; David Allen, office of Senator Bentsen; and Phillip Kawior, office of Senator Brock.

[The prepared statements of Senators Nelson and Bentsen in full follow:]

JOINT HEARINGS BEFORE SMALL BUSINESS COMMITTEE AND FINANCIAL MARKETS SUBCOMMITTEE, SENATE FINANCE COMMITTEE, ON SMALL BUSINESS TAX REFORM

NOVEMBER 13, 1975

OPENING STATEMENT OF SENATOR NELSON

This morning's session will conclude the public hearings on small business tax reform which were jointly undertaken this year as a part of an in-depth study by the Financial Markets Subcommittee of the Senate Finance Committee under the chairmanship of Senator Bentsen and the Select Committee on Small Business under my chairmanship.

The work of these two bodies during 1975 can also be traced back to Senator Bentsen's earlier reports on the capital shortages of small business in his report on the two-tier stock market in 1973 and to the development and introduction of the first small business tax reform proposal by the Small Business Committee in 1970.

In the intervening years, the tax and financial environment has grown worse for small and medium-sized businesses under a business income tax structure dating from 1950 and an estate and gift tax system established back in 1942. Inflation has rendered many of these provisions completely out of date.

Over the years, also, the tax system has become so top-heavy with complexity and paperwork that in terms of effective tax rates, the growing medium-sized business may pay twice as high a rate of federal taxes as his giant corporate competitor in this country. He is also paying a significantly higher rate than the same business in Canada which can claim a $100,000 equivalent of a surtax exemption.

Some statistics about this small business community underscore its importance to U. S. economic vitality. Small business furnishes 52% of all private employment, 43% of the entire U. S. business output, and one-third of the gross national product. It is the traditional source of over half the significant inventions and innovations and thus a prime factor in local and national economic growth.

The efforts of our Committees have made some progress in spreading recognition of the needs for small business tax reform among the Executive Branch and Congress. We are pleased that the Treasury Department has devoted some resources to these urgent matters in preparing today's testimony.

Unfortunately, until this year the work of our Committees did not produce any changes in tax legislation, and therefore no relief for the hard-pressed small and medium-sized independent businesses. Early in 1975, the emergency Tax Reduction Act of 1975

did, as a result of Congressional action, provide for a 2% rate reduction for companies earning under $25,000, and a 26% reduction on the next $25,000 of earnings.

However, this relief was enacted for a period of one year only.

The legislative history of 1975 is a classic illustration of how the small business community must work twice as hard to receive half as much.

At the outset, the investment credit--nearly half of which goes to the largest 350 corporations in the country--was the only benefit proposed for business in 1975. After Congress insisted on some rate reductions for smaller firms, the investment credit was still enacted for twice as long a period as the rate cuts. But, the current proposal in the other body compounds this imbalance. That bill proposes that the small business provisions be extended from the end of 1975 to the end of 1977; while the big business provisions are to be extended from the end of 1976 to the end of 1980.

In my view, this formula would be an ironclad guarantee that small business would fall farther and farther behind in our economy.

I feel that legislative action is necessary in the Senate to redress the inattention to this sector of economic life, and by restoring vigor to new, small, and independent business, benefit

our free, private enterprise system and the entire economy.

We are looking forward to this morning's testimony to assist our two Committees in summing up our investigation so we can formulate concrete and responsible small business proposals for consideration in connection with the pending tax reform legislation.

Our first witness will be the Deputy Assistant Secretary of the Treasury for Tax Policy, Mr. William Goldstein.

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STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM THE STATE OF TEXAS

This morning we begin the third round of joint hearings of the Senate Financial Markets Subcommittee, which I chair, and the Senate Small Business Committee, chaired by Senator Nelson, on the tax and financial problems of small businesses.

We are very fortunate to have as our lead off witness this morning Mr. William Goldstein who was recently appointed as the Deputy Assistant Secretary of the Treasury for Tax Policy. This is Mr. Goldstein's first appearance before the Finance Committee and I would like to welcome him.

Americans too often forget the indispensable role of small business in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. Small business, in many ways, is the essence of our country's promise. It is the small businessman who forms the economic backbone of our Nation. It is the small businessman who provides jobs for about one-half of our private work force. The survival of small businesses across our Nation is indispensable if we are to maintain healthy competition in our economy.

Following our first round of joint hearings last June, Senator Nelson and I introduced legislation to provide greater tax equity to our Nation's small businessmen by extending the provisions of the 1975 Tax Reduction Act which apply to small business. These provisions increase the corporate surtax exemption from $25,000 to $50,000 and also reduce the tax rate on the first $25,000 of corporate income from 22 to 20 percent. In addition, the amount of used property that can qualify for the investment tax credit is increased to $100,000 from $50,000. The House Ways and Means Committee has approved an extension of these provisions.

In an effort to reduce the mounting Federal paperwork burden, I have proposed legislation to amend the new pension law to specifically require the Secretary of Labor and the Secretary of the Treasury to issue simplified reporting and disclosure requirements for small pension plans. In addition, I introduced legislation which would require that all new legislation proposed by Congress include an explanation of the paperwork burden it would impose on business, particularly smaller enterprises.

Small businesses, especially "mom and pop" operations, must fill out numerous reports, as many as 52 tax forms in a single year. This is not an example of a Government which is concerned and responsive to the needs of its people. It is not a Government which is protecting free enterprise. It is instead a Government which favors only those large concerns that can satisfy repetitious requests for data, statistics and information.

We have to cut this tangle of redtape. We have to hold back the growing number of Government forms.

Earlier this week I introduced a limited small business tax reform bill which I believe has a good chance of quick Congressional action and which can offer some assistance in providing a healthier economic climate for the growth of small business.

First, this bill would allow a new business to carry forward for ten years any net operating losses incurred during the first ten years of operation of that new business. These net operating losses would be deductible against profits. This will assist small business growth which would help promote greater competition in our economy.

Second, this bill would expand the existing "Subchapter S" provisions of the Internal Revenue Code in order to enable a greater number of business enterprises to take advantage of these existing tax provisions which were enacted in 1958 to meet some of the special problems of smaller firms.

Third, it would allow the taxable year of a partnership to close at the death of a partner, with respect to the interest of the deceased partner, in order to provide greater flexibility for those enterprises that are organized as partnerships.

Finally, this legislation would also direct the Department of the Treasury to conduct a study to simplify inventory tax accounting for smaller businesses. Small businessmen lack the money to hire sophisticated tax lawyers and accountants and are simply unable to take full advantage of many existing tax provisions. We must enable smaller firms to utilize existing tax incentives.

This tax reform bill would result in a negligible revenue loss to the Treasury but would provide greater business flexibility for many small enterprises throughout our Nation.

Enactment of legislation to extend the small business provisions of the 1975

Tax Reduction Act; to reduce the paperwork burden; and to provide small business tax reform will be steps in the right direction.

But more is required. Government policy must be directed towards creating a favorable economic climate that will strengthen small firms and enable them to operate on a more equal basis with larger competitors.

The goals of these hearings is to formulate such a policy.

FACT SHEET, SENATOR LLOYD BENTSEN'S SMALL BUSINESS TAX REFORM ACT, S. 2646

1. Net Operating Losses for New Businesses.—Under this proposal, for the first ten years of operation of a new business the period over which net operating losses may be carried forward and deducted against profits would be increased from the present limit of 5 years to 10 years. New enterprises are generally more dependent on internally generated capital for growth and the current 5 year limit on the net operating loss carryover can have an adverse effect on growth. Since new businesses are frequently unprofitable for the first few years after formation operating losses incurred in the early stages of a business enterprise often cannot be recovered in the limited 5 year carry forward period now permitted. Thus although well established companies can usually utilize the net operating loss deductions, newer enterprises often cannot and this proposal would help eliminate this tax inequity.

2. Subchapter S Changes.—Last year the House Ways and Means Committee approved four tax changes which would facilitate use of the "Subchapter S" provisions of the Internal Revenue Code by small businesses. These four changes are included in this legislation. Under Subchapter S, the shareholders of closely-held corporations are taxed as though they were carrying on their activities as partners. Thus Subchapter S relieves the corporation itself from taxation but only on the condition that each stockholder reports his share of the corporation's income, whether distributed to him or not, on his individual tax return.

Subchapter S was enacted by Congress in 1958 to permit small corporations which are essentially partnerships to enjoy the advantages of the corporate form of organization without being made subject to the possible tax disadvantages of the corporation and to eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances.

(1) Under this legislation the maximum number of shareholders which a Subchapter S corporation is allowed to have would be increased from 10 to 15.

(2) In addition, in three types of situations trusts would be permitted to be qualified shareholders in Subchapter S corporations: (1) voting trusts; (2) grantor trusts (where the grantor is treated as the owner for tax purposes); and (3) instances where the holding by the trust is only temporary, for example, where it passes through a residuary trust to individual beneficiaries.

(3) Also under this legislation when Subchapter S stock has been held by a husband and wife, the estate of one of the spouses would not be considered a shareholder for purposes of determining the number of shareholders of the Subchapter S corporation.

(4) Finally, a Subchapter S election would be terminated under this proposal only upon a new shareholder's affirmative refusal to consent to a continuation of the Subchapter S election (instead of upon the failure of a new shareholder to consent to the election).

These reforms in Subchapter S which were approved by the House Ways and Means Committee last year would make it possible for many smaller enterprises to utilize these provisions which were originally enacted in 1958 to assist small firms.

3. Closing of Partnership Taxable Year on Death of a Partner.—Under this proposal the successor in interest of a deceased partner may elect to close the taxable year of the partnership with respect to the interest of the deceased partner as of the date of his death, instead of waiting until the close of the partnership taxable year or the date his interest is sold, exchanged, or liquidated. This would provide partnerships with greater flexibility.

4. Treasury Department Study to Simplify LIFO Accounting for Small Business.—Under existing law, any business, whether incorporated or not, may value its inventory and determine its cost by use of the LIFO method (last-in, first-out). In practice, however, a significant number of smaller enterprises find that they

are unable to use LIFO because of the ambiguity and complexity of the current regulations. This proposal would direct the Treasury Department to conduct a study to simplify the mechanics of applying LIFO.

Senator NELSON. Our first witness this morning is Mr. William Goldstein, Deputy Assistant Secretary for Tax Policy.

Mr. Goldstein, the committee is very pleased to have you present here this morning. If you will identify your associates so that the reporter will have the record correct, and then you may proceed to present your testimony however you may desire. It will be printed and included in the record.

STATEMENT OF HON. WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY SEYMOUR FIEKOWSKY, ASSOCIATE DIRECTOR OF BUSINESS TAXATION, OFFICE OF TAX ANALYSIS, TREASURY DEPARTMENT; AND CHARLES TEMKIN, LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Mr. GOLDSTEIN. Thank you, Senator.

This is Mr. Seymour Fiekowsky who is Associate Director of Business Taxation in the Office of Tax Analysis in the Treasury Department.

This is Charles Temkin an attorney on the Tax Legislative Counsel's staff.

If it's all right with you, Mr. Chairman, I would propose to follow the outline of my remarks, but I will try to skim through it somewhat if I could.

Senator NELSON. All right.

If you can summarize as you go along the main points, the statement will be printed in full in the record.

Mr. GOLDSTEIN. Thank you.

The first thing to observe is that I am new on this job and up until 2 weeks ago I was engaged in the private practice of law in which I was intimately concerned with the tax and financing problems of small- and medium-sized businesses.

So I may from time to time in my remarks refer to some experiences that I have had in my practice which I hope will be helpful to the committee.

The way that the discussions of the subject of taxation of small business have typically evolved, there is a lot of time spent in definitional matters, trying to figure out what a small business is and talking about the amounts of assets, sales, and number of employees, and so on.

I think in order to proceed with the discussion we do need some categorization, but I would like to use a somewhat less formal statistical approach than has been taken in the past.

As I see it there are four categories of businesses that we need to be concerned about which I will attempt to define in my own way.

The first I call small business; second, startup business; the third medium-sized business; and the fourth large business.

Now the first three categories are all in my view within the jurisdiction of the interests of this committee. A small business, as I see it, is the privately owned local producer of goods and services.

A typical company—this is a rough test only—would have net sales, that is, sales less cost of goods sold, of less that $100,000.

As you are aware, the great preponderance of such businesses are proprietorships and partnerships, but there are also a reasonable number of subchapter S and regular corporations in this category.

Perhaps the best way to understand the definitional approach which I am striving toward this morning is to look at the goals or ambitions of the owners of the businesses, and I mean to look at those as a significant item than any specific numbers.

Thus, in what I call the small business category, we find the owner-operators who derive from their businesses their principal source of livelihood, and their goal is simply to improve their livelihood.

They are workingmen who happen to run a business rather than work for somebody else. For example, the goals of the owner of the neighborhood drycleaning establishment or restaurant or small grocery store might be to expand his own operation, to make it more profitable and, perhaps, to open one or two more locations.

There are at least 10 million of this type of business based on the latest statistics I've seen, and we believe, and I'm sure the committee believes, that the significance of these businesses goes well beyond their number or their contribution to the various gross national product statistics, and so on.

It's these businesses that give us the personalized goods and services which add a little spice and variety to our lives.

The second category of business in broad terms is the "startup business." That is the individual or group of individuals with an "idea," whether a technological idea, marketing, or otherwise, which they believe if properly nurtured can form the basis of either a medium-sized or a large corporation at some future date.

Obviously what I'm talking about is the early stages of Xerox or Polaroid. They could be extreme examples of what we are talking about here.

Now these businesses may not be operating yet or barely operating, and they may not be in a position to provide anyone's livelihood, but they are different from the category that I just talked about because the goals of their founders are considerably more ambitious.

It seems to us that there is little doubt that there should be a national policy to encourage and foster the creation and development of this type of enterprise.

The third category which I call the "medium-sized business," is the upper range, middle to upper range, of what traditionally has been referred to here as small business.

Some of these are pretty good-sized enterprises, for a rough definition picture a company perhaps with net sales between $1 million and $20 million and assets of roughly three-fourths of these amounts.

Statistics show that this is a normal ratio in that category.

Now these businesses may be quite different in their ownership even though they are roughly the same size. They may be privately owned; they may be owned by a relatively small group of shareholders who have acquired the stock in private offerings; they may be partly owned by a large corporation but with some individual shareholding; or they may be publicly held companies but not the major ones.

They may have had a public offering of their securities and may be

registered with the Securities and Exchange Commission, but they are still not major national corporations.

Using what I call the "ambition" analysis, if you want to look at it that way, the owners of these medium-sized companies, depending on where they are in the spectrum, either have the goal of growing within the medium-sized category toward the top, or they want to move into the next category of the large business enterprise.

The large business category is, of course, the easiest to recognize, although again there have been arguments about just where you draw the line.

It is those few thousand corporations which qualify as major national business organizations. Typically they are listed on major stock exchanges and have substantial foreign operations.

They borrow money in the public bond market, issue commercial paper and have multimillion dollar lines of credit from syndicates of major banking institutions.

They belong to major trade associations and are well represented in State government matters and in Washington as well.

I would now like to talk about the major tax considerations that affect each of these four categories as I have described them.

That is, I would like to examine how Federal income taxes affect the realization of the goals or ambitions which the owners of each class of business have set for themselves.

Every one of these enterprises, in one way or another, is interested in growth and profitability. What we need to look at is whether our current system of taxation is a hindrance or a stimulant to achieving these goals.

Since, in turn, the problem of capital formation is in many instances a prerequisite to such desired growth, we think it would be of particular importance to see how our system of taxation affects the problem of capital formation in each of these four classes.

Now, to look first at the small class of businesses, or the class which I have described as "small," it would seem that the owners of such businesses are virtually indistinguishable as taxpayers from wage or salary earners in, let's say, the $10,000 to $20,000 annual income classification.

Even if these businesses are incorporated, the statistics indicate that they do not pay any significant corporate tax.

This is primarily because of the fact that they will pay salaries and bonuses to a sufficient extent to reduce their tax liability to zero or close to zero.

This is not to suggest that such businesses don't have any tax problems however. The burden of State and local franchise, capital stock, sales, property, gross receipts, and income taxes, Federal and State employment taxes, unemployment compensation premiums, which may be regarded as a tax for certain purposes, may be among the most significant burdens these small businesses do face.

With regard to Federal income taxes, although the actual payment of dollars to Washington may not be very significant, the time and expense involved in keeping the necessary records and in filling out the myriad of prescribed forms may boggle the mind of the small businessman.

With regard to tax relief for the proprietors regardless of form

of this type of business, since we view them essentially as equivalent to wage or salary earners at the same level, we think the relief that they could best use is simply the enactment of the President's program for individual tax cuts, that is the basic reduction in the tax burden which they have to pay when they send their form 1040's down to the District Director's office at the end of the year.

It should be noted that the proprietors, partners, and shareholder-employees of these small businesses who have adjusted gross income precisely equal to that of the wage-earners and salaried employees to whom I have been comparing them are still better off under our tax system in the practical way in which it's administered than the wage or salary earners.

That is, even the really small businessman takes opportunities to realize untaxed income in the form of deductible travel and entertainment expenses, the use of company cars, and so forth.

He may defer the taxation of economic income through some use of accelerated depreciation and, finally, he has certain flexibility in accounting matters particularly in regard to the calculation of closing inventories as a tax minimization or deferral technique.

Even the smallest corporation if profitable can take advantage of such tax benefits as plans to pay the medical expenses of its shareholder-employees with pretax dollars.

In summary, what I'm saying is that if you compare the salaried employee whose W-2 form shows $15,000 with a small business proprietor who shows $15,000 at the bottom of schedule C in terms of real economic position, I think the small business proprietor is somewhat better off. How much better, of course, varies from situation to situation.

There is no doubt that the small businesses that I've just been talking about have the need for increased capital in the form of both debt and equity.

Our view, however, is that the payment of Federal income taxes is not a material factor in such companies' ability or lack of ability to raise this type of capital.

Simplification of the tax laws, mitigation of the overall tax burden on these businesses, and the general tax relief proposed by the President seem the most helpful steps to be taken with regard to this first category of business.

I would like to turn now to the tax situation of what I've called the startup business. It follows from their description that it is likely that these businesses pay no taxes at all.

As a matter of fact, it's almost certain so long as such a business is truly in the startup phase. Indeed, as you know, the goal of these companies is to some day be in a position to be able to pay some Federal income taxes.

In addition to the techniques I mentioned before to minimize Federal income taxes, the startup company would typically be in a position to use the section 174 election to provide substantial deductions for research and development.

If it is an operation that uses a pilot plant, it will have depreciation deductions available to it, and if it's engaged in sales typically its sales and marketing expenses will be running well ahead of its income.

As you have recognized in the past, a more likely problem for the

startup company than the burden of Federal income taxes is the fact that the loss carryovers which develop during its earlier years may run out before it ever has any tax liability.

The startup company, on the other hand, has a very significant problem in its lack of access to capital markets.

This was the situation in which the fellow with the idea used to come in to see me. This was their typical problem—"How can we raise the money? We've got this terrific idea, if we can only get $50,000, $100,000, or a quarter of a million dollars, we can go out and beat the world."

And I was always very sympathetic to these people and did my best to support them in this connection.

I think the pattern of State and Federal regulation of the issuance of securities plays a major role. For example, I can cite to you the case of a type of new business in which I think your committee would be particularly interested.

These folks appeared to have invented a turbine engine which is more efficient than present automobile engines and which contributes less pollution to the atmosphere.

The company went out and raised a modest amount of capital in kind of a hit or miss fashion to finance its initial operations by selling its securities in several "intrastate" offerings.

At this point they were ready for the next step in their financing pattern, but what they had previously done had placed them in such a difficult position that before they could even get started on step two, they had to incur some very substantial expenses including the cost of making the rescission offer required by the relevant State law to all shareholders.

Only at that point was the company in a position to raise new equity capital with all the costs attendant to that effort.

Of course, you realize that if you're out to raise $500,000, $1 million, or even a quarter of a million dollars, the cost is not materially different so that the cost of raising the capital compared to what you raise is very significant.

Obviously what I'm talking about here goes well beyond pure tax considerations, but I thought I would highlight it for you in the interest of aiding small business.

Borrowing when you've got a little equity capital no matter how you've raised it is also a difficult task for the startup company.

First of all there's the risk factor which nobody can deny. That's a necessary aspect of the startup company. The other is the cost to the lending institution of investigating and administering loans to startup businesses or any small business for that matter.

It is far easier if you're a banker to add another half a million dollars or $2 or $3 million to the line of credit supplied by a banking syndicate to a major company than to investigate and supervise five $100,000 loans to startup companies.

In our view, there's at least one area where tax policy can be helpful to startup companies. This is to make the tax consequences of investing in such companies more favorable to anyone so inclined.

Also, by increasing the flexibility of tax-oriented forms of business organization, startup companies can be made more attractive as investment vehicles.

And I'd like to say some more about that at the end of my remarks.

To turn to the medium-sized business, although this group has perhaps received less attention than it should from the taxwriting committees of Congress and the Treasury Department, it can be argued that the companies at this level are the most important with regard to capital formation and the future growth and vitality of our economy.

At the outset, I think it should be noted that the owners of many of these medium-sized businesses which are privately held are very wealthy people.

This is not to suggest that these companies are not in need of careful consideration where tax equity is concerned.

It is merely to approach the problem with our eyes open. These people were, for the most part, the clients with whom I dealt up until a few weeks ago.

To put it another way, a closely held corporation with between a million and $5 million in net sales which reports more than $50,000 in taxable income is something of a rare bird; that is, it will do so only if the principal shareholder-employees, and in many cases their children and other relatives, are all drawing salaries which bring them well into the 50-percent bracket.

Indeed, with the enactment of the 50-percent maximum tax on earned income, and with the unreasonable compensation test of Code section 162 as the only real limitation on the ability to pay large salaries, it makes very little sense for a privately owned company to incur a tax of 48 percent and then still have the problem of getting the money out to its shareholder owners by paying dividends which again are subject to tax at high rates.

Or even if at some future date the shareholders in effect realize that benefit of its accumulated earnings by selling their stock at a price in excess of what they paid for it, they will incur a capital gains tax.

So as long as the corporation is privately held and at the relatively lower end of this broad category of what I've called a medium-sized business, every effort will be made to minimize its tax and to stay below the surtax level.

Medium-sized corporations have additional tax minimization opportunities that go beyond those I have noted before for the small business or for the startup company.

If privately held, they may elect to be taxed under subchapter S and thereby avoid the corporation income tax altogether.

Furthermore, they are likely to have enough income tax liability and the need for capital equipment that they can take meaningful advantage of the investment tax credit.

And, again, if they are at the relatively smaller end of the medium category, they at least have the potential for getting a better break than the larger companies because they can offset the first $25,000 of tax liability in full.

The surtax exemption is in itself a substantial benefit to these corporations, and I have an example here of the corporation which has $100,000 of taxable income.

Its corporation income tax bill would be $34,500; therefore, the surtax exemption is obviously a meaningful factor in reducing the effective rate at that point.

But even that liability could be reduced to less than $5,000 if the corporation in question purchased investment credit property that year at a cost of $300,000, and that's not a gigantic task assuming its a capital intensive business for the type of company that might have $100,000 in taxable income.

I have a sort of a parenthetical paragraph here which is not intended to sound as cynical as it may come off, but it represents an experience that I had many times in representing the acquiring company of a medium-sized business.

You begin of course, by asking for the financial statements which typically are the same as the tax returns. This is a privately owned company, and it will show, let's say, $100,000 of earnings.

And they will tell you the asking price for their business, and they will tell you what multiple they applied. And you'll wonder. There seems to be an arithmetic gap here, and the explanation is, well, although we only had $100,000 on our books, and for tax purposes, anybody who took over this business would very substantially increase these earnings because although my brother Jack and I have each been taking $50,000, you could get a professional manager to do both our jobs for $40,000.

Obviously, we don't need five or six Cadillacs. My wife doesn't need one. Your professional manager can drive an Oldsmobile. And, furthermore——

Senator HASKELL. I hope they don't make those admissions in front of Internal Revenue.

Mr. GOLDSTEIN. They make the admissions. When the agent brings the subject up, what typically happens is they get in an argument as to whether it's necessary, and maybe the agent will ultimately say: "We think it should only be $70,000 for you and your brother Jack. That's enough."

Or maybe, "one of the six Cadillacs isn't necessary," but that still leaves five. This is the typical way these businesses conduct themselves, and I'm not intending to be critical of them. I think that the Internal Revenue Service does the very best job to police these things. But these are the facts of life.

On the other hand, and I think more important, we must consider the private company's situation even after all these techniques have been utilized, as well as the relatively small publicly owned corporation which needs to maximize corporate earnings and which really can't use a lot of these techniques because it is carefully audited by major accounting firms and files all sorts of reports with the SEC.

In other words, when you start to get significantly above $50,000–$100,000 of taxable income, the corporation income tax does become a most substantial burden.

And, for example, as the tables in the appendix that you'll find attached to the printed text today show, corporations with assets of $2,500,000 to $10 million pay Federal income tax at the effective rate of 36.7 percent.

Thus, at the larger end of the range of what we have generally described as medium-sized corporations, the Federal income tax is a very considerable burden indeed.

There are several significant consequences of this burden. First of all, it is the most obvious manifestation that our system of taxation

impinges most heavily upon business earnings, and particularly upon the earnings from business capital.

In rough numbers, a corporation that's going to pay taxes at the effective rate of 36.7 percent has to earn over a dollar and a half to wind up with a dollar of earnings.

So if you're an investor, in view of the competition in the capital market, you're going to put your money to work where it is going to get the greatest return.

And, therefore, the capital of corporations has to be used more efficiently than capital in other types of ventures such as unincorporated real estate or oil and gas operations.

This system of double taxation of business earnings, in our view, has long since been discredited; and as you have heard many times before I'm sure, most of the modern, industrialized countries have by this time fully or partially eliminated any tax at the national level which resembles our Federal corporate income tax.

Having noted the burden of double taxation, it is not surprising to find that largely on account of it these medium-sized businesses face serious problems in capital formation, both with regard to debt and equity.

For example, one of the tables in the appendix we've attached shows that the debt to equity ratios of the medium-sized corporations show the least debt in their capital structures.

Although modified to a degree, the reluctance of bankers that I mentioned before to lend to medium-sized enterprises derives from the same factors, that is, the cost of administration, investigation and so on.

With regard to the equity capital market, the experience of recent years has made it clear that the ability to raise meaningful equity capital in a medium-sized enterprise has to do with the general state of the market.

Back in the good old days of 1968 and 1969 it was my observation that almost any startup or medium-sized company could go to the equity market and raise some money regardless of its merits.

Whereas for the past 3 years or so, again regardless of merit, the equity market has no interest in these companies.

This is in contrast to some of the largest corporations which, even though they may not like the price at which they have to raise equity, still have well-defined methods for doing so.

As far as what must be done about this, the obvious answer is to facilitate capital formation for the medium-sized company by eliminating or substantially mitigating the impact of our Federal corporate income tax.

As you know, the Treasury Department has proposed a program of integration, as part of its overall program of capital formation.

Now there are various versions of how this might be done. Our program combines the dividends paid deduction at the corporate level and a credit to be taken by the shareholders with regard to income that they receive for taxes paid by the corporation.

We think that this is the best way to do it, but I believe that any steps toward the accomplishment of this goal would be very beneficial to the types of corporations that we are talking about.

In the absence of integration, there are still some meaningful steps which can be taken to facilitate the growth of the medium-sized business enterprise.

Some of these are the ideas I mentioned before that make these vehicles more attractive. A second item which you will I think be hearing more about from other people in the Treasury Department within the near future is a more widely accepted and widely used version of the employee stock ownership plan.

Finally, simplification of the Internal Revenue Code and its administration will benefit medium-sized corporations as well as the smaller companies.

I have tossed out one idea here which I think has been suggested by others, but it seems like a good one. It focuses on the cost of putting in a qualified pension or profit-sharing plan.

What we would like to see happen is that prescribed forms and language be suggested by the IRS. There might also be a data sheet to look at the questions of distribution and discrimination which can really be used by any business or the financial officer of the business without having to use a pension consultant and a battery of lawyers.

In other words, at the very least, if you are willing to follow these forms you've got a qualified plan. If you want a more elaborate plan or try out some new theory fine. That's your own decision and you could proceed on that basis.

Turning to the large corporations for just a moment, I think there is one important point to cover. I think you may have heard it before, but no matter how many times it is discussed, the idea persists.

We frequently hear that the largest corporations pay a lower rate of tax than the medium-sized corporations that I just discussed.

The tables in the appendix indicate that any such apparent advantage is not present when the treatment of foreign source income is properly taken into account.

To put it another way, the apparent advantage of the largest corporations in terms of the effective rate of Federal income tax largely disappears if their wide-world income tax burden is compared with their worldwide income or if their U.S. income tax is compared with their U.S. income.

If you make that analysis on the companies where traditionally the comparison has been U.S. income tax and worldwide income—and if you also exclude the petroleum and the paper and lumber companies—you see that the effective rate is 44 or 45 percent, which is higher than the medium-sized companies.

The exclusion of these petroleum and lumber companies is because presumably there have been for many years independent decisions of Congress to give these companies special treatment. There are other examples such as shipping which you are well familiar with.

Another factor has led to some distortion I think in viewing the largest corporations compared with the medium-sized is the inclusion in the averages of some very large corporations, in terms of assets and sales, which had large losses but paid no tax at all.

Finally, as the tables in the appendix do indicate, and this of course tends to cut the other way a little bit, the largest corporations do realize somewhat greater benefits from the investment credit than the medium-sized corporations.

The tables also indicate that obviously there are some businesses which are more capital intensive and make more use of the investment credit the marketing and investment enterprises.

Since they are not the principal subject of our concern this morning, I will say no more about large corporations other than that they are also suffering from the discrimination in our tax system against business income and income from capital.

Once again I recommend a solution in terms of making our corporate enterprises competitive on a worldwide basis which is the integration of the corporate income tax.

I would like to turn now to the concluding part of my remarks which deal with at least a few things which we think can usefully be done right away, and in effect we agree with various bodies that have considered this before.

All but one of these provisions are contained in H.R. 237, which has commonly been called the Bible-Evins bill.

Some of them have been previously considered and viewed favorably by the Ways and Means Committee, but they've never been reported out, they have never found their way into legislation.

Some of these changes I guess you can call technical, but we think as presumably their proposers believed, that they still could be very helpful.

I also have one idea that appears to be new that I'd like to mention for your consideration a little bit later.

But first since you're pretty familiar with these proposals, I think I can be very brief about them because you've heard them before.

The first has to do with how long should net operating losses be carried forward into the future.

As you know, the present rule for losses is 3 years back and 5 years forward, and I think it's been properly suggested that for the small business, the startup business, that this may not be a long enough period to be fair.

And the proposal has been for a 10-year carry-forward for small corporations and we at the Treasury favor this and will support it as it's considered by the various committees of Congress.

In the partnership area, I think the first thing to note since a lot of small businesses have to operate under these rules is that they are unbearably complicated.

I recall well my tax professor coming to the chapter in our text on the taxation of partnerships. We were all eager to have that mystery unveiled to us. He made a terrible face and said, "I ve been trying to study this for 3 years." This is Ernest Brown from Louisiana, and "I can't understand it. And if I can't understand it, I see no reason to expect you to." And then he proceeded to say, "We'll go to the next chapter."

That was my introduction to partnership taxation. Fortunately in my law firm I had a partner who teaches partnerships at the NYU graduate program, and so we all eagerly referred our partnership questions to him.

Senator NELSON. When you say "the rules," are they IRS rules?

Mr. GOLDSTEIN. The statute in the first place, and then there is an attempt by regulations and rulings to make some sense out of the statute. So it's the whole group of rules.

Senator NELSON. Are we back to where we were? We are getting extensive complaints on pension plan reporting. We didn't establish any rules for reporting, but every accountant, every tax lawyer, every small pension plan administrator, is saying, "the IRS is killing us."

And we are going to be taking testimony and to talk with actuaries and CPA's and administrators who handle plans. Businessmen are saying compliance with the reporting forms are driving their pension plans out of business.

So very frequently we pass a law which may be somewhat complex, which is the Congress fault. But, when you start looking at the rules and regulations that the IRS establishes to be sure that one crook out of 100,000 is caught, you may find that the rules just ruin 99,999 in order to get one when you'd be better off to have something simple.

Mr. GOLDSTEIN. I agree with you, Senator, on that but I dare say no one will propose to write a statute or regulation which is intended to allow one cheat in a thousand plans.

But I wonder whether the gentleman who made that remark or wrote that letter to you whether he was talking about——

Senator NELSON. The proposed form 5500——

Mr. GOLDSTEIN. Right.

Senator NELSON. That's the one they are talking about.

Mr. GOLDSTEIN. There's still a lot more to come, and one of the things our office is involved in daily is the continuing process of trying to get regulations out, and of course we work with the Labor Department on that.

Senator NELSON. We will have testimony of CPA's that say that the cost per pension beneficiary will run as high as $1,000 a year.

They are better off to get rid of the plan and give them the $1,000. That's when you're down to 10 or 15 or 16 participants.

But they are willing to come in and testify that they have clients which are having to charge them $700 per beneficiary, or more, annually.

Now there's something pretty wrong with a reporting system which does that. Now, Senator Bentsen and I are proposing that you have a standard form that would be simple and cover the 93 percent of them which are truly small plans.

Mr. GOLDSTEIN. That, as I indicated, is what I think we should work toward. I don't know whether you cover 99 percent or 70 percent or 50 percent—but we should make it easy for a very substantial number and let the others that want more exotic plans or unusual provisions bear the cost of it. I think that we are working toward that goal.

I fully agree with you, and I know what you mean. And even in the law firm we had a pension plan for 15 years and we just kind of sailed along. Nobody paid any attention to it. Now we have some committees just trying to handle our own little problem without regard to our clients' problems.

I think we've tried to hire three, four, five new people just to work on this. It is a very serious problem.

Senator NELSON. If you drive all the little ones out of business, it certainly wouldn't be very worthwhile legislation.

Senator HASKELL. What are the complications that Senator Nelson referred to, the additional costs the accountants say have to be incurred to comply with the new pension law?

What are the elements that make for complication?

Mr. GOLDSTEIN. I am not really familiar with the particular problem the Senator raised, and I am also not the resident pension expert.

So what I would like to do on that is to get some further colloquy established. If I could find out what's been presented to you and maybe respond, or have my office respond to you, at a later date and see if we can nail it down.

Senator NELSON. We intend to have some hearings on that precise point anyway.

Mr. GOLDSTEIN. I must confess that in my years in practice I've made a concerted effort not to know very much about pensions so I'm going to have to learn.

Senator HASKELL. So you're the wrong guy to ask. We'll have to ask somebody else.

Mr. GOLDSTEIN. But we do have people that know about it.

Well, getting back to some of the things that are in this pending legislation, I do refer to one of the consequences of the death of a partner and support the suggestion which is in the bill to permit an election to have the deceased partner's year end with regard to his partnership either on the date of his death or on the date of the termination of the partnership's year.

With regard to subchapter S provisions, several of those that we favor are contained in the Bible-Evins bill. In 1969 the Treasury Department submitted a laundry list in effect of ideas and provisions to make the election more widely available and easier to comply with.

And since, obviously, I've been speaking in favor of integration today and against the corporation income tax, and since the one way to avoid the corporation income tax at the moment is to make the subchapter S election, we generally favor proposals which would accomplish that result.

For example, as you know there is a limitation on passive income of 20 percent. There was a good reason for that when it was put in. It had to do with pension considerations.

But since 1969 that reason no longer exists because subchapter S corporations are subject to the H.R. 10 limitations, and the Treasury's position would even go beyond that of the Bible-Evins bill and eliminate entirely the requirement of less than 20 percent on passive income.

Senator HASKELL. Mr. Goldstein, just so I understand you. I understand the passive income to be the ownership of an apartment house where you just get rental.

Mr. GOLDSTEIN. Dividend and interest. Yes, sir.

Senator HASKELL. And you would eliminate that entirely?

Mr. GOLDSTEIN. There's a requirement now that in order to maintain your election under subchapter S that type of passive income not exceed 20 percent of the corporation's gross.

Senator HASKELL. You would eliminate that requirement?

Mr. GOLDSTEIN. Yes, sir.

Senator HASKELL. Then what you would do, to go further in that direction, at least as I would view it, of permitting—there's a great dispute as to whether there should be allowed depreciation where part of the property is financed with a nonrecourse note.

And you would really move in the direction of allowing people to in effect take deductions in the nature of depreciation by use of a subchapter S corporation in which basically maybe they only have an equity of say 25 percent, and they borrowed the rest of it from the bank. They get the full depreciation basically without ever having any investment in it.

Would you really advocate that?

Mr. GOLDSTEIN. No, sir. I don't believe that's the way it would work, because the way that does work in partnerships, the regulation which has permitted you leverage on a nonrecourse basis, typically in a limited partnership, is the provision in the regulations which permits the investor to add to his basis in his partnership interest his share of the nonrecourse indebtedness of the partnership.

In other words, so long as no partner is liable on the debt. If you're a 20-percent partner and the partnership has borrowed a million dollars to buy this office building, you can add $200,000 on to your actual investment and take deductions up to that amount.

Under subchapter S, there is no comparable provision. In a subchapter S corporation, you are limited in the deductions that can flow through the subchapter S corporation to your actual investment.

Senator HASKELL. Well, let me just give an example. Let's say you're buying an apartment house. Subchapter S corporation buys an apartment house for $100,000. I have only invested, say, in the subchapter S corporation, $20,000.

I go to my friendly banker and he puts up the $80,000. Now it seems to me that if I remember correctly that then the depreciation by the corporation would be taken on $100,000.

Mr. GOLDSTEIN. Yes. And let's say——

Senator HASKELL. And therefore I get the benefits since there's no corporate tax and everything flows through to me. I get the benefit of the full depreciation on the $100,000.

Mr. GOLDSTEIN. But you don't.

Senator HASKELL. Isn't that what you're advocating?

Mr. GOLDSTEIN. No, sir. Not at all.

I'm trying to explain to you that that would not happen. If you did that as an individual and, let's say by resaon of depreciation and other deductions, even though you'd invested only $20,000 of your own money and borrowed the other $80,000 the excess of the deductions over the income that year was $30,000, as an individual you could deduct $30,000 that year even though you only invested $20,000.

If you did that through a subchapter S corporation, you would be limited to $20,000 even though the corporation would show a loss of $30,000.

You could not take that yourself as a sole shareholder.

Senator HASKELL. I see. You are not advocating—I thought you were going in the direction of——

Mr. GOLDSTEIN. No, sir. We are not in any way trying to proliferate tax shelters. Now I should add that even in the partnership area and in the individual area, the legislation which has been reported out by the Ways and Means Committee which Treasury has supported would prevent you from offsetting that type of excess deduction even as an individual or as a partner against your income from other sources.

Senator HASKELL. I misunderstood what you were driving at.

Mr. GOLDSTEIN. All I'm trying to do is, in effect, increase the flexibility, and what I'm focusing on is not the loss situation but the profit situation.

Basically you can run an investment club, if you want to call it that, as a partnership. But you can't run it as a subchapter S corporation. I see no reason to make the distinction. That's all that proposal relates to.

I think I can skip over to our views on section 1244. First of all it's been proposed—well, let me remind you, at least if it's not fresh in your mind, what a section 1244 stock is.

It is stock which can be issued by a small business corporation as defined in the Internal Revenue Code which, if the business does well, as the investors hope, and the stock is sold someday or the corporation is liquidated, the typical tax treatment is capital gain.

But, on the other hand, if the corporation fails and you sell your stock or your corporation is liquidated, you are permitted an ordinary loss.

The purpose of this legislation was to encourage investment in the small business or the startup enterprise.

There is a proposal to liberalize this provision in several ways. The first way would be to increase the amount of loss which the individual or married couple could claim from $25,000 and $50,000 a year, respectively, under the present law to $50,000 and $100,000.

Furthermore, there is a proposal to modestly increase the size limits defining a small business corporation for this purpose.

We are reviewing these proposals to see if there is anything wrong with them, but my inclination is that we will shortly be in a position to endorse them.

A new idea, though, one that hasn't been proposed before that we also think merits careful consideration is to permit not only individuals and estates to purchase and own section 1244 stock; we believe that all taxpayers should have the opportunity to buy this stock, whether corporations, partnerships or trusts, thereby in effect increasing the market for those owners of small businesses who are seeking equity capital and would like to have a tax advantage to sell along with the great hope and promise they have for their venture.

And as I said, this is being considered. It seems like a helpful extension of what already exists in this area.

Also in the 1244 area, the way it's set up now, I have found from personal experience that the requirement of the adoption of a plan is largely a trap for the unwary. The rigamarole that you have to go through to show that you have 1244 stock is unduly complicated; we should seek an approach where something very simple such as stamping a certificate to show that it's a section 1244 stock.

And we are going to look into that as well. We understand that Senator Bentsen has just or is about to momentarily introduce a bill containing several of the provisions which I have discussed orally here today. Obviously, to the extent we have already indicated our approval, we hope that this bill finds its way to enactment.

We understand that a further provision in that bill requests the Treasury Department to study the LIFO method of inventory ac-

62-209 O - 76 - 45

counting with a view toward simplifying such method to make it more easily usable by small businesses.

There are at the moment in my office at the Treasury Department four or five projects having to do with LIFO, and I've been elected to handle them, so I'm trying to sort it out.

I agree with you that it's complicated. I would also point out that the administration favors the LIFO method as a more realistic method of reflecting income in our inflationary economy.

And I guess the message is that we are already studying LIFO, and we would be happy to study proposed simplifications of it to make its use easier by smaller businesses.

Needless to say, there are many other proposals outside of the Bible-Evins bill for easing the tax burden of small businesses.

Some of these seem unsuited to accomplishing their purpose. Others that I haven't mentioned we do favor, and we stand ready at any time to explore any new idea in this area.

As I have noted, we are supplying you with an appendix today which I haven't dwelt upon in any detail, but I think you and your staffs may find some very helpful data there in comparing businesses of various sizes as they are affected by our tax system.

It's been a real pleasure for me to appear before you today, and if you have any further questions, I'll be glad to answer them, or try to.

Senator NELSON. Thank you very much, Mr. Goldstein.

[The prepared statement of Mr. Goldstein in full follows:]

For Release Upon Delivery

STATEMENT OF

WILLIAM M. GOLDSTEIN

BEFORE THE

SENATE SELECT COMMITTEE ON SMALL BUSINESS

AND THE SUBCOMMITTEE ON CAPITAL MARKETS

NOVEMBER 13, 1975

Mr. Chairman and Members of the Committee and Subcommittee:

My name is William M. Goldstein, and I am the newly appointed Deputy Assistant Secretary for Tax Policy of the Treasury Department. I welcome the opportunity to appear before you to comment on certain aspects of the taxation of small business. Because until very recently I was engaged in the private practice of law and heavily concerned with the tax and financing problems of small and medium-sized business, I may from time to time draw upon such experiences in stating my views on the issues at hand.

At the outset, it appears that we must discuss certain definitional matters in order to create the proper frame of reference. In his testimony before the Committee last February, Assistant Secretary Hickman, as you will recall, attempted to place certain parameters upon the description of small business. We have also supplied the Committee and Subcommittee with an Appendix containing certain statistical information prepared by our Office of Tax Analysis which presents information based upon various categories of business determined by reference to assets, sales, and income. In my remarks today, however, I would generally hope to be somewhat less specific and refer to certain general categories of businesses in which we understand you have the most interest.

WS-467

In my remarks, I propose to deal with four such categories of business enterprises - (1) small business; (2) start-up business; (3) medium-sized business; and (4) large business. I shall begin by attempting to define broadly these categories and then proceed to discuss certain tax considerations affecting each of them in turn. Finally, I would like to discuss certain pending legislative proposals which are intended to aid "small business" and to suggest briefly some other types of assistance which might merit further consideration.

For purposes of today's discussion my concept of a "small business" is the privately owned, local producer of goods and services. A typical company would have net sales (that is, sales less cost of goods sold) of less than $100,000. As you are aware, the great preponderance of such businesses are proprietorships and partnerships, but there are also a reasonable number of Subchapter S and regular corporations.

Perhaps the best way to understand the definitonal approach I am striving towards this morning is to look at the goals or ambitions of the owners of the businesses in question. Thus, in the small business category, we find the owner-operators who derive from their businesses their principal source of livelihood; their goal is simply to improve that livelihood. For example, the goals of the owner of the neighborhood dry cleaning establishment or restaurant or small grocery store might be to expand his own operation, to make it more profitable and, perhaps, to open one or two more locations.

Taken together there may be at least 10 million of these enterprises but their primary importance lies neither in their number nor in the share of private business production they account for, although such share is not inconsiderable in terms of output or in terms of their role as consumers of the output of other business enterprises. The prime importance of these small businesses does lie in the tangible expression they give to the ideals of freedom and individual choice which our society cherishes. It is these small businesses upon which we rely for personalized goods and services which lend spice and variety to our lives. It is these small businesses and the start-up businesses to be mentioned hereafter, and particularly the opportunity to establish one, which assures us of the maximum likelihood that new ideas will get a fair trial and that the economic

needs of particular communities will be met. New ideas and less-than-national needs may not be recognized by the bureaucracies of large businesses or get lost in committees. Small businesses are the humanizing element of an economy and it has been and will be a matter of concern to Congress and to the Administration that no inadvertent burden be imposed on this element of the private business sector.

The second category of business of present concern is the "start-up business." That is, the individual or group of individuals with an "idea," whether technological, marketing, or otherwise, which they believe if properly nurtured can form the basis of either a medium-sized or large corporation at some future date. Obviously, the early stages of such companies as Xerox and Polaroid come readily to mind. Unlike the small businesses just discussed, these start-up companies may not even be in operation and may not be providing anyone's livelihood, but the goals of their founders are considerably more ambitious. There seems little doubt that it should be a national policy to encourage and foster the creation and development of such enterprises.

The third category, the "medium-sized business," without attempting to be too specific, would seem to have net sales of between $1 million and $20 million and "assets," as defined in the Appendix, of roughly three-fourths of these amounts; <u>i.e.</u>, a business which is clearly out of the fledgling stage <u>but</u> is not a major factor on the national scene. Such businesses may be (1) privately owned, (2) owned by a relatively small group of purchasers who have acquired their stock in "private offerings," (3) owned partially by subsidiaries of larger corporations, or (4) registered with the Securities and Exchange Commission but not listed on a major stock exchange. Indeed, they may have had their initial "public offering" but see no near term possibility of further financing of this type; indeed, the "market" may actually be depressing the "value" of their stock. Using the "ambition" analysis, the owners of these medium-sized companies have the desire either to grow within the rather broad category described above or to move into the next category of the large business enterprise.

The fourth and final category--"large business"--is perhaps the easiest to recognize. It is the few thousand corporations which qualify as major national business organizations. Typically they are listed on major stock

exchanges and have substantial foreign operations. They borrow money in the public bond market, issue commercial paper and have multi-million dollar lines of credit from syndicates of major banking institutions; they belong to major trade associations and are well represented in their dealings with both State and Federal governments.

I would like to turn now to the major tax considerations which presently affect the operation and growth prospects of the four classes of corporations described above. Put another way, I would like to examine how Federal income taxes affect the realization of the goals or ambitions which the owners of each class of business have set for themselves. Since each of these enterprises, in one way or another, is interested in growth and profitability, we must consider whether our current system of taxation is a hindrance or a stimulant to achieving these goals. Since, in turn, the problem of capital formation is in many instances a prerequisite to such desired growth, it will be of particular importance to see how our system of taxation affects the problem of capital formation in the business enterprises under consideration.

Looking first at the class of businesses which I have described as "small," it would seem that the owners of such businesses are virtually indistinguishable from wage or salary earners in the $10,000 to $20,000 annual income classification. Even if such businesses are incorporated, no significant corporate tax is paid due to the offsetting of corporate income with salaries and bonuses.

This is not to suggest that such businesses do not have any tax problems. The burden of State and local franchise, capital stock, sales, property, gross receipts, and income taxes, and Federal and State employment taxes, unemployment compensation premiums, etc., may be among the most significant burdens these businesses face. With regard to Federal income taxes, although the actual payment of dollars to Washington may not be very significant, the time and expense involved in keeping the necessary records and filling out a myriad of prescribed forms may boggle the mind of the small businessman.

In our view, the most appropriate tax relief for the proprietors of the type of business now under consideration would be the enactment of the President's program for individual tax cuts. That is, the proprietor, partner, or

shareholder-employee of a small business who nets $15,000 per year of adjusted gross income from his enterprise will find his Federal tax burden most expeditiously lightened by a basic cut in the effective rate of tax he pays with his Form 1040 each year.

It should be noted that the proprietors, partners, and shareholder-employees of small corporations who have adjusted gross income from their small businesses which is precisely equal to that of wage-earners and salaried employees are nevertheless generally favored over the latter type of taxpayer under the practical administration of our present tax system. That is, even the really small businessman takes opportunities to realize untaxed income in the form of deductible travel and entertainment expenses and company cars, to defer the taxation of economic income through some use of accelerated depreciation and to further defer taxation through the understatement of closing inventories. Similarly, even the smallest corporation, if profitable, can take advantage of such tax benefits as plans to pay the medical expenses of its shareholder-employees with pre-tax dollars.

There is no doubt that the small businesses we are now discussing have the need for increased capital in the form of both debt and equity. Our conclusion, however, is that the payment of Federal income taxes is not a material factor in such companies' ability or lack of ability to raise this type of capital. Simplification of the tax laws, mitigation of the overall tax burden on these businesses and the general tax relief proposed by the President seem the most helpful steps to be taken with regard to these small businesses at this time.

Turning to what I have described as a start-up business, it is likely that there will be no payment of Federal income taxes, and hence no burden at all, at least as they are starting up. Indeed, the goal of most of these companies is to some day be in the position of having to pay some Federal income taxes. In addition to the techniques described above with regard to tax minimization by business enterprises which are not available to the wage or salary earner, the start-up company would typically be in a position to use the section 174 election to deduct research and development expenses, claim depreciation deductions on its pilot plant (perhaps including additional first year depreciation) and to deduct the initial marketing and advertising costs associated with a new business enterprise. As you have recognized

in the past, a more likely problem for the start-up enterprise may be its inability to carry forward its Federal tax losses for a long enough period for them to become useful.

As I see it, one of the most significant problems of the start-up business is its lack of access to capital markets. In this connection the pattern of State and Federal regulation of the issuance of securities plays a major role. For example, I can cite the case of a type of new business which your Committees appear to be most anxious to encourage - i.e., a company that appears to have invented a turbine engine which is more efficient than present automobile engines and which contributes less pollution to the atmosphere. The company had raised a relatively modest amount of money to finance its initial operations by selling its securities in several "intrastate" offerings. In order to place it in a position to proceed with further financing on a proper basis, this company would have had to incur substantial expenses, including the cost of a rescission offer to all shareholders. Only at that point would it have been in a position to raise new equity capital with all the costs attendant to that effort, particularly when viewed as a percentage of the dollars raised. Obviously this example goes beyond pure tax considerations, but I thought this matter should be highlighted in the interest of aiding small business.

Similar problems exist in connection with the raising of capital by start-up companies through borrowing. In addition to the risk, or apparent risk, of lending to such companies, the cost of investigation and administration by lending institutions is very high in relation to funds disbursed. It is far easier to simply add $500,000 to the line of credit supplied by a banking syndicate to a major company than to investigate and supervise five $100,000 loans to start-up companies.

There is at least one area where sound tax policy and new tax legislation may prove helpful to start-up companies. This is to make the tax consequences of investing in such companies more favorable to anyone so inclined. Also, by increasing the flexibility of tax-oriented forms of business organization, start-up companies can be made more attractive as investment vehicles. I will have further remarks in this area at the end of my presentation.

I turn now to what I have previously described as the "medium-sized" business. Although this group has perhaps received less attention than it should from the tax-writing Committees of Congress and the Treasury Department, it is arguable that the companies in question may be among the most important with regard to capital formation and the future growth and vitality of our economy.

At the outset, it should be recognized that many of the owners of these medium-sized businesses which are privately held are very wealthy people. This is not to suggest that these companies are not in need of careful consideration where tax equity is concerned; it is merely to approach the problem with our eyes open. Put another way, a closely held corporation with between $1 million and $5 million in net sales which reports more than $50,000 in taxable income will usually do so only if the principal shareholder-employees, and in many cases their children and favorite nephews, are all drawing salaries which bring them well into the 50 percent tax bracket. Indeed, with the enactment of the 50 percent maximum tax on earned income, and with the unreasonable compensation test of Code section 162 as the only limitation, it makes very little sense for a privately owned company to pay corporate income tax at the rate of 48 percent and still run the risk of further taxation of its accumulated earnings upon the payment of dividends or the ultimate sale of the corporate stock. Parenthetically, of course, the bracket considerations favoring the pay-out of large corporate salaries also have a negative effect on capital formation.

Medium-sized corporations have additional opportunities for tax minimization in addition to those discussed above. First of all, if privately held, they may elect to be taxed under Subchapter S and thereby avoid the corporation income tax altogether. Such corporations are likely to have enough income and need for capital equipment that they can take significant advantage of the investment tax credit; in addition, the fact that they can offset the first $25,000 of their taxable income in full through such credit permits them a potentially fuller realization of such credit, at least on a percentage basis, than larger corporations.

The surtax exemption is in itself a substantial tax benefit to those corporations whose taxable income does not greatly exceed the surtax dividing line. That is, even after paying substantial salaries, contributing to pension

and profit sharing plans, paying for group term insurance and the medical expenses of shareholder-employees, and playing year-end games with inventories, a corporation which has $100,000 in taxable income will only have a Federal income tax bill of $34,500; and this in turn would be further reduced to less than $5,000 if such corporation purchased property in that year which qualified for the investment credit and cost $300,000.

Incidentally, if your Committees are skeptical about whether the tax minimization techniques just described are in fact used by privately owned medium-sized business, I could share with you numerous experiences in which the owners of such companies have explained to me how the $100,000 of apparent earnings for tax purposes should "really" be viewed as $300,000 or $500,000 by a potential acquiring company if Uncle Max was taken off the payroll, the credit cards and Cadillacs were turned in and the inventories were properly valued.

On the other hand, even after all the techniques described above are fully utilized in the case of a privately owned corporation, or in the case of a relatively small publicly owned corporation which needs to maximize corporate earnings, the corporate income tax does become a most substantial burden as taxable income rises above the levels just considered. Indeed, as the tables in the Appendix show, corporations with assets of $2,500,000 to $10,000,000 pay Federal income tax at the effective rate of 36.7 percent. Thus, at the larger end of the range of what we have generally described as medium-sized corporations, the Federal income tax is a very considerable burden indeed.

There are several significant consequences of this burden. First of all, it is the most obvious manifestation that our system of taxation impinges most heavily upon business earnings, and particularly upon the earnings from business capital. Because of the extra burden on capital held in corporate form, investors who naturally look for the highest yield will turn to corporate equity investments only if the after-tax return compares favorably with the after-tax earnings of other types of investments. Put another way, a corporation subject to corporate income tax at the effective rate described above must be substantially more productive in the use of its capital on a pre-tax basis than other competing forms of investment such as unincorporated real estate or oil and gas operations. This system of

double taxation of business earnings should long since have been discredited; as you well know, most modern, industrialized countries have by this time fully or partially eliminated any tax which resembles our Federal corporate income tax.

Having noted the burden of double taxation, it is not surprising to find that medium-sized businesses face serious problems in capital formation, both with regard to debt and equity. For example, we are submitting herewith statistical information which illustrates debt to equity ratios in various classes of business enterprises. As one might suspect, the medium-sized companies seem to be at a relative disadvantage in terms of raising money through the issuance of indebtedness. Although modified in degree, the basic reluctance of bankers to lend to medium-sized enterprises derives from the same factors previously noted when discussing loans to start-up companies.

With regard to the access to the equity capital markets, the experience of recent years has made it clear that the ability to raise this type of capital in the case of a medium-sized enterprise depends upon the general state of the market. As I observed in my law practice, in 1968 and 1969 almost any start-up or medium-sized company could go to the equity market, regardless of its merit, whereas for the past 3 years no such company could arouse any investor interest, also regardless of its merit. The fact that the equity capital market and its managers tend to over-react on both the up and down sides is most severely felt by the medium-sized company which lacks an established method of providing a regular in-flow of equity capital.

One important consequence of the difficulties experienced by medium-sized companies in raising debt and equity capital is the continued trend to mergers and acquisitions. Too often the cycle, even after an initial, successful public offering, ends with the sell-out to the large company when it is time for the second major infusion of capital.

Speaking simply about what must be done, the obvious answer is to facilitate capital formation by the medium-sized company. The most significant step in accomplishing this would be to eliminate or substantially mitigate the impact of our Federal corporate income tax. As you know, the Treasury has proposed a program of integration, as part of its overall program of capital formation, which combines

a corporate deduction for dividends paid and a credit to shareholders for corporate income taxes paid by their company. We urge upon you the need to recognize the wisdom of this legislation as a benefit not only to the largest class of corporations but also to those companies which I today have classified as "medium-sized" but which under traditional tests have long been within your field of interest under the classification of "small business".

In the absence of integration, there are still some meaningful steps which can be taken to facilitate the growth of the medium-sized business enterprise. Some of these encompass the same type of statutory changes which would benefit and make more attractive the start-up businesses discussed above. A further development which could prove most beneficial would be a widely accepted and widely used version of the employee stock ownership plan which will shortly be discussed in more detail by other representatives of the Treasury Department. Finally, simplification of the Internal Revenue Code and its administration will benefit medium-sized corporations as well as the smaller companies. For example, in the area of pension and profit sharing plans, we would hope that regulations containing model plans which would be automatically acceptable to the IRS could be adopted so that such plans could be effectively implemented by business enterprises without unnecessary administrative delays and substantial expenses for legal fees and consulting services.

Turning to the large corporations which must be viewed by you for purposes of comparison, it seems most significant to comment upon the frequently heard remark that such corporations pay a lower effective rate of tax than the medium-sized corporations discussed above. The tables in the Appendix indicate that any such apparent advantage is not present when the treatment of foreign source income is properly taken into account. Put another way, the apparent advantage of the largest corporations in terms of the effective rate of Federal income tax largely disappears if their world-wide income tax burden is compared with their world-wide income or if their United States income tax is compared with their United States income. For example, in 1970, of the largest 100 corporations 82 had positive net income; the effective rates of tax paid in such year by 59 of these 82 corporations (excluding only petroleum and paper and lumber companies) were 44.1 and 45.1 percent, respectively, on the bases just described.

Another distorting factor which has led to some misapprehensions in recent years has been the inclusion in the "averages" of some very large corporations in terms of assets and sales which have had large losses and hence have paid no tax at all. Finally, as the tables in the Appendix indicate, the largest corporations do realize greater benefits from the investment credit than their medium-sized counterparts.

Since they are not the principal subject of our concern today, I will say no more about large corporations other than that they also suffer from the discrimination in our tax system against business income and income from capital. Once again, our recommended solution in terms of making our corporate enterprises competitive on a world-wide basis is the integration of the corporate income tax.

I would like to turn now to the concluding part of my remarks which deal with certain changes which can be made in the Internal Revenue Code to encourage the establishment and growth of start-up and medium-sized businesses. Although, as I indicated previously, many of the problems of such businesses in the capital formation area must look to solutions outside of the tax area, we should certainly proceed with any tax law changes which might prove helpful. The changes I have in mind are largely familiar to you and are not dramatic. Rather, they tend to make the operation of the tax laws somewhat simpler or produce a more sensible result in certain factual situations. These changes may be described as "technical," but this does not mean that they would not be significant.

It is appropriate to focus attention on the set of small business proposals commonly referred to as the Bible-Evins Bill. We will shortly submit for the record a lengthy report which the Treasury Department has prepared on this Bill, which was introduced in the House this year as H.R. 237. As the report shows, some of these proposals seem to us to be helpful and others do not. I am briefly going to discuss several of these proposals in order to illustrate the nature of the areas where changes would be meaningful. I will then discuss one new idea which might prove helpful to certain small businesses trying to raise equity capital.

Under present law, most taxpayers can carry net operating losses back 3 years and forward 5 years, offsetting income earned in the carryover years. The issue of whether this

carryover period is adequate for taxpayers generally raises many hard questions. One point of which we feel relatively sure is that this period is too short for small businesses. This is especially true for start-up businesses which have substantial start-up costs and which do not expect to show a profit until some years down the road. In 1971 the Treasury sponsored legislation which would have provided a 10-year carryforward for individuals and for corporations with no more than 250 employees, 250 shareholders, and $1 million of equity capital. Last year the House Ways and Means Committee tentatively decided on a similar measure, but never reported it out to the House. The Bible-Evins Bill would also create a 10-year carryforward for small businesses as defined in the Small Business Act. While the terms of these three proposals are not identical, there appears to be a consensus on the basic idea, and we intend to continue efforts to see it enacted.

A court once noted that the rules governing the taxation of partnerships are at least as complicated as those governing corporations. Indeed, my tax law professor skipped the entire chapter on partnerships on the grounds that if he could not understand the subject, there was no reason to expect us to.

Under present law there may be an unfortunate tax consequence when a partner dies. At death, the partner's taxable year closes; income received subsequently is taxed to his estate or heirs. However, the partnership's taxable year does not close when one of the partners dies if the partnership continues to operate as before. Thus, unless the partner dies precisely at the close of the partnership's taxable year, the partnership's taxable year will end after the partner's last taxable year. Because a partner includes his share of partnership income in the year within or with which the partnership's year ends, the partner's share of the income earned prior to his death will nevertheless be taxed to his estate. This result may seriously distort the income of the partner's last year and the estate's first year. It can be avoided, but only with careful tax planning and only under certain economic circumstances.

The Bible-Evins Bill would permit the personal representative of a deceased partner to elect whether to have the partnership year with respect to the deceased partner end on or after his death; in the absence of an election, the partnership year would end on his death, thereby avoiding

the result I just described. Permitting this type of flexibility was recommended by the American Bar Association almost 20 years ago. The Treasury Department supported this proposal when it was discussed last year by the Ways and Means Committee. Like the loss carryover measure, it was tentatively agreed to but never reported out.

Under subchapter S of the Code, a corporation may elect not to be taxed as a corporation but instead to have its shareholders taxed approximately like the partners of a partnership. In 1969 the Treasury Department submitted an extensive series of recommendations designed generally to make the election more widely available, easier to comply with and generally more attractive. A number of these proposals are incorporated in the Bible-Evins Bill.

Present law limits the permissible number of shareholders to ten and allows only individuals and estates to be shareholders. The reason for these restrictions was that the Congress was dealing with a novel concept, had the small partnership in mind as a model and had to draw the line somewhere. However, we now believe that these restrictions are too narrow. The Bible-Evins Bill would increase the permissible number of shareholders to 15 generally and to 25 in the case of corporations in existence for at least 5 years. It would also permit grantor trusts, voting trusts, and trust created by wills which hold the stock for not more than 60 days to be shareholders. These changes would make the on-going operation of subchapter S corporations more flexible and may give the subchapter S corporation greater potential as a vehicle for attracting capital.

Secondly, subchapter S corporations are now forbidden from having "passive" income such as rents, dividends, and interest account for more than 20 percent of their gross receipts. Originally, this limitation was necessary because subchapter S corporations could participate in pension arrangements on terms more favorable than those open to self-employed individuals. Since the H.R. 10 limitations were imposed on subchapter S corporations in 1969, this limitation is no longer necessary. The Bible-Evins Bill would retain the 20 percent test in modified form--*i.e.*, the subchapter S election would be terminated only if the corporation exceeded this limit both in its current year and in one of the 3 prior years. The Treasury Department believes that this test should be eliminated entirely.

A third area in need of revision is the rules dealing with losses. Both a shareholder of a subchapter S corporation and a partner of a partnership face the limitation that they may deduct their share of losses only up to the amount of the adjusted basis of their interest in such entities. However, in the case of the partner, any excess of the loss over basis is allowable as a deduction when such excess is restored to his partnership capital account--for example, by his making an additional capital contribution or by failing to withdraw all of his distributive share of partnership profits in a subsequent year. In the case of the Subchapter S shareholder, on the other hand, such excess is not carried over to future years but is lost forever. The Bible-Evins Bill would remove this inequity by entitling the subchapter S shareholder to partner-type treatment. The Treasury agrees with this change subject to the proviso that the right to the deduction upon the restoration of basis should not be transferable from the shareholder who incurred the loss.

The foregoing items are examples of the types of legislation with narrow but nevertheless significant aims whose usefulness has been recognized but which has, for one reason or another, never been adopted. We hope that these hearings will create the momentum necessary for them to be acted upon.

I would also like to present another matter for your consideration. Code section 1244 creates a category of stock which, if sold at a gain, produces capital gain but which, if sold at a loss, produces ordinary loss. The corporation issuing such stock must be below a certain size and must issue the stock pursuant to a special plan. Only taxpayers who are individuals are entitled to the benefit of section 1244, and the maximum amount of losses which can receive ordinary loss treatment is $25,000 in any one year ($50,000 for married individuals filing jointly).

So far as we know, the only attention section 1244 has received in recent years has been with regard to its dollar limitations. The Bible-Evins Bill, for example, would raise the annual loss ceiling to $50,000 for a single individual and to $100,000 for married couples filing jointly and would modestly increase the permissible corporate size limitations. The Treasury is studying this provision to determine whether or not such an expansion of section 1244 is desirable and will shortly state its position.

In addition, we are considering whether or not investment in section 1244 stock should be made available to all taxpayers. This would permit the owners of small businesses to seek financing not just from individuals with funds to invest, but also from corporations, partnerships, and trusts. There would have to be a corresponding amendment of the accumulated earnings tax provisions to the effect that the reasonable needs of a business will include the ownership of section 1244 stock. The possibility of abuse should a corporation own section 1244 stock in a fellow member of a controlled group of corporations would also have to be considered. The requirement that section 1244 stock be issued pursuant to a special plan, a rule which has served mainly as a trap for the unwary, might well be simplified.

We understand that Senator Bentsen just introduced a new bill which includes many of the points just discussed. Obviously, in general, we wish it well. We understand that such bill also includes a requirement that the Treasury Department study the LIFO method of inventory accounting with a view towards simplifying such method to make it more easily usable by small businesses. We are presently engaged in a variety of regulations and rulings projects involving the LIFO method which hopefully will result in a more workable system for all businesses. As you know, the Treasury Department favors the use of the LIFO method as the most realistic method of accounting in this inflationary economy. We will be happy to proceed with the study under any terms mandated by Congress.

Needless to say, there are many other proposals outside of the Bible-Evins Bill for easing the tax burden of small business. Upon examination, many of these seem ill-suited to accomplishing their purported ends. On the other hand, we are always willing and anxious to explore new ideas and you may be assured of our prompt response to any such ideas coming from your Committees or elsewhere.

We are submitting with my statement today an Appendix containing statistics developed by our Office of Tax Analysis which we think you will find helpful in comparing the tax status of small, medium-sized and large businesses. By and large, the tables in the Appendix supplement data supplied to you on prior occasions by our Department.

It has been a great pleasure for me to appear before you today, and I thank you for the opportunity.

62-209 O - 76 - 46

Statistical Appendix

General description of data and terms used.

All data are extracted from 1972 tax returns which were sampled by the Statistics Division of the Internal Revenue Service for their regular statistical reporting function published annually as Statistics of Income: Corporation Income Tax Returns. The sampling procedures employed are described in these annual volumes which also present tables of sampling variability.

In order to achieve a greater degree of homogeneity within the asset classes reported herein, the so-called "zero asset" returns have been deleted. "Zero asset" corporations are those in liquidation, or bankruptcy, as well as U.S. branches of foreign corporations, for which financial statements filed are either literally "zero" or incomplete summaries of financial and operating magnitudes.

Additionally, data for corporations engaged in mining, agriculture and fisheries, finance and real estate, and those which were unclassifiable are not reported here. These exclusions were made for the reasons that the industrial classification resulted in extreme heterogeneity and that, for small businesses, excessive sampling variability masked underlying relationships.

In all other respects the basic data are the same as those which will be published in standard format by the Internal Revenue Service.

Summary and description of tables:

A. Debt-equity ratios, by asset size of corporations, selected industries.

One important indicator of the way business firms are financed is the ratio of debt to equity, or the ratio of creditors' claims against the assets of an enterprise to the residual claims of shareholders. In order to construct the asset-size classification system, and for computation of the debt-equity ratios presented, an adjustment was made to individual corporation balance sheet information.

Since every business firm is, to one extent or another, an extender of trade credit or a receiver thereof, this credit was "netted-out." That is, if accounts receivable plus notes receivable within one-year were exactly equal to accounts payable and notes payable within one-year, both the balance sheet total assets and liabilities were reduced by the amount of the credit, the remainder being the net assets employed in the business which must be financed by long-term debt or by owners' equity. If trade credit extended (accounts and notes receivable) exceeded trade credit received (accounts and notes payable), the trade

credit received was subtracted from both the total assets and liabilities. In this instance, a portion of the net assets employed in the business is net trade credit extended, presumably necessary to carry out the business function of the enterprise. Finally, if trade credit received exceeded trade credit extended, trade credit extended was subtracted from both total assets and liabilities. In this instance, a portion of the assets employed is financed by trade credit received, which then becomes a part of the total debt financing of assets employed in the business. It is this adjusted asset figure for the corporation which is used for size classification purposes. Similarly, the adjusted total liabilities and net worth figure (equal to adjusted assets) is the basis for computing the debt-equity ratios within asset-size classes.

It should be noted that within each industry-asset-size class, the debt-equity ratio is a ratio of aggregates of actual debts and equities of the individual firms, not an average of individual firms' ratios.

Within each of the industry categories reported, debt-equity ratios tend to decline with asset size. Corporations engaged in construction and services have generally higher debt-equity ratios than the others; corporations engaged in manufacturing have generally lower ratios.

Although time did not permit classification of these same firms by size of business receipts, given the close relationship between business receipts and size of assets employed within a given industry, it is highly probable that the same patterns of decline with increasing size as measured by business receipts would hold.

B. Earnings per dollar of assets employed:

The total product of business enterprise, the value of goods and services produced during a year, represents purchases of materials and supplies from other firms, payments for labor services and a gross return to the assets (capital) employed. When depreciation is deducted from the gross return to assets, the remainder is herein called "earnings." Earnings thus defined differ from conventional measures of "taxable income" or "net income" in the following ways:

(a) "Earnings" are inclusive of charitable contributions, which are deductions from income for tax purposes. They are included in earnings because charitable contributions are a conscious dispostion or allocation of the income flow from assets which is encouraged by the lax laws, not a cost of employing capital.

(b) "Earnings" are inclusive of Federal corporation income tax liability. The value of enterprise product is determined in the market place; it is the prices paid for this product which determines income shares of the factors which produce that product. Since some of the income share to capital is paid as interest to creditors, who then are

subject to income tax, the only consistent measure of total earnings from assets partially financed by debt is one which treats all income claims before income tax.

B-1 Earnings per dollar of assets employed, officers', compensation included.

Corporate officers are simultaneously shareholders, particularly in the bulk of all corporations which are owned and controlled by one person, his family, or a small group of associates. In this event, an indeterminate part of the compensation paid such officers is most likely a share of the income flow from assets allocable to equity. Lacking a basis for estimating the portion of officers' compensation which may be regarded as earnings of the assets employed, the "earnings" in this table are inclusive thereof. In the following table, "earnings" are net of officers' compensation.

Within each industry group, earnings per dollar of assets employed tend to decline with asset size.

B-2 Earnings per dollar of assets employed, net of officers' compensation.

Naturally, exclusion of officers' compensation reduces the measure of earnings more for smaller enterprises than for the very largest, since the connection between ownership and control is highest among the small. As a consequence, earnings per dollar of assets employed declines more slowly with size.

C. Taxability of corporations of different sizes.

Since taxable income as defined in the Tax Code differs substantially from economic income, and because of statutory special deductions, surtax exemption, the alternative tax rates on capital gains, tax credits, and other special provisions, the apparent effective rates on income of U.S. corporations may vary substantially among industries and sizes of firms in any year. In addition, some corporations may elect to be taxed essentially as partnerships under Subchapter S. Effective tax rates have been computed for those industrial divisions which are accorded "normal" tax treatment, i.e., for which certain special provisions such as percentage depletion, reserves for bad debt, and capital gains are relatively unimportant. In addition, income of Subchapter S electors is omitted since it is untaxed at the corporation level. Similarly, corporations without net income in the study year are excluded since their losses do not lead to reduction in tax in the same year.

The overall conclusion that emerges from the pattern of effective tax rates is that when size is measured by total assets the tax rate is smallest for the smaller-sized corporations. The average rate increases as firms become larger, at least up to $25 million of assets. Lower rates of tax for the remaining 1.6 percent of corporations, which are

largest in terms of net assets, are primarily due to the treatment of income from foreign sources. Foreign income is included in the denominator of the reported tax rates, but the foreign income tax paid and accrued is eliminated from the numerator; thus the reported ratio is reduced. When adjustment is made to separate income from foreign sources, or to add foreign taxes paid to total tax, the apparent lower rates for giant corporations disappear.

The results of the tax studies reported here strongly suggest that average effective corporation income taxes do increase with the size of corporations when size is measured by total assets.

C-1 Effective corporation income tax rates, by asset size of corporations, selected industries:

The definition of "effective tax rate" employed here is the ratio of "tax liability after credits" to "net income" which is measured by total receipts less total "ordinary and necessary" business deductions plus contributions to charity (which are regarded here as uses of income rather than offsets to income). By this definition, net income includes a number of items which are not fully subject to tax. Among these are (1) interest on tax-exempt bonds, (2) dividends received from other corporate entities, (3) taxable income of related foreign corporations and (4) contributions to charity. In addition, net income by this definition is before deduction for carryforward of prior year net operating losses and for statutory special deductions. The effective tax rates in the table may be lower than the statutory normal and surtax rates, therefore, because the income definition is more inclusive than that of the tax Code. The rates are also reduced by the investment, foreign, and WIN tax credits, and by the lower alternative rate on long-term capital gains.

The relative importance of these various tax-reducing provisions among several industries may be seen in Table C.1 by comparing tax rates in each column. However, despite variations in tax rates among industries, the tax rates within every industrial class increase with corporation size until at least the smallest 93 percent of firms are accounted for. The principal reason for the lower tax rates for smaller firms is the surtax exemption. The fact that net operating loss carryforward is a larger share in the income of smaller firms also contributes to the result.

C-2 Effects of foreign and investment tax credits, all industries:

When taxes are measured before foreign tax credits, the foreign tax credit is shown to have little effect except in the four highest asset classes, which contain the largest 5 percent of firms. Therefore, one may regard the measures of effective tax rates presented in Table C-1 as not seriously biased by their inclusion of foreign-source income, and the exclusion of foreign income taxes paid, except for these large corporations.

The tax reducing effect of the investment credit is virtually constant except for the three lowest classes, which receive little benefit from it.

C-3 Alternative measures of effective tax rates for 82 of the largest U.S. corporations, by asset size, 1970:

The importance of adjusting for foreign-source income when comparing "big-business" to smaller corporations, is shown by a separate study of tax returns of the largest U.S. non-financial corporations. These data are from an analysis of the 1970 tax returns for 97 of the 100 largest corporations included in the Fortune 500 list of U.S. corporations. 1/ Of these 97, fifteen did not have net taxable income in 1970, and they are excluded.

The first two columns of tax rates in Table 3 illustrate the problem of mismatching U.S. taxes with measures of income which include foreign source income. In the first column, taxable income is as defined as in the Internal Revenue Code. This column is comparable to rates presented in Tables C-1 and C-2 (although the definition here is slightly less broad). The second column includes in income a number of income items not fully subject to U.S. tax. This column shows clearly that the low effective tax rates often reported for largest class of corporations are largely due to the relatively great importance in that class of certain low-taxed industries.

The effect of subtracting foreign source income from the base may be seen from comparison of columns two and three. Column three is derived by subtracting from income all foreign source income that is subject to income taxation by other countries. This adjustment brings the average effective tax rates for all industries except petroleum, paper, and lumber to 45.1 percent--near the statutory rate.

Another appropriate measure of effective tax rates for corporations with foreign-source income is to add to U.S. tax liability those income taxes "accrued, paid and deemed paid" in other countries and to compute this as a fraction of world-wide economic income. The resultant rates are shown in Column (4). They will be smaller than those in Column (3) for most corporations because U.S. tax liability will be incurred for foreign source income whenever income tax rates are lower in the country where income originates. (This also explains why the rate may exceed the statutory U.S. rate in Column (3) and (5).)

1/ The 1970 returns are the latest available for which the necessary foreign source income and foreign taxes paid and accrued data items are tabulated. The 1972 data elements will not be processible until late December, 1975.

Columns (5) and (6) show the effect of treating the investment tax credit as a direct subsidy rather than as a reduction in tax liability. Since it is clear that the tax credit is an incentive measure rather than a refinement of income definition, it may be appropriate for purpose of these comparisons to calculate effective rate as "tax liability before investment credit" divided by income plus the subsidy represented by the credit. This method is used in computing Columns (5) and (6).

D. Income status of owners of capital.

In the Federal tax system, income from capital is taxed partially at the source--if the source is incorporated enterprise equity--and when it is realized by the owner of capital. In these tables, two related statistical descriptions of the comparative "taxability" of business income are presented. In both, the data are from a sample of individual tax returns constructed to be representative of the 1975 tax return filing population. As is well known, many income recipients are not required to file a return because their reportable incomes fall below the legal minimum for their filing status--single, married, head of household. As a consequence, "factor incomes" reported in the tables are understatements of national totals, particularly in the case of wages and salaries. Moreover, since the likelihood is greater that non-filers have personal service incomes rather than property income, the tables tend to understate the greater proportion of personal service incomes at the low end of the income distribution.

It should also be noted that notwithstanding the labelling of "interest" in the tables as income from capital, a considerable, but indeterminate, fraction of reported interest income receipts originates in the nonbusiness sector, as service of government and consumer debt. However, while the magnitude of interest income receipts may be overstated, the distribution of the receipts is probably unaffected.

A related problem exists with respect to proprietorship income. In this case the amounts reported include not only a return to the proprietor's equity in his business, but also his personal service income as a manager of the enterprise. Again, although the amount of proprietorship income is overstated by an indeterminate amount, the distribution is probably not severely affected. To the extent it is, business incomes of proprietors at the low end of the income distribution are more greatly overstated.

D-1 Distribution of returns reporting items of factor incomes by form of income and size of taxpayer's income.

These percentage distributions show that income from capital in various forms is far less frequently reported by taxpayers than personal service incomes and that receipt of income from capital is more concentrated among the higher income taxpayers.

Returns reporting partnership and Subchapter S corporation[2] income receipts are the forms of income that most frequently go to high income individuals; among property incomes, interest most frequently accrues to low income individuals. Wages and salary items are least frequently reported by high income individuals.

D-2 Distribution of factor incomes, by form of income and size of taxpayer's income.

This table distributes the amounts of the several forms of factor incomes by size of the recipient's total income. These show that the income from ownership of capital is far more "concentrated" among high income taxpayers than wages and salaries, and given the progressivity of income taxes, the capital income share becomes more heavily taxes than personal service income. Subchapter S corporation incomes are most concentrated, interest incomes least concentrated among the forms of income from capital.

E. Distribution of corporations, by industry, taxpaying status, and asset size.

Corporations classified as deriving the major portion of their receipts from trade were most numerous in 1972; corporations engaged in transportation least numerous.

Using 2.5 of assets as the upper-limit for small corporations--since this is generally the limit reached by Subchapter S corporations--within industry concentration of small business is highest in the services industries, lowest in manufacturing.

2/ Subchapter S corporations are those corporations owned by 10 or fewer persons whose stockholders elect to have the corporation's income taxed essentially as proprietorships. Consequently, Subchapter S corporations accrue no corporation income tax liability.

Table A

Corporate Debt-Equity Ratios for Selected Industries for Firms with Net and Without Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	19.34	2.23	1.41	1.13	.91	.80	.81	.62	.58	.62	.69
Services	3.73	1.96	1.39	1.42	1.71	2.33	2.52	2.17	1.87	1.82	1.34
Construction	7.13	2.58	1.61	1.38	1.70	1.75	1.79	2.22	2.38	2.13	1.17
Transportation	3.98	2.06	1.52	1.41	1.20	1.43	1.40	1.36	1.36	1.46	1.19
Wholesale and retail trade	5.15	2.06	1.48	1.10	1.00	1.06	1.20	1.16	1.19	1.09	1.08

Office of the Secretary of the Treasury
Office of Tax Analysis

November 12, 1975

Table B-1

Earnings Including Compensation of Officers, per Dollar of Assets, for Corporations With and Without Net Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	.49	.39	.35	.28	.24	.22	.18	.16	.14	.12	.10
Services	2.42	1.03	.53	.29	.19	.13	.11	.09	.09	.09	.07
Construction	.85	.53	.40	.30	.23	.19	.16	.13	.09	.08	.05
Transportation	.42	..26	.26	.23	.18	.15	.13	.11	.10	.08	.05
Wholesale and retail trade	.49	.34	.29	.24	.21	.20	.17	.15	.12	.12	.09

Office of the Secretary of the Treasury
Office of Tax Analysis

November 12, 1975

Income = total receipts - total deductions + interest + officers' compensation + charitable contributions

Table B-2

Earnings, Excluding Compensation of Officers, per Dollar of Assets for Corporations With and Without Net Income by Asset Class, 1972

Asset class (thousands)	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Manufacturing	-.13	.00	.06	.07	.09	.11	.12	.13	.12	.11	.10
Services	2.12	.99	.10	.09	.08	.07	.07	.06	.07	.08	.06
Construction	-.04	.02	.09	.09	.08	.08	.09	.07	.06	.06	.05
Transportation	-.03	.05	.07	.09	.09	.09	.09	.09	.09	.07	.05
Wholesale and retail trade	-.07	.04	.07	.10	.11	.11	.12	.07	.11	.11	.09

Office of the Secretary of the Treasury
Office of Tax Analysis

November 12, 1975

Income = total receipts - total deductions + interest + charitable contributions

Table C-1

Effective Tax Rates (Percent) for Taxpaying Corporations with Net Income, by Size of Assets, Selected Industries, 1972*

Industries		Under $25,000	$25-50,000	$50-100,000	$100-250,000	$250-500,000	$500-1,000,000	$1,000,000-2,500,000	$2,500,000-10,000,000	$10,000,000-25,000,000	$25,000,000-100,000,000	Over $100,000,000	Average
All industries	Tax Rate	13.3	16.4	19.5	22.6	28.0	32.7	36.0	36.7	34.4	32.5	28.5	30.0
	No. of firms	162.3	114.4	154.4	215.2	124.8	75.3	46.1	26.6	9.2	6.1	2.9	937.4
Manufacturing	Tax Rate	9.9	13.8	17.7	20.6	29.6	35.4	38.9	41.1	40.9	40.5	31.9	33.9
	No. of firms	10.4	16.5	15.1	24.3	18.3	13.8	10.8	6.5	1.4	.9	.6	112.6
Construction	Tax Rate	11.2	17.4	17.7	21.4	28.0	31.6	36.6	37.3	36.7	38.0	31.4	31.6
	No. of firms	13.3	8.3	12.6	17.6	9.7	6.1	3.6	1.6	.2	.1	.02	73.0
Trade	Tax Rate	12.1	16.1	20.6	24.1	24.3	34.0	36.9	36.3	32.0	29.4	36.7	32.6
	No. of firms	36.3	35.2	53.4	80.7	47.5	28.5	15.6	5.7	.8	.4	.1	304.4
Transportation	Tax Rate	15.0	14.1	16.0	17.9	26.2	32.6	34.7	36.4	39.2	34.2	34.3	33.9
	No. of firms	5.8	4.5	6.2	7.9	4.4	2.6	1.6	.8	.2	.2	.2	34.6
Services	Tax Rate	14.9	17.4	19.6	23.3	27.8	31.5	32.0	34.8	37.4	33.2	33.4	29.2
	No. of firms	58.5	24.7	23.3	22.9	10.6	5.1	2.8	1.2	.2	.1	.04	149.5

Office of the Secretary of the Treasury
Office of Tax Analysis

November 6, 1975

*Assets and number of firms in thousands.

Effective tax rate = U.S. corporation income tax liability after credits/total receipts - "ordinary and necessary" business deductions + contributions to charity.

Table C-2

Effect of Tax Credits on Effective Tax Rates for All Taxpaying Corporations by Size of Assets, 1972*

	Under $25,000	$25-50,000	$50-100,000	$100-250,000	$250-500,000	$500-1,000,000	$1,000,000-2,500,000	$2,500,000-10,000,000	$10,000,000-25,000,000	$25,000,000-100,000,000	Over $100,000,000	Average
Tax after credit	13.3	16.4	19.5	22.6	28.0	32.7	36.0	36.7	34.4	32.5	28.5	30.0
Tax before foreign tax credit	13.3	16.5	19.5	22.7	28.1	32.7	36.1	37.0	35.2	33.9	37.6	35.6
Tax before foreign & investment credit	13.8	17.5	20.9	24.5	30.1	35.0	38.3	39.0	37.0	35.9	40.9	38.4

Office of the Secretary of the Treasury
Office of Tax Analysis

November 6, 1975

*See notes to Table C-1.

Table C-3
Alternative Measures of Average Effective Tax Rate (percent) for 82 Corporations Among 100 Largest U.S. Corporations, by Industry, 1970*

Industry type	No. of companies (Excludes corp. w/o taxable income)	Effective tax rates, percent					
		Measures of tax liability					
		U.S. income tax after credits			U.S. & foreign income tax paid or accrued	U.S. tax before investment credit	U.S. and foreign tax before investment credit
		Measures of income					
		Taxable IRC	Presumptive world-wide economic income	Presumptive domestic economic income	Presumptive world-wide economic income	Presumptive dom. economic income + invest. credit	Presumptive world-wide econ. income + invest. credit
		(1)	(2)	(3)	(4)	(5)	(6)
01 - Computers & business machines	5	26.5	25.9	46.9	47.2	47.1	47.3
02 - Motor vehicles	3	31.1	30.5	45.1	45.6	46.6	46.6
03 - Aero-space	5	38.4	36.7	43.4	40.5	46.3	43.1
04 - Metal fabrication	4	33.4	29.7	38.3	38.7	40.6	40.5
05 - Food and related products	11	41.6	40.5	46.6	46.0	46.9	46.4
06 - Drugs, Chemicals, & related products	13	36.5	34.4	44.3	42.8	45.7	43.9
07 - Electrical & electronic products	7	39.3	35.8	48.2	41.6	50.1	43.2
08 - Conglomerates	7	29.9	27.0	42.7	41.8	43.2	42.1
09 - Miscellaneous	4	38.1	36.6	42.9	42.0	43.9	42.9
10 - Petroleum	16	12.8	8.9	13.6	33.9	15.8	35.0
11 - Paper and Lumber	7	21.3	20.6	26.4	25.3	30.1	28.3
All industries	82	28.0	26.4	35.2	40.4	36.7	41.4
All industries except petroleum and paper	59	33.5	32.0	45.1	44.1	46.3	44.9

Office of the Secretary of the Treasury
Office of Tax Analysis

October 31, 1975

*See accompanying text for definition of tax and income measures.

Table D-1

Distributions of Tax Returns by Form of Factor Payment Reported, by Adjusted Gross Income Class of Recipient, 1975

Item	All taxpayers		Sole proprietorships		Partnerships		Subchapter S corporations		Dividend income		Interest income	
	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum. %
Number of returns in thousands	$84,999		$7,344		$3,273		$789		$12,043			
AGI of recipient:												
Under $5,000	30.3	30.3	20.8	20.8	13.2	13.2	11.7	11.7	11.7	11.7	17.8	17.8
5,000 - 10,000	24.2	54.5	19.0	39.8	10.3	23.5	5.7	17.4	16.9	28.6	20.4	38.2
10,000 - 25,000	38.6	93.1	42.6	82.4	40.6	64.1	39.9	57.3	46.7	75.3	49.7	87.9
25,000 - 40,000	5.1	98.2	11.7	94.1	20.5	84.6	22.6	79.9	15.9	91.2	8.9	96.8
40,000 - 75,000	1.4	99.6	4.6	98.7	11.2	95.8	14.1	94.0	6.6	97.8	2.5	99.3
75,000 - 150,000	.3	99.3	1.1	99.8	3.5	99.3	4.8	98.8	1.8	99.6	.6	99.9
150,000 - 500,000	.1	100.0	.2	100.0	.7	100.0	1.1	99.9	.4	100.0	.1	100.0
500,000 - 1,500,000	++	100.0	++	100.0	++	100.0	.1	100.0	++	100.0	++	100.0
1,500,000 - 5,000,000	++	100.0	++	100.0	++	100.0	++	100.0	++	100.0	++	100.0
5,000,000 and over	++	100.0	++	100.0	++	100.0	++	100.0	++	100.0	++	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 12, 1975

++Less than .1 percent.

Table D-2

Distribution of Factor Incomes Reported in Tax Returns, by Form in which Paid, by Adjusted Gross Income Class of Recipient; 1975

Item	Wages and salaries		Income from capital									
			Sole proprietorship		Partnership		Subchapter S corporations		Other corporations		Interest	
	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum. %	%	Cum.%
Amount of income (billions)	$782.0		$50.1		$16.2		$4.1		$20.0		$46.1	
AGI of recipient:												
Under $5,000	6.7	6.7	-2.4	-2.4	-13.0	-13.0	-14.6	-14.6	7.2	7.2	11.0	11.0
5,000 - 10,000	17.1	23.8	7.7	5.3	3.5	-9.5	2.7	-11.9	7.3	14.5	17.4	28.4
10,000 - 25,000	58.1	81.9	36.7	42.0	30.1	20.6	19.0	7.1	27.7	42.2	39.1	67.5
25,000 - 40,000	12.2	94.1	27.9	69.9	30.7	51.3	23.8	30.9	15.4	57.6	15.6	83.1
40,000 - 75,000	4.1	98.2	20.9	90.8	30.0	81.3	29.4	60.3	16.4	74.0	8.9	92.0
75,000 - 150,000	1.4	99.6	7.9	98.7	13.9	95.2	23.5	83.8	12.3	86.3	4.7	96.7
150,000 - 500,000	.4	100.0	1.2	99.9	3.8	99.0	13.8	97.6	9.4	95.7	2.6	99.3
500,000 - 1,500,000	++	100.0	.1	100.0	.5	99.5	1.3	98.9	2.6	98.3	.5	99.8
1,500,000 - 5,000,000	++	100.0	++	100.0	.1	99.6	.6	99.5	1.4	99.7	.2	100.0
5,000,000 and over	++	100.0	++	100.0	.4	100.0	.5	100.0	.3	100.0	++	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

November 12, 1975

Totals may not add because of rounding.
*Includes returns with and without net income.
++Less than .1 percent.

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Table E

Percentage Distribution of Corporations by Size of Total Assets According to Taxpaying Status; Selected Industries; 1972

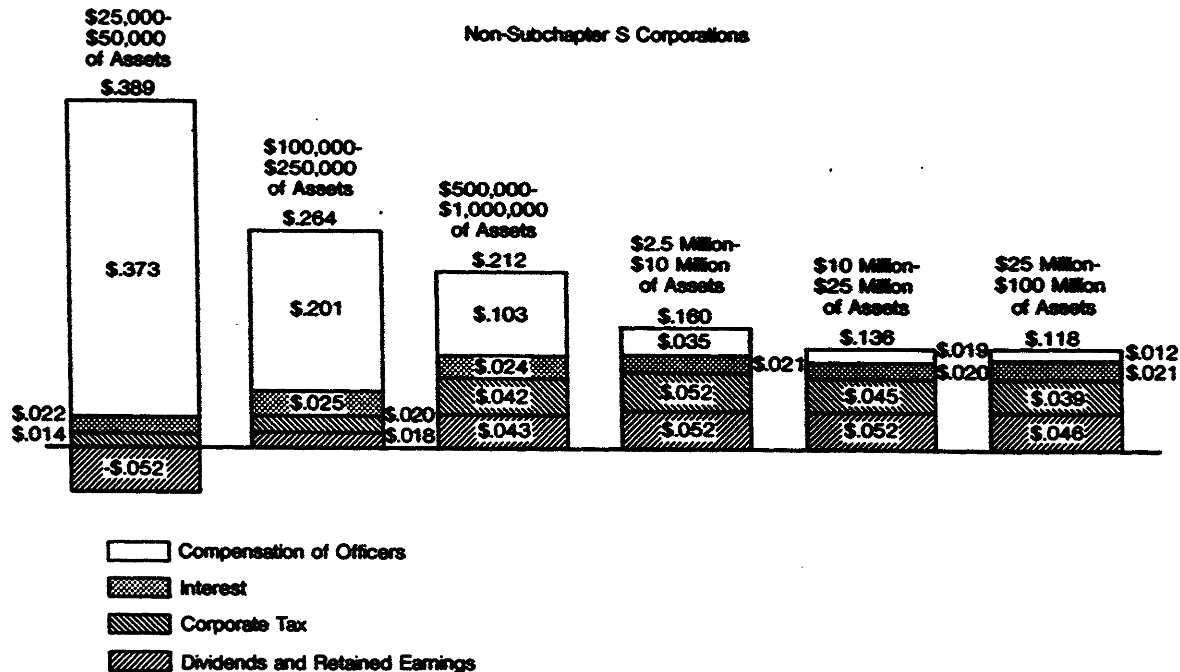
Asset classes (thousands)	Total no. of corps.	Under $25	$25-50	$50-100	$100-250	$250-500	$500-1,000	$1,000-2,500	$2,500-10,000	$10,000-25,000	$25,000-100,000	Over $100,000
Wholesale and retail trade:												
Non-Subchapter S corporations												
With and without net income	441,900	18.9	14.3	17.7	23.3	12.6	7.4	4.0	1.5	.2	.1	*
With net income	306,400	11.9	11.6	17.5	26.6	15.6	9.4	5.1	1.9	.3	.1	*
Subchapter S corporations												
With and without net income	103,400	23.9	18.2	20.6	22.8	9.6	3.6	1.1	.2	*	*	*
With net income	70,300	17.1	16.6	21.8	26.3	11.9	4.1	1.4	.2	*	*	*
Services:												
Non-Subchapter S corporations												
With and without net income	241,337	45.7	15.1	14.3	13.3	6.0	3.1	1.7	.7	.1	*	*
With net income	149,531	39.1	16.5	15.6	15.3	7.1	3.4	1.9	.8	.2	.1	*
Subchapter S corporations												
With and without net income	47,179	48.0	16.9	14.4	12.8	4.6	2.0	1.1	.2	*	*	*
With net income	28,503	42.4	17.7	16.7	15.1	4.9	2.0	1.0	.2	*	*	*
Manufacturing:												
Non-Subchapter S corporations												
With and without net income	165,600	15.2	11.0	14.0	20.2	14.5	10.3	8.1	4.7	1.0	0.7	0.4
With net income	112,600	9.2	9.3	13.4	21.6	16.2	12.3	9.6	5.7	1.2	0.8	0.6
Subchapter S corporations												
With add without net income	28,900	25.8	14.5	20.6	22.0	10.0	4.6	2.2	0.4	*	0	0
With net income	19,400	18.7	21.8	21.8	25.8	12.1	6.1	2.8	0.5	*	0	0
Contract Construction:												
Non-Subchapter S corporations												
With and without net income	116,239	26.0	12.7	16.0	20.5	11.4	6.8	4.0	1.9	.3	.1	*
With net income	73,031	18.3	11.3	17.2	24.2	13.3	8.3	4.9	2.1	.3	.1	*
Subchapter S corporations												
With and without net income	28,063	31.1	13.8	20.1	19.1	9.3	4.2	1.8	.6	*	*	*
With net income	18,852	25.6	14.6	19.3	22.2	10.9	4.5	2.1	.8	*	*	*
Transportation:												
Non-Subchapter S corporations												
With and without net income	56,100	25.4	14.1	16.7	20.4	10.2	6.2	3.7	1.9	0.5	0.4	0.5
With net income	34,600	16.7	13.0	18.0	22.9	12.7	7.6	4.8	2.4	0.7	0.5	0.7
Subchapter S corporations												
With and without net income	11,900	28.7	23.0	15.0	22.7	6.2	3.3	0.9	0.2	*	0	0
With net income	7,300	21.8	26.1	15.3	26.4	7.5	3.6	1.1	0.2	*	0	0

Office of the Secretary of the Treasury
Office of Tax Analysis

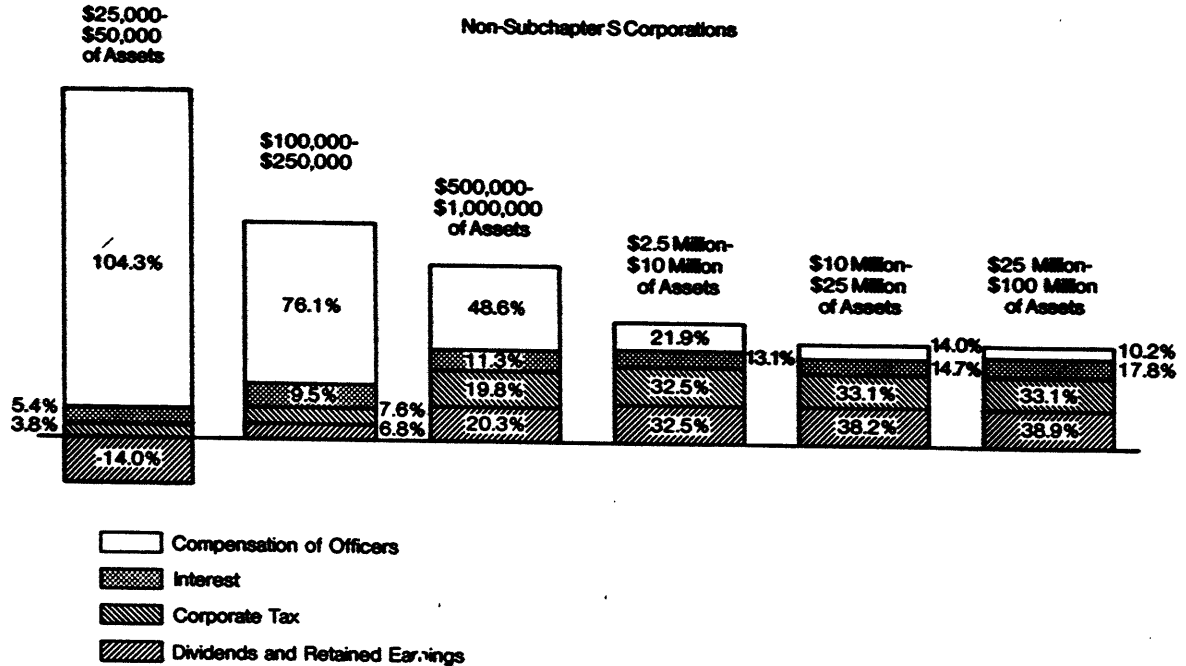
November 12, 1975

*Less than .1 percent.

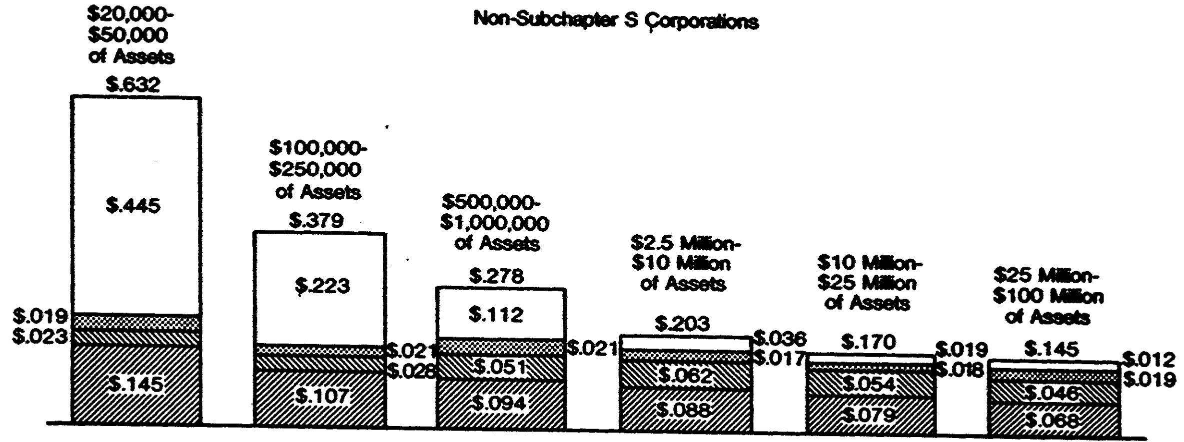
Earnings Per Dollar of Assets for Various Sizes of Manufacturing Corporations With and Without Net Income, 1972



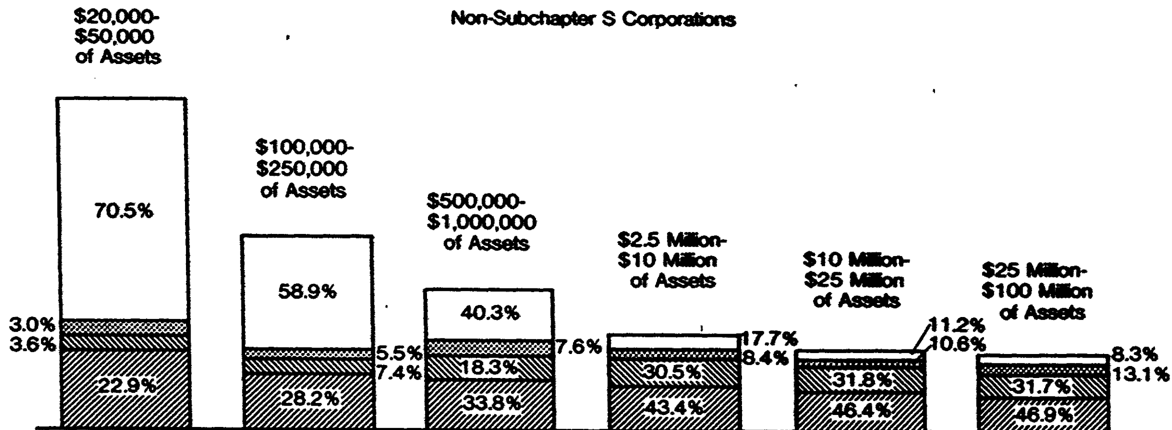
Percentage Distribution of Earnings for Various Sizes of Manufacturing Corporations With and Without Net Income, 1972



Earnings Per Dollar of Assets for Various Sizes of Manufacturing Corporations With Net Income, 1972



Percentage Distribution of Earnings for Various Sizes of Manufacturing Corporations With Net Income, 1972



Senator NELSON. Do you have any questions?

Senator ROTH. Could I take a few minutes?

Senator NELSON Yes.

Senator ROTH. I am sorry. I just returned to Washington and I missed your testimony. But in Delaware, the State I represent, I made—I had a young summer intern who was interested in the problems of small business, and we made a survey of small businesses in Delaware to determine whether or not they were experiencing difficulties with Federal regulations and paperwork.

And the two agencies that came out on top, one was OSHA—which was not too surprising—and the other was the Internal Revenue Service.

Generally speaking, most of the criticisms of the Internal Revenue Service—and if you've already answered these, tell me and I'll go back and read the testimony.

Mr. GOLDSTEIN. I didn't answer them, but I did suggest that one of the most significant burdens on small businesses coming from the tax part of the Government is not so much how much tax such business pays but rather how much paperwork is required.

Senator ROTH. That's exactly one of the points that I was going to make. But there are two or three things, the general paperwork problem, the IRS requirement which was particularly serious.

Are you doing anything to review—I guess you're new in the business.

Mr. GOLDSTEIN. Yes, sir.

Senator ROTH. But what is Internal Revenue Service doing?

Mr. GOLDSTEIN. As you know, the President has spoken as forcefully as anybody with regard to trying to reduce the burden of paperwork.

Senator ROTH. But what the President says and what the Congress says doesn't mean much unless translated into action.

Mr. GOLDSTEIN. Within the IRS, there's a Small Business Committee which has been established whose principal if not sole purpose is to try to meet this problem.

I don't know what progress, if any, they've made.

Senator ROTH. But I'd like to suggest—the chairman isn't here—I realize you're new, but I'd like to know exactly what progress has been made.

Let me say there isn't a problem in this Government that a committee or special task force or something hasn't been formed on.

I'm not being critical of you; don't misunderstand me, but that doesn't mean anything. And what I think we're interested in is what, in fact, you are trying to do to simplify the whole thing.

I'm really shocked as I go around at home and hear of the number of small businesses, and many of them are going out of business.

They just find that the redtape and the bureaucracy and the regulations, as they say, "has taken the fun out of being in business for yourself."

And I would just like to have some kind of a report as to what your task force is doing.

Mr. GOLDSTEIN. Yes, sir. The only comment I would add to that is that I did note in my earlier remarks that it's not all the Federal Government by any means, it's State and local people as well.

Senator ROTH. I'm talking about the Federal Government. The study of the complaints came—I agree with you. A lot of the problems are at the local level, but this complaint, the No. 1 complaint, was Internal Revenue sharing that distinction with OSHA.

The other general criticism—and perhaps you have discussed this—centered on the requirements to deposit funds in advance for income tax and social security withholding purposes. The dissatisfaction with the depository requirements centered on the frequency required which created cash flow problems and heavy bookkeeping costs for particularly the very small businesses.

Mr. GOLDSTEIN. I know that that has been a subject of concern. That's in the bill.

Mr. TEMKIN. I would say in the last year we proposed new regulations about depositing employment taxes which will have substantial liberalization effects for employers who have less than $25,000 liability in a quarter.

I believe also we initially proposed—we had said that we were going to do away with the 90-percent test. We were going to require a 100-percent tax to be put in under a certain time, but, in the last few days, that was relaxed so that we backed up and we are back to 90.

Together these should ease considerably the filing requirements for really small businesses. Of course, you get into the problem that the Government has to satisfy itself that the money is deposited. In total, substantial sums of money are involved and there is some tendency on the part of the businesses which are having trouble to stop paying Uncle Sam first.

And as a matter of protecting the revenues, we have to be fairly fast with collections.

There's also the problem of certain social security interests that aren't really Treasury interests, but they have to know what is going on each quarter in order to figure out benefits for people, and that complicates the whole scheme.

We tried to do something about that, but like many things it's just complex inherently.

Senator ROTH. But when you make these changes, to what extent—I'm relatively new to the Finance Committee—to what extent do you keep either the staff or the Ways and Means and Finance Committees advised of what you're doing?

Mr. TEMKIN. It's my understanding that the staff of the Joint Committee on Internal Revenue Taxation worked out these new deposit requirements with us.

I wasn't personally involved in that, but I'm positive they were consulted on that and they are familiar with it.

Also we are doing this in proposed form so that interested people can submit comments before the regulations become final.

We recognized that there was a problem there, but it's just like many things, there are no easy solutions.

Senator ROTH. Mr. Chairman, I won't take more time. As I said, we made a little survey of small businesses at home. A number of complaints came, and I would like to submit them to the Treasury and ask them to comment for the record.

Mr. GOLDSTEIN. We would be delighted to do that.

Senator ROTH. Thank you, Mr. Chairman.

Senator NELSON. Anybody else?

Senator HASKELL. Yes, Mr. Chairman.

One thing—and I realize that you're new to your position, Mr. Goldstein. But the real complexities of the Internal Revenue Code I think you might agree come from the special considerations that Congress in its wisdom and the administration in its wisdom decides to give certain business enterprises.

And from my experience as a practicing lawyer the Internal Revenue Code has a great resemblance to swiss cheese.

We had, for instance, we sat in this room a few months ago and in came the paper recyclers, and they said the timber people had an advantage, so they in turn wanted a comparable advantage.

Mr. GOLDSTEIN. I too have heard from the paper recyclers.

Senator HASKELL. One good loophole deserves another. The metal recyclers came in and perfectly properly said that they were at a disadvantage because the natural resources industry had percentage depletion. They didn't get what they wanted because nobody could quite figure out exactly what they wanted. They wanted $10 a ton. The AEPA said the advantage was $1.75 a ton, so that kind of confused us. So we didn't give them the advantage.

But I don't know. I'd like to see the Treasury Department—and I don't think it will because your immediate superior when he was being confirmed in answer to a question seemed to think that things were pretty good the way they were.

Somebody some time ought to give a little look at why not make the Internal Revenue Code provisions comparable to normal accounting practices.

You mentioned, for example, the conversion of the financial statement of a small corporation when they decided to go public.

And I've had the same experience. They restate their income in accordance with normal accounting practices. They obviously raise the income, and it's all perfectly legal.

So many of these complexities arise because of our desires to help Joe because Joe has something. I would like at some point—I notice all the witnesses that follow say, "raise the investment tax credit."

Well, the investment tax credit is just a check from the Government to somebody who buys machinery. Senator Nelson in his State has a lot of dairy farmers.

Why shouldn't the dairy farmers get something when they buy a cow?

I wish somewhere, sometime, somebody in Treasury would take a look at the real way to simplify the tax code and that's to write out the special goodies and then you can reduce rates.

Now I don't know whether you are in a position to do that, and this is more speech than a question, but it's just something——

Mr. GOLDSTEIN. Let me respond to it if I may.

First of all, with regard to Mr. Walker, who is my boss, one of the ways I came to know him, and one of the reasons why I'm here is because he asked me to be here, was that we were both on the Special Committee on Simplification of the American Bar Association Tax Section, as is Mr. Asbill who is sitting behind me.

And I think all of us on that committee favor real simplification. I think the problem is that it's terrific to talk about it when you're

in the bar association, and as part of my education here I am learning the things that you have already learned.

Because, as I said, I've heard from the paper recyclers already, and they haven't given up.

Senator HASKELL. Oh, no. Nor have the copper recyclers I'm sure.

Mr. GOLDSTEIN. And the fact is that this system that we have has been with us a long time. As soon as a new idea comes up, a new association is formed and the arguments of equity as among various groups are appealing, and as you know the advocates are well organized.

There have been numerous studies. The bar association itself did one 10 years ago of the general concept of broadening the tax base, reducing rates dramatically, and treating everybody more or less alike.

But, of course, I'm sure that you have heard and will hear again the position of the petroleum industry and how such treatment of them, for example, would have very serious consequences.

Senator HASKELL. Everybody says that. And you've got to step on an awful lot of toes. You've got to step on the timber folks, the real estate folks, the natural resource folks.

But really that's the only way to get true simplification.

Mr. GOLDSTEIN. Well another thing that Mr. Walker and I have discussed when we get a little spare time late in the day is that we would like to hire—we would plan to add to our staff at least one person who has nothing else to do, no other responsibilities but to sit in a room by himself, read everything that's been written and report to us periodically on really basic reforms and simplification changes that can be made.

There are also numerous studies recommending Presidential Commissions and so forth.

Senator HASKELL. I'm very pleased to hear that because I think if that is done—I realize the political pressures are such that it would be tough to get it through, but I think it would be very useful—a very useful exercise for your office and I'm delighted that you are putting something in order.

Mr. GOLDSTEIN. I think the point to be made is that we are willing to take the initiative on that but obviously if anything is really going to be done you and your colleagues would probably have to do it.

Senator HASKELL. If I could get a few folks to join me, I would be glad to take that up. I thank you very much.

Senator NELSON. Well, thank you very much. I wish we had more time. But, we do have a panel of three witnesses, and it's 5 minutes to 11, so I think we'd better move on.

Thank you very much.

If the committee members have some further questions, I assume you will be glad to respond to them in writing?

Mr. GOLDSTEIN. Yes, sir. And I think there will be some based especially on our pension——

Senator NELSON. One of them that we will probably want to send you, and we did not mention this morning, is the question of the estate tax, and the fact that since the exemption was set at $60,000, the current inflationary rate would have to be $146,000. If it was valid at $60,000 in 1942, what do you think it ought to be today?

But we will send you that in order to expand on the record.

Mr. GOLDSTEIN. Thank you.

Senator NELSON. Our next witnesses will be a panel of legal, financial, and accounting experts.

Mac Asbill, Jr., attorney and former chairman, tax section, American Bar Association, Washington, D.C.

Dr. Allen Sinai, director of financial economics, Data Resources, Inc., Lexington, Mass., and visiting associate professor of economics and finance, Massachusetts Institute of Technology, Cambridge, Mass.

William Penick, chairman, Federal tax division, American Institute of Certified Public Accountants, and CPA, Washington, D.C.

The three panel members have submitted their statements to the committee, and I have your statements here and they will be included in full in the record.

So if you could avoid repeating what other witnesses have said, we would be able to finish within the time allotted.

STATEMENT OF MAC ASBILL, JR., ATTORNEY AND FORMER CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. ASBILL. Mr. Chairman, do you have a copy of my statement? I have extra copies here.

I am an attorney who has been engaged in the private practice of law here with emphasis on tax matters for some 25 years.

And in that capacity, Mr. Chairman, I have represented a number of small, medium, and large businesses.

I've been very active, as you've noted, in the tax section of the American Bar Association, and in my capacity as an officer of that association I worked rather closely with the staff of this committee, and particularly with Mr. Spira in aspects of tax legislation and administration relating to small businesses.

It has been a pleasure to do so. I am appearing today not in any official capacity as a representative of the tax section, but simply in my individual capacity as an interested practitioner who's concerned about the problem and who appreciates the work you gentlemen have been doing.

I think the select committee has played a very significant role in this drama. I think it's been responsible for some significant tax legislation, although I'm sure you feel yourself, and I agree with you, that your achievements have not come up to your expectations yet in that regard.

But much more importantly, it seems to me you have focused the attention of Congress and the attention of the administration and the public, I think, on the plight of the small businessman under the existing tax laws.

You've identified major areas where relief is necessary or appropriate, and you've started some in-depth studies which might bear significant fruit.

And I would like just to look very briefly at what you have done as I see it from my perspective as a platform from which to suggest some things that you might concentrate on in the future.

S. 1089, which is the 1973 version of the Small Business Tax Sim-

plification Reform Act and which was the successor as you know to previous bills, was described in the words of Senator Bible as "a vehicle for the systematic consideration of the Tax Code from the small business viewpoint."

Now I think that is a very important concept. That legislation itself was not comprehensive at all. It had several very significant suggestions and legislative provisions in it, but it was not comprehensive.

But viewed as a vehicle for systematic consideration it seems to me it is a landmark, and I think systematic consideration is needed if we are ever going to get anywhere.

I want to come back to that in a minute with emphasis on simplification and sort of reiterate the theme that Senator Haskell initiated.

This bill had eight titles and I think that indicates its scope. I am going to talk about that a little bit later.

It covered the adjustment of rates, provisions to encourage the establishment of small businesses, the growth of small businesses, provisions relating to partnerships, Subchapter S corporations, and the preservation of small business independence.

Title I of the bill, which focused on simplification, would have established an intragovernmental committee to study on a permanent basis tax simplification for small business.

It would have also created in the Office of the Treasury Department an Office of Small Business Tax Analysis which I take it is roughly what Mr. Goldstein told you they are contemplating doing now.

Now I think the most significant feature of Title I is its recognition, as I said, for the—of the need for a systematic approach to the problem of simplification.

This is something which I believe in very strongly. I had the pleasure last summer of testifying on a panel before the Ways and Means Committee, as part of its hearings on tax reform, on the general subject of simplification.

Our panel recommended that a deliberate, long-range approach to the revision of the Internal Revenue Code was necessary if real simplification was to be achieved.

We suggested that the Tax Writing Committee, prepare an agenda which might extend for 4 or 5 years, that on that agenda be scheduled parts of the Code for in-depth consideration with an eye toward simplification, that the committees commit themselves to the maintaining of that agenda in the sense that they would commit to take up and pass on, one way or another, the items on the agenda at the time the agenda indicated they would be considered, so that the public would know the schedule and be able to make whatever input it thought desirable.

It was our view that some permanent organization would be necessary in order to conduct the analysis and the studies necessary to accomplish this.

We thought that a newly-created branch of the staff of Joint Committee on Internal Revenue, beefed up, would be the best vehicle to do this.

This would be a branch of that staff which, in our view, would have to be sort of insulated from the day-to-day pressures to which that staff is subjected.

And it would conduct long-range studies, confer with the public,

businessmen or other sources of available information. Whether that mechanism is better than what S. 1098 has suggested in the case of small business studies, and intragovernmental committee, I think perhaps it's open to debate.

We chose the staff because we thought its relationship with the tax-writing committees and its experience might make it a better vehicle.

I think that what is not debatable is that some such organization to study simplification on a long-range, fundamental basis is necessary if we are ever going to get anywhere.

And I think the recognition of this fact by the legislation as it eminated from the Senate committee is a very significant thing.

Some of the recommendations in S. 1098, as you know, found there way into the consideration by the Ways and Means Committee of Tax Reform, and many of them or some of them found their way into that committee's tentatively approved version of the Tax Reform Act of 1974.

As you know, that verson foundered in the last days of the last Congress because of the time pressures imposed, and was not enacted, but then you kept at the job and you made your influence felt, I think, in the Tax Reduction Act of 1975.

That act did not satisfy you and it didn't satisfy a number of other people insofar as its impact on small business was concerned.

And Senator Nelson and some of his colleagues introduced S. 2149 to be considered by the Finance Committee in conjunction with the House version of the tax reduction bill.

Several of those recommendations that you made then found their way into the final legislation in one form or another, an increase in the minimum accumulated earnings credit, a temporary reduction in the normal tax for the first $25,000 dollars of corporate income, and a temporary increase to $100,000 in the limitation upon used property qualifying for the investment credit.

Now you weren't satisfied with that result I don't think, and I wasn't either. I don't think a lot of people were, but I am encouraged because I think the significant thing is that this committee made its presence felt and it did so because of its extensive work and its perseverance in calling to the attention of the taxwriting committee the needs of small business.

Now that gets me down to 1975, and to a look into the future. In the summer of 1975 Senators Nelson and Bentsen appeared before the Ways and Means Committee in connection with the renewed activity of that committee on the subject of tax reform legislation and suggested a number of reforms that they thought would be helpful to small business.

They dealt with lower rates, a simplified capital recovery system—and I want to talk about that a little more in a minute—with lessening the tax burden on the employment of labor—and we just had some discussion of that in response to Senator Roth's question—with the effect of tax legislation and other legislation on industrial combinations, or mergers, and the ability of small business to remain independent on the death or withdrawal of a member of the family.

You didn't stop with those recommendations, though. As late as last month Senator Nelson announced that you were studying a comprehensive estate tax reform proposal which would mitigate the impact

of death taxes on small business, that you were studying simplified depreciation and capital recovery with particular emphasis on small business, and that you were looking into the impact of ERISA, the Pension Reform Act, upon small business.

Now these recommendations, in my view, provide a checklist of items which certainly deserve consideration by the tax writing committees.

And I think they are quite broad in their scope and they would go a long way, if they were carefully considered, toward providing needed relief to the small business.

You recognize, and I think this is probably the most significant thing about the whole business as far as I am concerned, that small business with its limited resources cannot always obtain the necessary technical and professional assistance to permit it to deal with complex legislation such as our tax laws.

You recognize that in that situation, complexity in itself is inequity, and that it imposes an unfair burden on taxpayers that they shouldn't have to bear.

And I think you are aware as I am that unless we achieve some simplification it seems to me quite likely that voluntary compliance by some substantial number of taxpayers in this country is going to suffer.

I think a good example of the need for simplification is the provision in the law, the provisions in the law and regulations, dealing with capital recovery.

We've got something called the ADR system, the asset depreciation range system, which was initiated several years ago, which gives some relief as far as capital recovery is concerned.

It provides some relief and flexibility and I think it does a lot for substantial businesses, but if you get a small businessman who can understand the regulations on ADR, he's a very unusual fellow.

I've studied them at length, and I have a great deal of difficulty with them. And I think the fact of the matter is that the system is simply not designed for the average small businessman. It is designed for big business.

And something simpler than it is necessary to give appropriate relief in my view in the capital recovery area to small business.

Incidentally, and this bears on the question that was previously asked, the Revenue Service has recently formed a Small Business Advisory Committee, a committee of outside experts, to advise the Commissioner about what he can do to help small business cope with its problems under the tax laws.

My law partner, Randolph Thrower, who is a former Commissioner of Internal Revenue, is the coordinator of that committee, and he tells me that this business of some simplified method of capital recovery is one of the things to which the committee is giving early attention.

Now, they have also in that committee spent some time on another problem which Senator Nelson identified and which has been talked about today, and that is the impact of this new pension legislation on small business.

I'm sure you gentlemen are aware that this new legislation is probably the most complex that we have seen in the tax field.

I, like Mr. Goldstein, have tried to stay away from it as much as possible and I get somebody else in my office to do it because it is an absolute nightmare.

It was borne out of a desire to protect the interest of employees, which obviously is a laudable desire, but I'm afraid that its complex requirements and the severe penalty which it imposes in the event people make mistakes, make it counterproductive in the case of many small employers. They are going to say either "we can't afford to establish a plan," or they are going to say "let's get rid of the plan that we've got" in order to avoid having to cope with this massive complexity.

I think some attention is needed rather soon on this to avoid a drop in the number of retirement plans available in this country.

Finally, Mr. Chairman, I'd just like to say that small business needs a champion. It doesn't have any ready-made champions, but this committee has served as its champion.

I think you have focused on the issues that need consideration, and you have persisted in your efforts, maintained the pressure that is necessary to insure that something is done about it.

You've got on your agenda as outlined by Senator Nelson some of the most fundamental issues that are affecting the future of small business.

I think what is needed is more of the kind of activity that you have conducted. I commend you for your efforts and just hope that you will keep it up.

Thank you, Mr. Chairman.

Senator NELSON. Thank you very much, Mr. Asbill.

[The prepared statement of Mr. Asbill in full follows:]

Statement by Mac Asbill, Jr.
Before Senate Select Committee on Small Business and the Financial Markets Subcommittee of the Senate Finance Committee
November 13, 1975

Mr. Chairman, and members of the Committee and the Subcommittee --

My name is Mac Asbill, Jr. I have been engaged as an attorney in the practice of tax law in Washington for over 25 years. During that period, I have represented a number of businesses, small, medium and large, in connection with their federal income tax problems. For many years, I have been active in the Section of Taxation of the American Bar Association, an organization containing approximately 17,000 lawyers interested in tax practice, and in 1971-72 I was Chairman of that organization. As an officer of the Section of Taxation, I had the pleasure over the course of several years of working with the Staff of the Select Committee, and particularly with Herb Spira, in an effort to improve the tax laws, and the administration of those laws, relating to small business. Together we worked on such matters as legislation, forms, and the Tax Handbook for Small Business. I do not appear today as a representative of the Section of Taxation, however, but rather as an interested practitioner who is concerned about the impact of federal taxes on small businesses, and

who appreciates the efforts of the Small Business Committee and the Financial Markets Subcommittee in this area. I welcome the opportunity to address you briefly on this subject.

The Senate Small Business Committee has been directly responsible for some significant legislation granting a measure of tax relief to small business. But even more important, in my view, it has succeeded in focusing the attention of Congress and the Administration on the plight of small business under our existing tax laws; it has identified the major areas where relief is appropriate; and it has initiated in depth studies of some of these areas which, hopefully, will lead to enlightened and comprehensive legislation. It might be helpful, as a guide to possible future action by the Committee, to review briefly what it has already done.

The underlying theme of the Committee's legislative recommendations has been to "provide a seed from which meaningful small business tax reform can spring, and a framework from which a more equitable free enterprise tax system can be built." (Compilation on Small Business Tax Reform, 1970-74, Select Committee on Small Business, U. S. Senate, July 25, 1974, p. 3.) Thus, for example, S. 1098, the Small Business Tax Simplification and Reform Act of 1973, which was the successor to earlier similar bills, was

offered, in the words of Senator Bible as "a vehicle for the systematic consideration of the Tax Code from the small business viewpoint." It is useful, I believe, in assessing the contribution of this Committee, to focus on some of the provisions of that bill. Its eight Titles indicate the scope of its coverage. They covered simplification, adjustment of tax rates, provisions to encourage establishment of small businesses, provisions to assist the growth of small businesses, provisions relating to partnerships, those relating to Subchapter S corporations, business development corporations and, finally, the preservation of small business independence.

Under Title I the bill would have established an intra-governmental committee to study on a permanent basis tax simplification for small business. The crying need for such simplification is evident to anyone who represents small business in federal tax matters. The bill would also have established in the Treasury Department an Office of Small Business Tax Analysis to study on a continuing basis the impact of taxes on small business. It would have required a study of simplified depreciation policy and equalization of the treatment of retirement plans as between incorporated and unincorporated small business enterprises.

I believe the most significant feature of the approach taken in Title I of this legislation was its recognition

62-209 O - 76 - 46

of the need for a systematic approach to the problem of simplification. I had the pleasure last summer of participating in a panel discussion before the Ways & Means Committee on the general subject of simplification. It was the conclusion of our panel that if basic simplification is ever to be achieved, a systematic, continuing, long-range approach to the problem is required. It was our view that perhaps the best organizational structure for this purpose would be a newly created separate branch of the Staff for the Joint Committee on Internal Revenue Taxation which would be responsible for in depth consideration of basic simplification and which would be relieved of responsibility for day-to-day legislative matters. Whether such a mechanism is preferable to an intra-governmental commission such as that provided for in S. 1098, is open to debate. What is not debatable, I think, is the fact, recognized by the drafters of S. 1098 as well as by our panel on simplification, that some permanent on-going organization is required to study the problems of simplification and to make recommendations on them if any significant progress is to be achieved.

I might pause to say that a number of the specific provisions in S. 1098 have their counterparts in legislative recommendations which have been approved from time to time by the Section of Taxation of the American Bar Association.

These include provisions relating to the amortization of organizational expenses of partnerships; simplifying and liberalizing depreciation methods for small business; increasing the minimum accumulated earnings credit; permitting amortization of expenses incident to the issuance of stock; making partnerships more workable and decreasing the extent to which they can be a trap for the unwary; liberalizing certain of the provisions relating to electing small business corporations under Subchapter S; and eliminating the discrimination against self-employed individuals and against closely-held corporations with respect to qualified pension and profit-sharing plans.

The recommendations in S. 1098 formed the basis for a great deal of input into the Ways & Means Committee's deliberations in 1973 and 1974 on the general subject of tax reform. The work of the Senate Small Business Committee in this regard stimulated interest in other areas. Thus, for example, Congressman Chamberlain and eight other members of the Ways & Means Committee in 1973 introduced H.R. 14837, the Small Business Tax Relief Act of 1974. This Act provided for increasing the investment credit from 7% to 10% on the first $20,000 of qualified investment, for increasing first-year depreciation, for simplifying the LIFO inventory method insofar as it applied to small businesses, and for increasing the loss carry-forward from 5 to 10 years. Several

of these suggestions were tentatively approved by the Ways & Means Committee as part of its 1974 tax reform package. Other provisions in S. 1098 were similarly approved, including the increase in the minimum accumulated earnings credit, a provision relating to the close of a partnership taxable year upon the death of a partner, and a provision liberalizing certain of the Subchapter S rules.

As all of us are aware, however, time pressures in the waning days of the last Congress prevented the passage of the Ways & Means tax reform package. Instead, in early 1975, that Committee reported out H. R. 2166 which later became the 1975 Tax Reduction Act. Since that bill did not give adequate recognition to certain of the problems of small business, Senator Nelson and his colleagues introduced S. 1119, the Emergency Small Business Tax Reduction Act of 1975, which was considered by the Finance Committee in conjunction with its consideration of the Ways & Means Committee bill. S. 1119 contained a number of provisions relating to capital recovery and tax rates which would have been of considerable assistance to small business. Not all of these provisions were acceptable to the Finance Committee. However, a number of them were, and three of them found their way into the final legislation in one form or another. These were an increase in the accumulated earnings

minimum credit from $100,000 to $150,000, a temporary reduction of normal tax rates on the first $25,000 of corporate income from 22% to 20%, and a temporary increase to $100,000 in the dollar limit upon used property qualifying for the investment credit.

Thus, it is clear that this Committee made its presence felt, largely as a result of the extensive work and study which it had conducted in recent years, and particularly during 1974-75, and because of its persistence in calling to the attention of the tax-writing committees the reed for relief for small business.

This brings the story down to the summer of 1975 when Senators Nelson and Bentsen appeared before the Ways & Means Committee in connection with the renewed activity of that committee on the subject of tax reform and urged again favorable consideration of tax relief for small business. They recommended that the temporary relief granted by the Tax Reduction Act of 1975 be made permanent (and they introduced S. 2149 to accomplish that result); that lower rates be applied to small and medium sized businesses in recognition of the fact that they do not have access to public capital markets; that capital recovery provisions of the Code be greatly simplified insofar as smaller businesses are concerned; that the tax burdens on the employment of labor (i.e., the reporting and deposit

requirements) be reduced; and that the tax-writing committees study the long-term effects of tax legislation (including the various estate tax provisions and the provisions relating to corporate reorganizations and adjustments) on industrial combinations and on the ability of a small business to remain independent upon the death or withdrawal of its founder.

Your Committee did not stop with these recommendations. As late as last month, Senator Nelson announced that you were studying a comprehensive estate tax reform proposal which would mitigate the impact of death taxes upon small businesses; that you were at work on a proposed simplified depreciation and capital recovery system; and that you were studying the impact of the Pension Reform Act (ERISA) upon small business.

Your recommendations in the summer and fall of this year with respect to tax reform designed to aid small business have been far-reaching and fundamental in nature. They provide a checklist of items which certainly deserve the most careful consideration by the tax-writing committees. I would like to comment briefly on a few of those recommendations which relate to the need for simplification.

Your Committee has reocgnized that, particularly in the case of small businesses whose limited resources cannot always obtain the necessary technical and professional assistance, undue complexity is itself an inequity. It imposes

unfair burdens on taxpayers, burdens which they should not have to bear. While the need for simplification is great in virtually every aspect of our tax laws, it is particularly urgent in the case of small businesses. I hope you will continue your efforts to see that it is achieved. Unless it is achieved, I fear that voluntary compliance by a substantial portion of the taxpaying public will suffer.

A good example of the need for simplification is afforded by those provisions of the law and regulations dealing with capital recovery. Your Committee has recognized that many of these provisions are simply too complicated to be of much use to many small businesses. The asset depreciation range system instigated several years ago is helpful to many substantial businesses, but few small businesses can cope with its complexities. Some simpler, easier method is necessary. Senator Nelson has referred several times to the newly formed Small Business Advisory Committee which the Commissioner of Internal Revenue has established to assist him in dealing with the problems of small business. My law partner, Mr. Randolph Thrower, former Commissioner of Internal Revenue, is coordinator of that Committee. He advises me that one of the committee's prime concerns is consideration of capital recovery systems which will be comprehensible and usable by small business.

That Advisory Committee has also spent a considerable

amount of time on another problem identified by Senator Nelson -- the last manifestation of complexity to which I shall refer -- and that is the impact of new pension legislation on small business. As you undoubtedly know, that legislation is probably the most complex that we have seen in the tax field in many a day. It was born out of a desire to protect the interest of employees -- a laudable objective. But I fear that its complex requirements and severe penalties may make it counter-productive in the case of many small employers who may decide to terminate existing retirement plans or not to adopt new ones just because they are unwilling to foot the cost and the inconvenience of compliance with the myriad requirements of the new Act. Prompt action is warranted, not to give tax "relief" to small business, but to encourage small business to adopt and continue retirement plans for its employees.

Small business needs a champion in the tax area. The Select Committee has filled that role admirably. It has focused on the issues that need consideration; it has, through constant and sustained effort, maintained the pressure that is necessary to ensure that such consideration is forthcoming. On your agenda as outlined by Senator Nelson are some of the most fundamental issues affecting the future of small business. What is needed, I submit, is more of the

kind of dedicated persistent effort already exhibited by
your Committee. Keep up the good work!

Senator NELSON. I don't know whether it was so much persistence on our part in the Finance Committee. I think the more practical reason that we got a few things done is because we have six members of the Small Business Committee who are now voting on the Finance Committee, which is always helpful in such matters.

Thank you very much for your very fine presentation.

I think that, if the other members don't object, we will get all the statements presented in the record, and then if there are questions we will ask them at that time, and then if we do not have time to get to the questions, I'm assuming we will send you some questions that you will respond to for the record.

Now, next is Dr. Allen Sinai, director of financial economics, Data Resources, Inc.

Dr. Sinai, your statement will be printed in full in the record. You may present it however you desire. If you can summarize the key points, it would be very valuable, very useful to the committee, and economical on the matter of time.

Go ahead, please.

STATEMENT OF DR. ALLEN SINAI, DIRECTOR OF FINANCIAL ECONOMICS, DATA RESOURCES, INC., AND VISITING ASSOCIATE PROFESSOR OF ECONOMICS AND FINANCE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. SINAI. Thank you, Mr. Chairman.

Probably the best way for me to proceed is to briefly explain and summarize the work that we have been doing at Data Resources on the question of tax incentives, capital formation, and the financial position of business.

It would be helpful if everyone had a copy of the statement since I'll be referring to some of the charts and tables.

I'm not sure that other people have had access to it. There aren't any on the table, so it would be useful—does everyone have a copy?

The perspective that I bring to the question of small- and medium-sized business tax reform is one of the analytical economist rather than a proponent of any tax incentives or a set of tax proposals or as an accountant or as a lawyer.

My interest is in determining the effects of tax policy in an economy-wide context by using the tools of economic analysis.

The crux of our work has been directed at evaluating capital needs and determining the prospects for capital shortages. Capital shortages affect all businesses, large and small, and therefore are certainly of interest.

The nature of the analysis that is required to deal with this question is more broadly based and macroeconomic than it is microeconomic. So I think my testimony will be quite different from the typical testimony that has been presented before the committee.

Nevertheless, the study of the quantitative effects of tax policy on business capital formation, liquidity, and firms' creditworthiness that we have done with the Data Resources model of the U.S. economy should be quite relevant to the questions that concern you.

Now, in the debate over whether a capital shortage threatens the

U.S. economy, virtually all of the participants agree that the financial position of business has steadily deteriorated during the last decade.

The depleted liquidity and balance sheet instability of the business sector have been partially responsible for the weakness in capital outlays since 1974 and the limited access to capital and stock markets by small- and medium-sized businesses. At best, under existing tax laws, the financial condition of business will probably improve over the near term, but still be fragile as the economic recovery proceeds. Without a drastic improvement in business sector liquidity and the structure of its balance sheet, a prolonged expansion would prove to be very difficult.

Thus, a critical question is whether tax reform for business is needed to promote capital formation, to ease the financing of fixed investment, and to improve the liquidity of the business sector. A related issue concerns the benefits and costs of tax subsidies for business in terms of the effects on the overall economy.

In our study, the effects of the following changes on tax policy were considered. First, a permanent increase in the investment tax credit on equipment from 10 to 12 percent; second, a two-stage reduction in the tax rate on corporate profits from 48 to 42 percent, 22 to 19 percent for businesses with incomes between $25,000 and $50,000 and 20 to 17½ percent where earnings are less than $25,000; and third, the institution of an allowance for replacement cost depreciation. The benefits and costs of these policies, in an economy-wide context, are also briefly assessed.

The focus of the study was on the nonfinancial corporate sector so that the effects on small business, the businesses that are proprietorships and partnerships, really could not be determined. But the general conclusions in the study would likely apply to all businesses, and not just nonfinancial corporations.

The method of study is computer simulation of the tax policies with the DRI econometric model of the United States to determine the effects of tax incentives on capital formation, liquidity, and the business balance sheet. Business liquidity and the degree of riskiness in the balance sheet structure of business as evidenced by certain measures, for example, the debt-equity ratio, the maturity structure of debt, the quick ratio, and several others, are analyzed with the model.

Essentially what we do is to put in tax incentives and use the model of the U.S. economy to find out for 1976 to 1980 the effects of these incentives on the balance sheet in terms of the measures that I've mentioned. Alternative simulations which embody the various tax policies were obtained for the next 5 years and compared to a baseline solution of the model in order to determine the impact of the tax incentives.

Let me briefly summarize the conclusions and then turn to some of the tables and charts in the appendix to provide a little more detail.

First, business tax reform would enhance capital formation and the ability of firms to finance new investment at a minimal cost to other sectors of the economy. A higher investment tax credit, reductions in the corporate profits tax, or an allowance for replacement cost depreciation would lower the effective price of capital goods and raise real business cashflow. Thus, the return on new capital formation and availability of finance would be increased.

Second, each tax policy considered stimulates business capital formation and eases the demand for external funds. The liquidity of business improves, the balance sheet becomes less risky, and the creditworthiness of firms is enhanced. This conclusion would hold even more strongly for small businesses which typically suffer greater financial difficulties in times of tight credit conditions.

Third, after the tax incentives are imposed, firms rely more on internally generated funds to finance capital outlays, reduce bank loans and new issues of bonds, and sell more common stock.

The increased cashflow from the tax incentives and modest rises of short-term interest rates are responsible for the decreasing use of external sources of funds. After-tax profits are higher with a tax credit or reduction in the corporate profits tax, thus contributing to an improving climate for equity issues.

Fourth, the most potent tax policy is the reduction of the tax on corporate profits, which increases cashflow by a large amount. The higher investment tax credit has only minimal effects on capital formation since the amount of the increase is small and applies only to producers' durable equipment expenditures.

Fifth, the loss of tax revenues causes a greater Federal budget deficit and increases new issues of Treasury debt. In the absence of accommodating monetary policy, short-term interest rates rise as Treasury requirements for capital have to be met before some offsetting declines in the credit needs of the business sector. The higher short-term interest rates lead to some deposit outflows from financial institutions, a reduction in the availability of mortgage money, and fewer housing starts.

Sixth, the overall performance of the economy is essentially unchanged from the baseline simulation, but business capital spending is a higher proportion of GNP, and residential construction is lower.

The economy is essentially the same, but the mix of the expenditures changes to favor the business sector as against the residential construction sector. Thus, without accommodating monetary policy or any further tax reform, the primary cost of the business tax subsidies is a reduction in housing. Real growth and the unemployment rate do not change. The capital stock of the economy increases and so does potential GNP.

Last, if monetary policy accommodates the larger Federal budget deficit, which is on the order of $3 to $5 billion as a result of the business tax subsidies there are lower costs to the economy of a more liberal tax policy. Interest rates are essentially unchanged, deposit flows and mortgage money remain ample, and the housing sector does not suffer. There is no additional inflation because of central bank accommodation. In fact, the performance of the overall economy is enhanced and the unemployment rate drops slightly. The rate of growth of the narrowly defined money supply, while somewhat higher than without Federal Reserve accommodation, still remains noninflationary.

Let us turn to the appendix for a moment, and get an idea of what these analyses show by looking at a few graphs. These will quickly tell the story.

The first five charts in the appendix show how the liquidity and riskiness of the business balance sheet has worsened since 1965. The

measures in history and also that are forecasted by our model are familiar ones. The first is the ratio of cashflow to capital outlays. The second is the ratio of the debt burden of the nonfinancial corporate sector to its cashflow. The third shows the proportion of total liabilities held in short-term debt. The fourth is the quick ratio, financial assets to short-term liabilities. And the last is the debt-equity ratio.

All of these charts indicate that the fragility of the business sector balance sheet has worsened rapidly since 1965. Each of these measures illustrates something about the liquidity of business and something about their riskiness and creditworthiness. Each of the measures provide some information on the ability of firms to finance their capital outlays and to not get into so much trouble that they might go bankrupt.

The obvious correlation between the pattern in these charts to what is going on in the economy is that inflation rates have steadily worsened since 1965, and in fact inflation is primarily responsible for business liquidity problems since it raises nominal credit requirements, causes higher interest rates, and reduces the real value of cashflow.

The current tax laws have not yet been changed to offset these harmful effects of inflation on business. Now, what would happen to the measures on charts 1 through 5 under each of the tax proposals that I've mentioned the increase in the tax credit from 10 to 12 percent, two-stage reduction in the tax rate on corporate profits from 48 to 42 percent, and an allowance to bring historical cost depreciation more in line with inflation costs.

Charts 12 to 15 indicate the results under each of these simulations of the economy, and there you will see an improvement in each measure of business liquidity and business balance sheet riskiness.

What has happened to business use of external financing under each of the tax policies? In charts 16 to 18 we see that increased cashflow from the tax incentives lead to a reduction in bank loan financing, a reduction in new bond issues, and in chart 18, an increase in new issues of equity.

This means that common stock issues, which have been very difficult for both large and small firms to sell, would be made easier by any of the tax incentives. Actually the one that is—turns out to be the most potent and the one that has the greatest effect is the corporate profit tax reduction in various stages.

What would happen to the economy as a result of these policies? Tables 1 to 3 show increases in business fixed investment. The resulting capital stock of the economy and the ratio of business fixed investment to gross national product are higher for each of these tax incentives. You will note that the effects are delayed, but that by 1977 to 1980 they are quite strong.

There is a range of $1 billion to $5 billion increases for business fixed investment. The capital stock of the economy, both for plant and equipment, rises and the share of gross national product that goes into fixed investment is higher.

In table 2 we see some improvement in the economy as measured in terms of real gross national product. We see an increase in the potential of the economy and we see that there are no inflation costs

of these policies. There is no difference in inflation rates for each of these simulations of tax policies compared with the baseline solution.

What would be the cost of the business tax subsidies in terms of the rest of the economy being harmed? In charts 19 and 20 we see that the Federal budget deficit rises because of the loss of tax revenues from each of the tax incentives. This, of course, forces the Treasury to issue more bonds to finance the deficit. Assuming that the Federal Reserve does not accommodate that deficit, the result is higher interest rates, especially short-term, and that's shown in chart 21 where the 3-month bill rises above what it is in the baseline simulation.

The major effect on the economy of the deficit-induced higher interest rate is to reduce residential construction and in charts 23 and 24 I've pictured the shares going to fixed investment and to residential construction under each of the tax alternatives. The cost, however, is not great in terms of the number of housing starts, e.g., 50,000 housing starts per year for 1 or 2 years.

The cost of the business tax incentives can be avoided by a monetary policy that accommodates the higher deficit and such action will not be inflationary. Tables 3 to 6 present the result of each tax incentive simulation under the assumption that the Federal Reserve Board will keep these rates constant.

The overall conclusion——

Senator ROTH. Can I ask you a question?

Can you explain—I'm not an economist—but you said by our monetary policy we could take care of the impact without any inflationary impact.

Is there a general agreement on that among economists?

Dr. SINAI. It would depend on how much the monetary authorities—how much in the way of reserves the moretary authority would have to provide to maintain interest rates at the same level as before.

The revenue loss to the Treasury from these tax incentives ranges from $2 billion to $5½ billion a year, and the increase in the Federal Budget deficit is about that amount. So we are talking about the Treasury having to issue an additional amount of debt that is not very great. Yet it does push short-term interest rates up.

Now for the Fed to take out the increase in the higher short-term rates, the amount of reserves that is necessary is fairly small and that is why the accommodating monetary policy does not lead to any resurgence of inflation.

If, on the other hand, we were talking about a revenue loss of $20 billion or $30 billion and the monetary authority accommodated that, then the potential of overstimulating the economy and causing inflation would be much greater.

Well, these model simulation tests lead us to an overall conclusion that additional business tax reform can significantly improve capital formation, business liquidity, and the ability of business to finance their activity.

The costs of helping business through the kinds of measures analyzed in the study are minimal and could be almost fully eliminated through the use of monetary policy or other methods of neutralizing the revenue loss to the Treasury.

Senator NELSON. Thank you very much, Dr. Sinai. We appreciate your presentation.

[The prepared statement of Dr. Sinai in full follows:]

TAX INCENTIVES, CAPITAL FORMATION, AND THE FINANCIAL POSITION OF BUSINESS

Statement of

Allen Sinai
Director, Financial Economics
Data Resources, Inc.

and

Visiting Associate Professor, Sloan School
Massachusetts Institute of Technology

prepared for the
Select Committee on Small Business
and the
Financial Markets Subcommittee of the Senate Finance Committee

November 13, 1975

TAX INCENTIVES, CAPITAL FORMATION, AND THE FINANCIAL POSITION OF BUSINESS

by Allen Sinai*

I. Introduction and Summary

In the debate over whether a capital shortage threatens the U.S. economy, most participants agree that the financial position of business has steadily deteriorated in the last decade.[1] The depleted liquidity and balance sheet instability of the business sector have been partially responsible for the weakness in capital outlays since 1974. Furthermore, even in a steadily recovering U.S. economy the outlook for fixed investment, the financing of new capital formation, and the balance sheet of the business sector is uncertain. At best, under existing tax laws, the financial condition of business will improve over the near-term but still be fragile as the economic recovery proceeds. Without a drastic improvement in business sector liquidity and the structure of its balance sheet, a prolonged expansion may prove difficult.

Thus, a critical question is whether tax reform for business is needed to promote capital formation, to ease the financing of fixed investment, and to improve the liquidity of the business sector. A related issue concerns the benefits and costs of tax subsidies for business in terms of the effects on productivity, potential output, real economic growth, employment, prices, interest rates, flows-of-funds, and the expenditures of households or governmental units.

This statement presents some preliminary results from a forthcoming DRI study of tax policy and the potential for a capital shortage in the corporate sector of the U.S. economy.[2]

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*Terry Glomski and Roberta Gerson provided the research assistance for this testimony.

[1]New York Stock Exchange, The Need for Equity Capital, February 1975; B. Bosworth, J.S. Duesenberry, and A.S. Carron, Capital Needs in the Seventies, Washington, D.C.: Brookings, 1975, pp. 58-60; A. Sinai and R.E. Brinner, The Capital Shortage: Near-Term Prospects and Long-Term Outlook, Lexington, Mass.; Data Resources, Inc., August 1975, pp. 17-18, 23-27, 62-67; R. Jones, "Why Business Must Seek Tax Reform," Harvard Business Review, September-October, 1975.

[2]A.F. Brimmer and A. Sinai, "The Effects of Tax Policy on Capital Formation, Corporate Liquidity, and the Availability of Investable Funds: A Simulation Study," to be presented at a joint session of the American Economic Association and the American Finance Association Meetings, Dallas, Texas, December 28, 1975.

Specifically, the effects of the following changes in tax policy are considered: a permanent increase in the investment tax credit on equipment from 10 to 12%, a two-stage reduction in the tax rate on corporate profits from 48 to 42% (22 to 19% for businesses with incomes between $25,000 and $50,000 and 20 to 17.5% where earnings are less than $25,000) and the institution of an allowance for replacement cost depreciation. The benefits and costs of these policies, in an economy-wide context, are also briefly assessed. Finally, some conclusions are drawn about the appropriate mix of fiscal and monetary policy to maximize the benefits from any business tax reform.[3]

The effects of changes in tax policy on the small businesses that are proprietorships or partnerships thus cannot be determined. But the general conclusions would likely apply to all businesses, not just nonfinancial corporations.

The method of study is computer simulation of the tax policies with the 1975 version of the DRI econometric model of the United States. Several features of the DRI model facilitate the analysis. First, an integrated flow-of-funds model for the nonfinancial corporate sector has been developed with equations for capital expenditures, the volume of financing that is needed, and the distribution of this financing between internal funds, short-term debt, bonds, and new stock issues. Second, the business balance sheet is explicitly modeled to provide a framework for analyzing the interrelations between tax policy, business spending, and financial decisions. The equations for business fixed investment utilize an expanded version of the Hall-Jorgenson-Coen rental price of capital that fully reflects tax incentives and changes in

[3]The focus of the study is on the nonfinancial corporate sector of the U.S. economy, which includes both large and small companies. Corporate nonfinancial business comprises all private corporations not specifically covered in financial sectors. It includes holding companies and investment companies on a consolidated basis, and also real estate firms. It is identical with ~~the nonfinancial~~ corporate group shown in the Department of Commerce tables except that it excludes farm corporations. The industry breakdown of the nonfinancial corporate sector is food and beverages, textile mill products, paper, chemicals, petroleum, rubber, stone, plain glass, primary metals, machinery except electrical, electrical machinery, transportation equipment, railroad transportation, transportation except rail and air, air transportation, communication, public utilities, mining, contract construction, services, wholesale and retail trade, insurance, and other durable and nondurable goods.

62-209 O - 76 - 49

the cost of financial capital. The effective price of capital goods, the cashflow, and the debt burden of the business sector have explicit effects on fixed investment. Feedbacks from the balance sheet to business expenditures for plant and equipment, inventories, and payrolls give the real economy a strong response to financial constraints. Third, measures of financial instability and illiquidity have been developed for the nonfinancial corporate sector and can be analyzed through the various simulations to provide a tracking of the financial position of business. Alternative simulations which embody the various tax policies are obtained for the period 1976:1 to 1980:4 and compared to a baseline solution of the DRI model in order to determine the impacts of the tax incentives.

The conclusions are:

1) business tax reform would enhance capital formation and the ability of firms to finance new investment at a minimal cost to other sectors of the economy. A higher investment tax credit, reductions in the corporate profits tax, or an allowance for replacement cost depreciation would lower the effective price of capital goods and raise real business cashflow. Thus, the return on new capital formation and availability of finance would be increased;

2) each tax policy considered stimulates business capital formation and eases the demand for external funds. The liquidity of business improves, the balance sheet becomes less risky, and the creditworthiness of firms is enhanced. This conclusion would hold even more strongly for small businesses which typically suffer great financial difficulties in times of tight credit conditions;

3) firms rely more on internally generated funds to finance capital outlays, reduce bank loans and new issues of bonds, and sell more common stock. The increased cashflow from the tax incentives and modest rises of short-term interest rates cause the decreasing use of external sources of funds. After-tax profits are higher with a tax credit or reduction in the corporate profits tax, contributing to an improving climate for equity issues;

4) the most potent tax policy is the reduction of the tax on corporate profits, which increases cashflow by a large amount. The higher investment tax credit has only minimal effects on capital formation since the amount of the increase is small and applies only to producers' durable equipment expenditures;

5) the loss of tax revenues causes a greater Federal budget deficit and increases new issues of Treasury debt. In the absence of accommodating monetary policy, short-term interest rates rise as Treasury requirements for capital must be met before some offsetting declines in the credit needs of the business sector. Also, the financing of the Federal government sector directly affects the three-month Treasury bill rate. The reduction in the use of external funds by business is distributed between bank loans and bond issues, thus only indirectly affecting short-term money market rates. The higher short-term interest rates lead to deposit outflows from financial institutions, a reduction in the availability of mortgage money, and fewer housing starts;

6) the overall performance of the economy is generally unchanged from the baseline simulation, but business capital spending is higher and residential construction lower as a share of GNP. Thus, without accommodating monetary policy or further tax reform, the primary cost of the tax subsidies is a reduction in housing. Real growth and the unemployment rate are essentially unchanged. The capital stock of the economy rises and so does potential GNP;

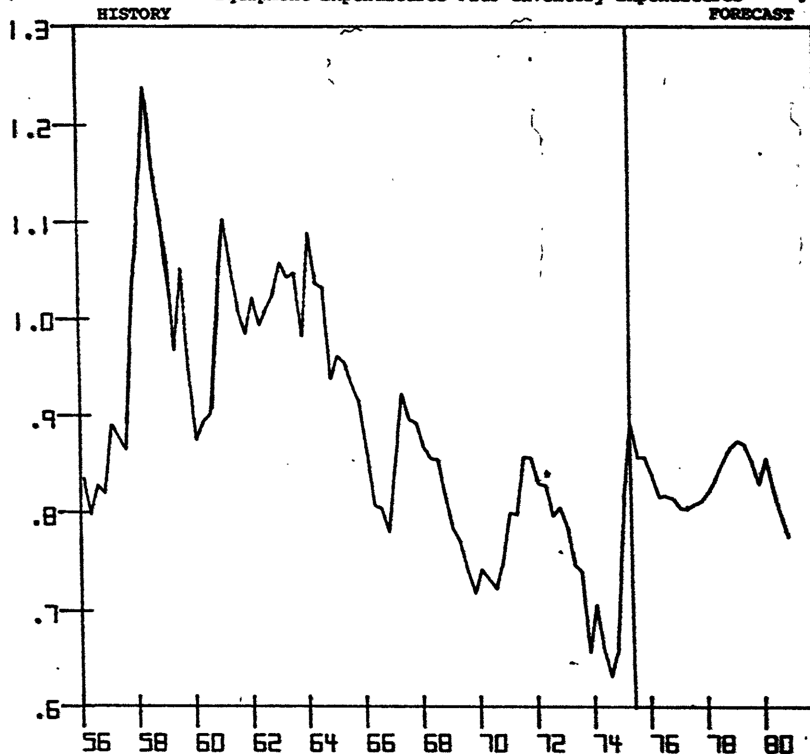
7) if monetary policy accommodates the larger Federal budget deficit, there is little cost to the economy of the more liberal tax policies. Interest rates are essentially unchanged, deposit flows and mortgage money remain ample, and the housing sector does not suffer. There is no additional inflation because of the central bank accommodation; in fact, the performance of the overall economy is enhanced and the unemployment rate drops slightly. The rate of growth of the narrowly defined money supply, while somewhat higher than without Federal Reserve accommodation, still remains noninflationary.

APPENDIX

Results of Simulations

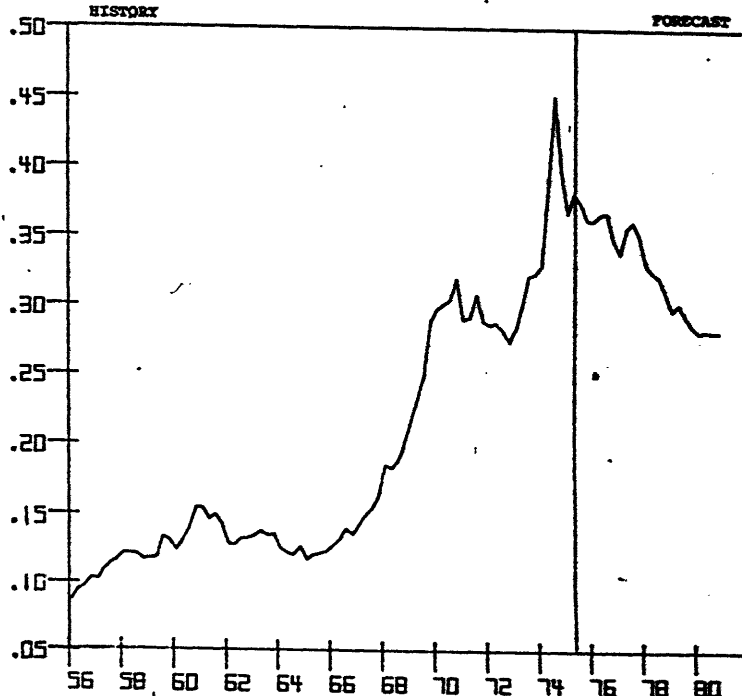
Charts and Tables

Chart 1. - Nonfinancial Corporate Sector: Cashflow/Plant and Equipment Expenditures Plus Inventory Expenditures*



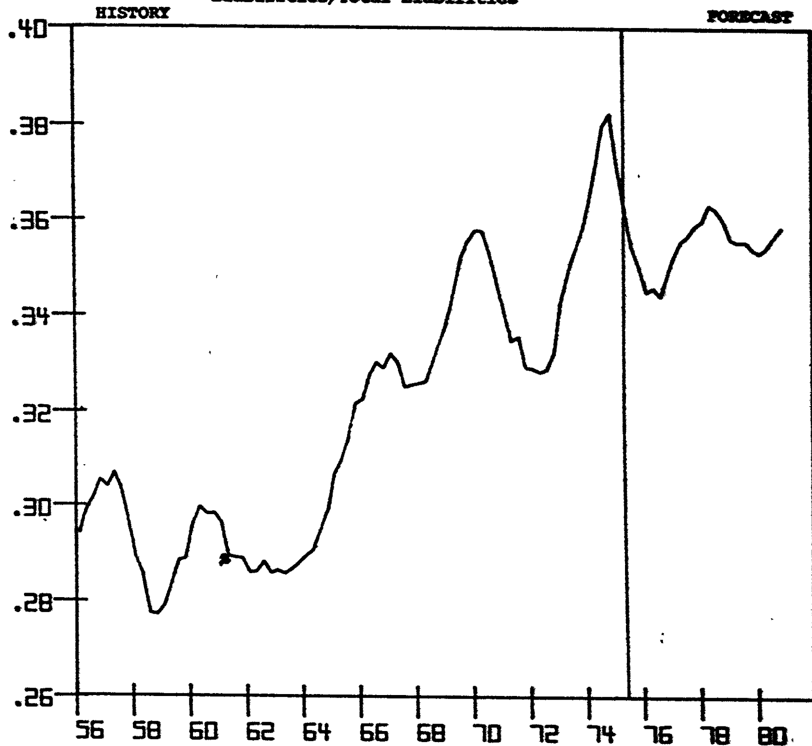
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.
*Cashflow equals the sum of retained earnings, foreign branch profits, capital consumption allowances, and the inventory valuation adjustment.

Chart 2. - Nonfinancial Corporate Sector: Debt Burden/Cashflow*



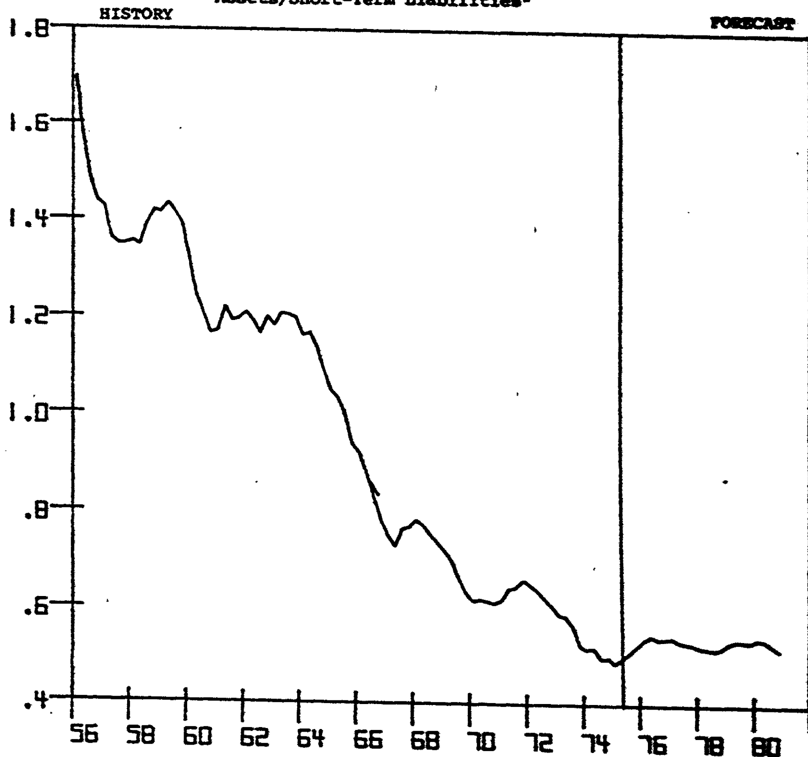
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.
*Debt burden equals the sum of the weighted average of past new issue rates*the past level of bonds, the weighted average of past prime rates* the past level of bank loans, and the weighted average of past 4-6 month commercial paper rates*the past level of open market paper. Cashflow equals the sum of retained earnings, foreign branch profits, capital consumption allowances, and the inventory valuation adjustment.

Chart 3. - Nonfinancial Corporate Sector: Short-Term Liabilities/Total Liabilities*



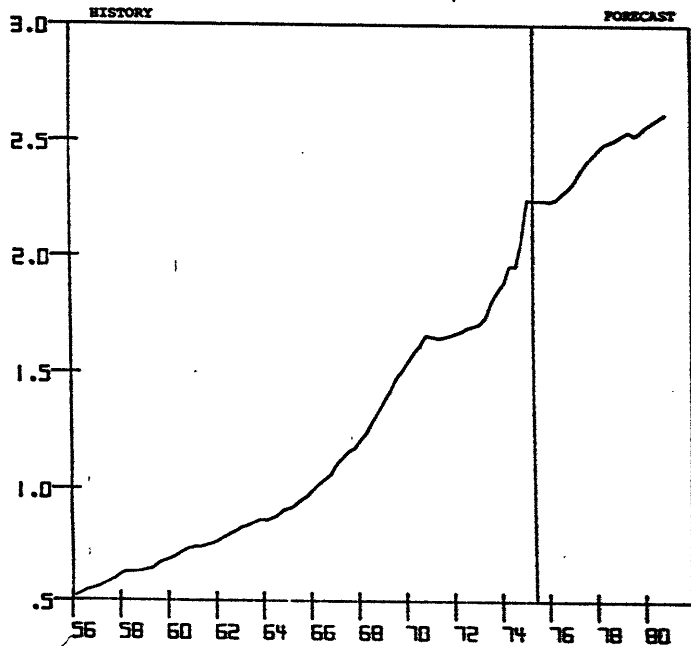
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.
*Short-term liabilities are the sum of bank loans, open market paper, finance company loans, and U.S. Government loans. Total liabilities are the sum of short-term liabilities, corporate bonds, and mortgages.

Chart 4. - Nonfinancial Corporate Sector: Financial Assets/Short-Term Liabilities*



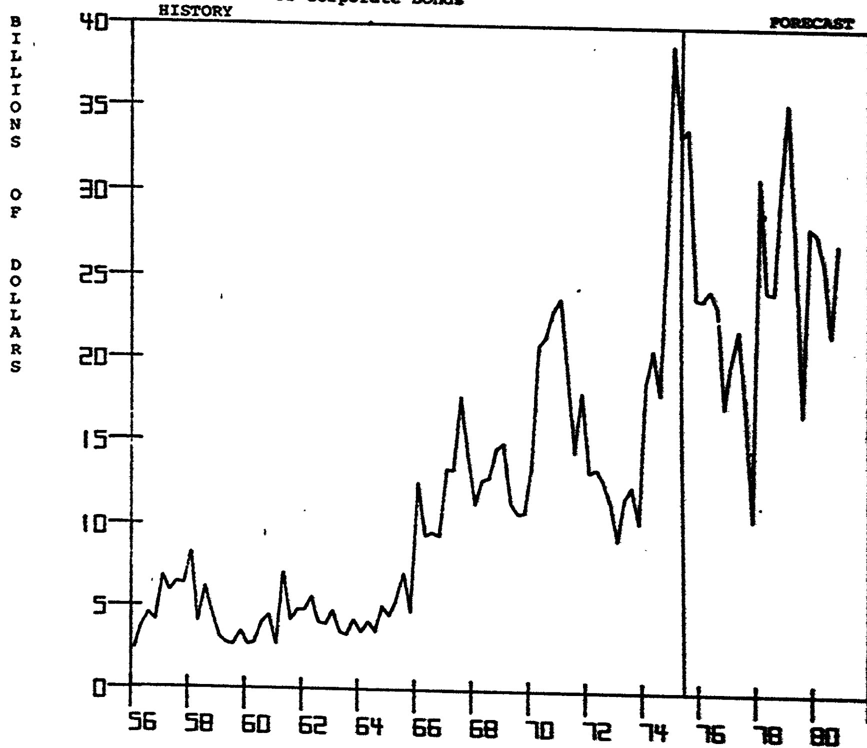
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.
*Financial assets are the sum of money, deposits, and short-term marketable securities. Short-term liabilities are the sum of bank loans, open market paper, finance company loans, and U.S. Government loans.

Chart 5. - Nonfinancial Corporate Sector: Debt/Equity*



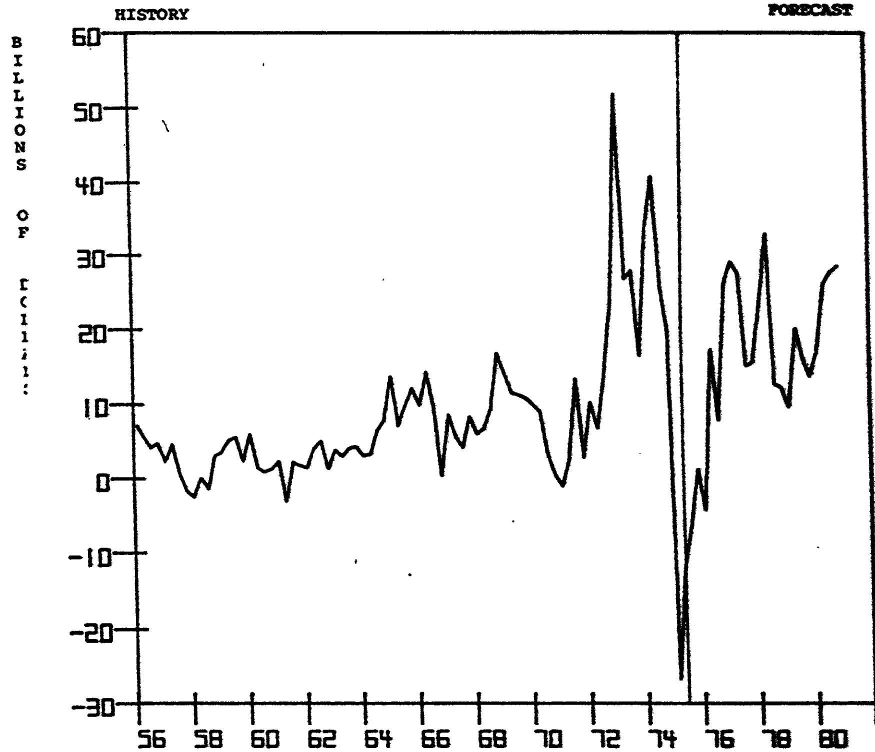
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.
*(1) Debt burden equals the sum of the weighted average of past new issue rates*the past level of bonds, the weighted average of past prime rates*the past level of bank loans, and the weighted average of past 4-6 month commercial paper rates*the past level of open market paper. Cashflow equals the sum of retained earnings, foreign branch profits, capital consumption allowances, and the inventory valuation adjustment.
(2) Debt equals the sum of bank loans, mortgages, bonds, open market paper, finance company loans, and miscellaneous liabilities. Equity equals the sum of the outstanding level of stock and undistributed corporate profits.

Chart 6. - Nonfinancial Corporate Sector: New Issues of Corporate Bonds



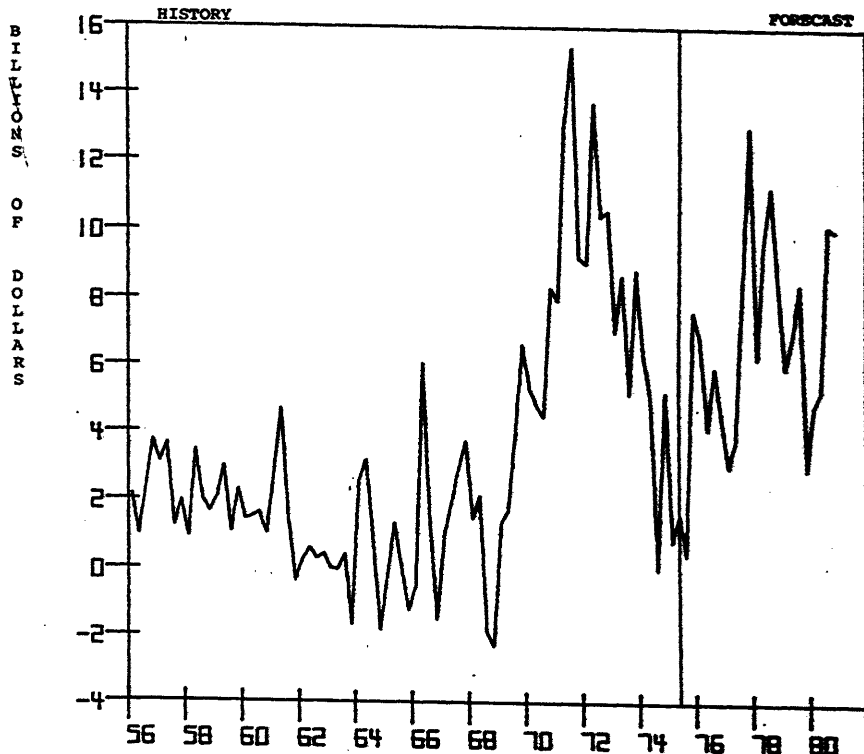
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.

Chart 7. - Nonfinancial Corporate Sector:
Change in Bank Loans



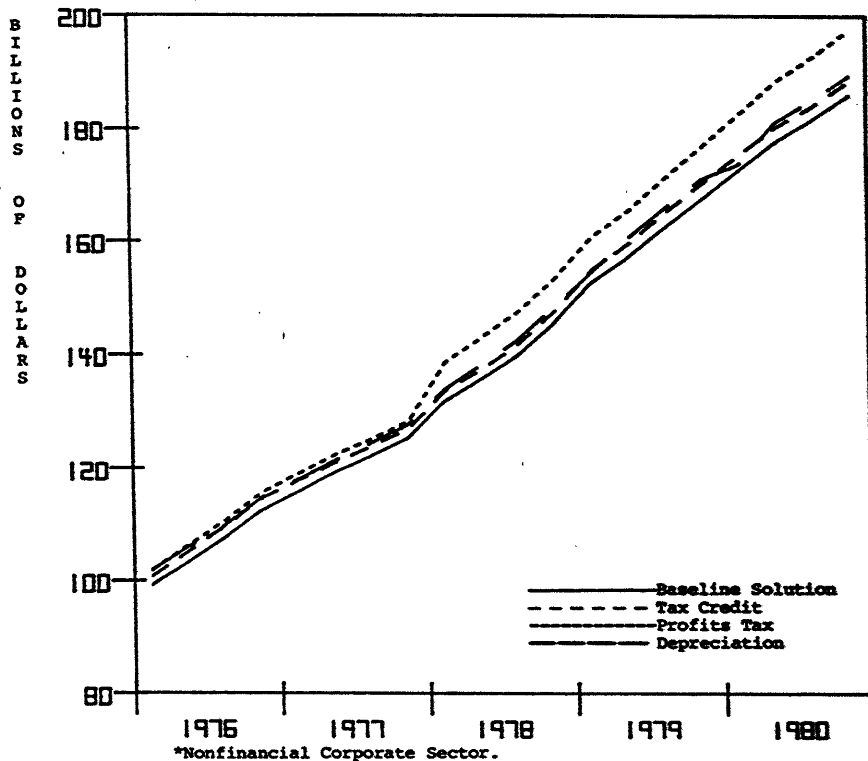
Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.

Chart 8. - Nonfinancial Corporate Sector: Net New Share Issues



Sources: Federal Reserve Board, Flow-of-Funds, DRI Baseline Solution.

Chart 9. - Effects of Tax Incentives on Cashflow*



*Nonfinancial Corporate Sector.

Chart 10. - Effects of Tax Incentives on Rental Price of Producers' Durable Equipment

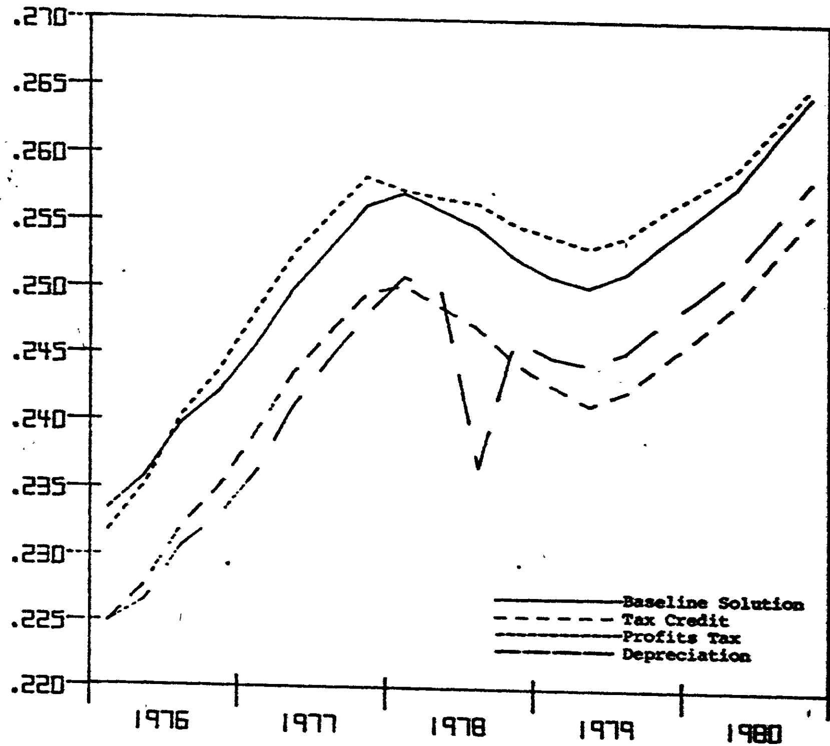


Chart 11. - Effects of Tax Incentives on Rental Price of Private Nonresidential Structures

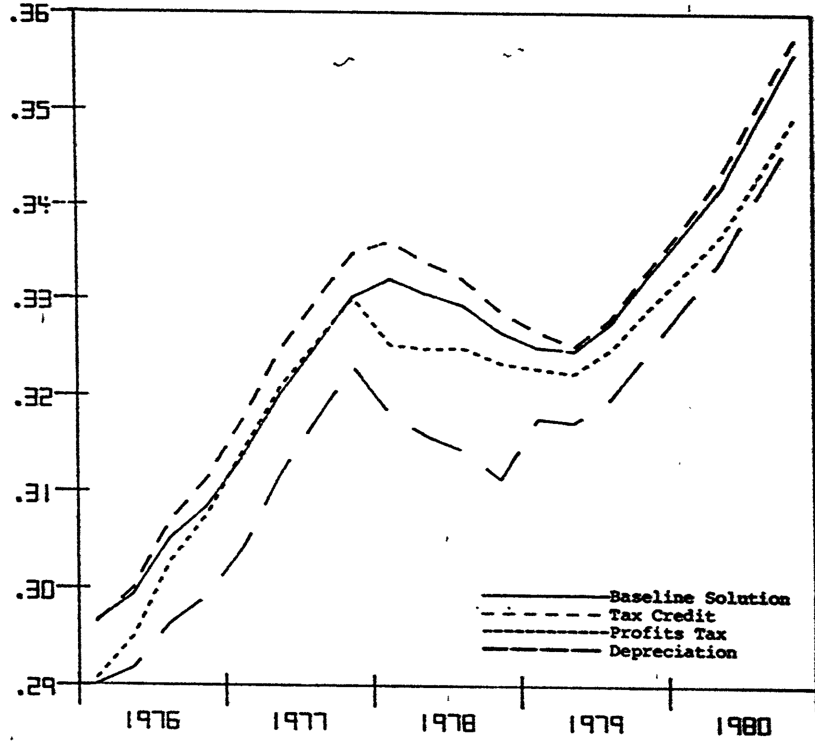
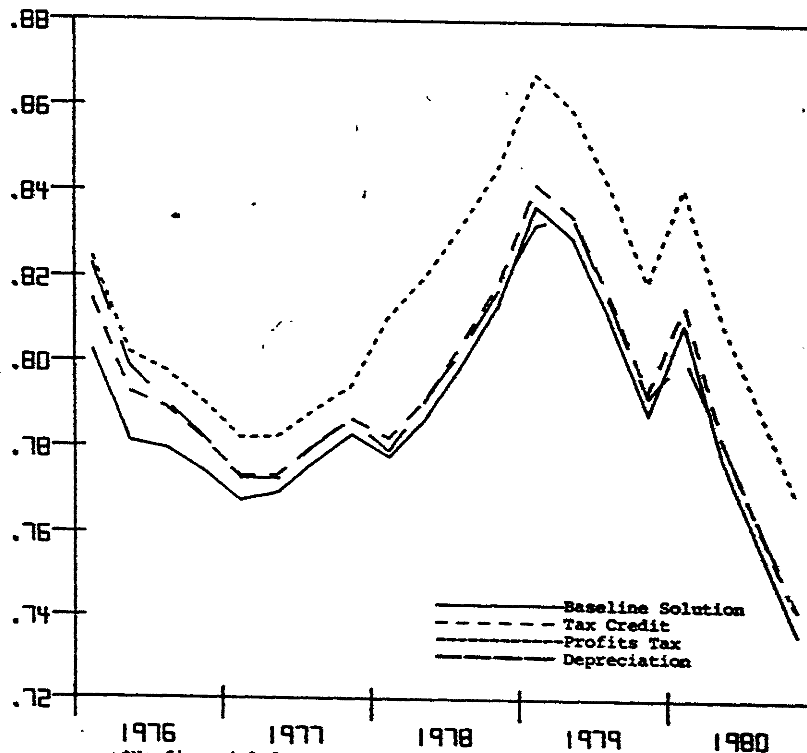


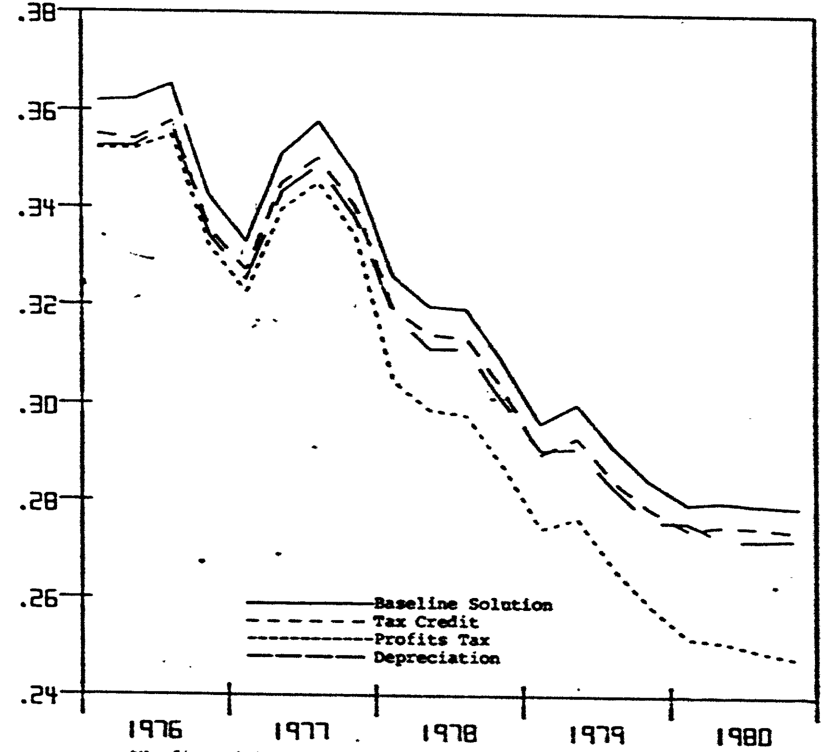
Chart 12. - Effects of Tax Policy on Business Liquidity: Cashflow Relative to Capital Outlays*



*Nonfinancial Corporate Business - See Chart 1 for definitions.

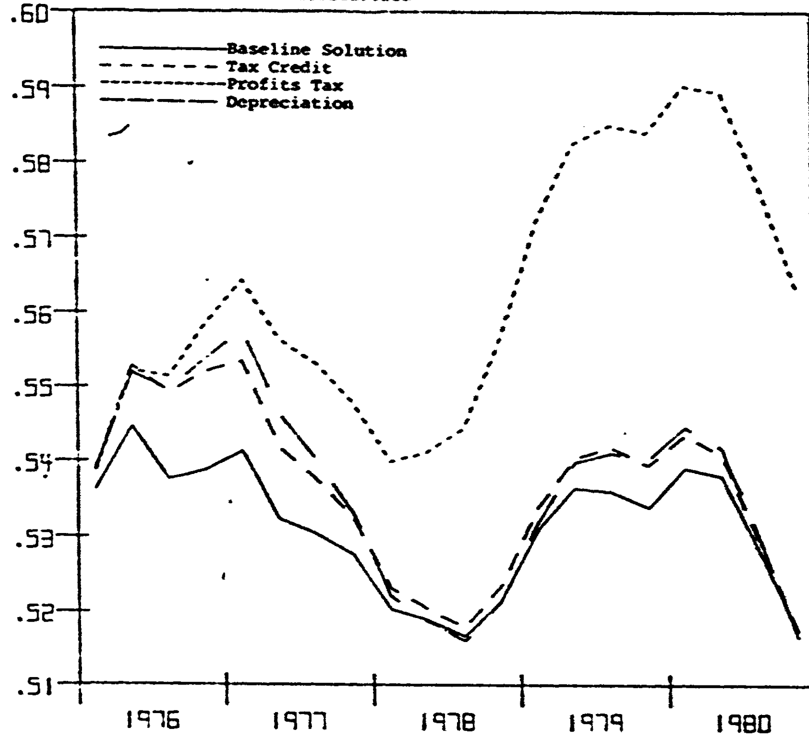
82-209 O - 78 - 80

Chart 13. - Effects of Tax Policy on the Balance Sheet of Business: Debt Burden Relative to Cashflow*



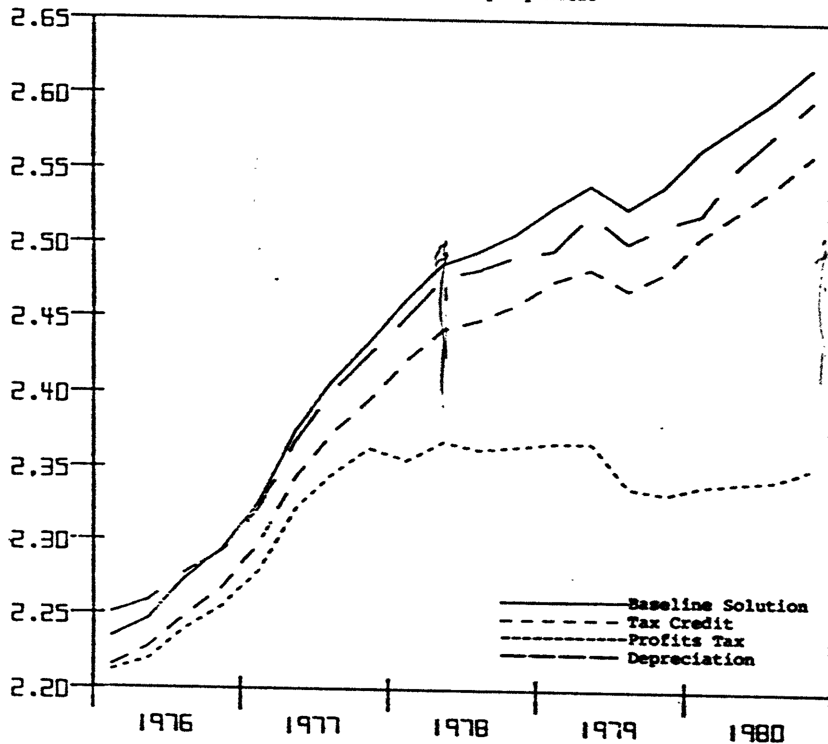
*Nonfinancial Corporate Business - See Chart 2 for definitions.

Chart 14. - Effects of Tax Incentives on the Balance Sheet of Business: Financial Assets as a Ratio of Short-Term Liabilities*



*Nonfinancial Corporate Business - See Chart 3 for definitions.

Chart 15. - Effects of Tax Incentives on the Balance Sheet of Business: Debt-Equity Ratio*



*Nonfinancial Corporate Business - See Chart 5 for definitions.

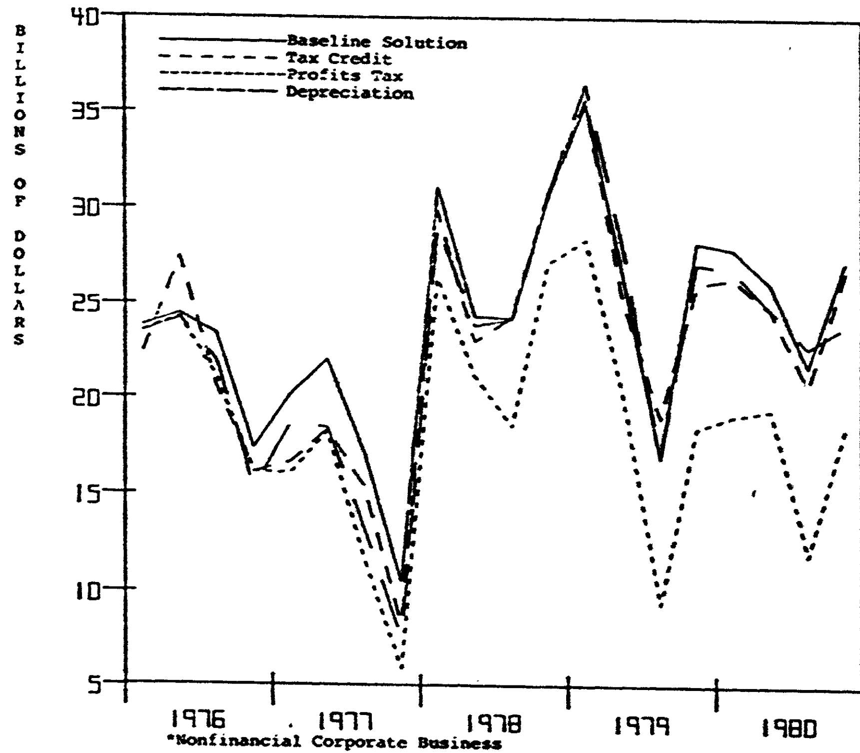
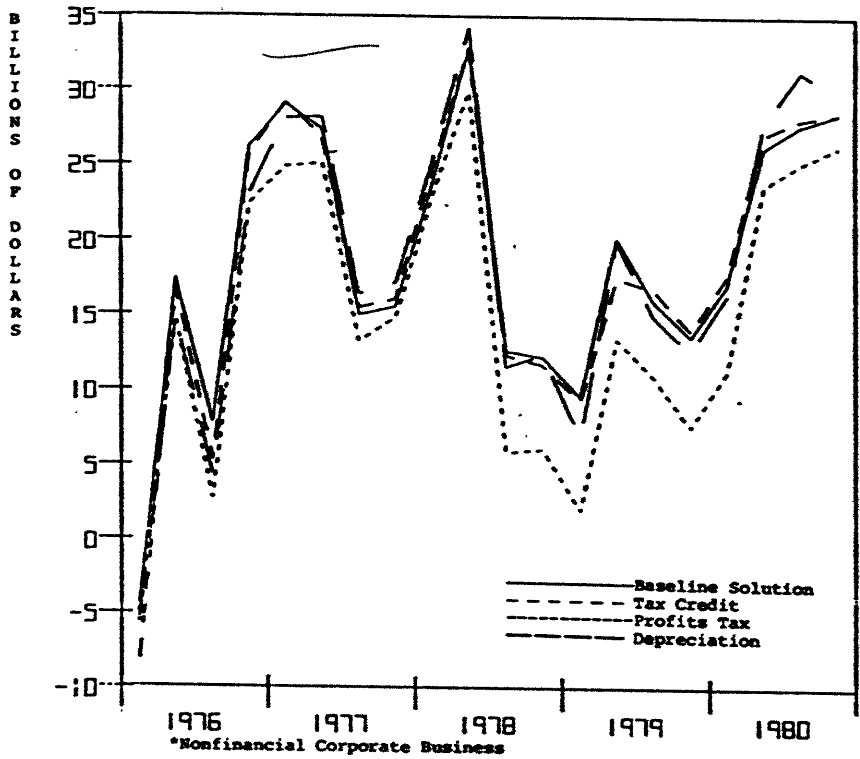


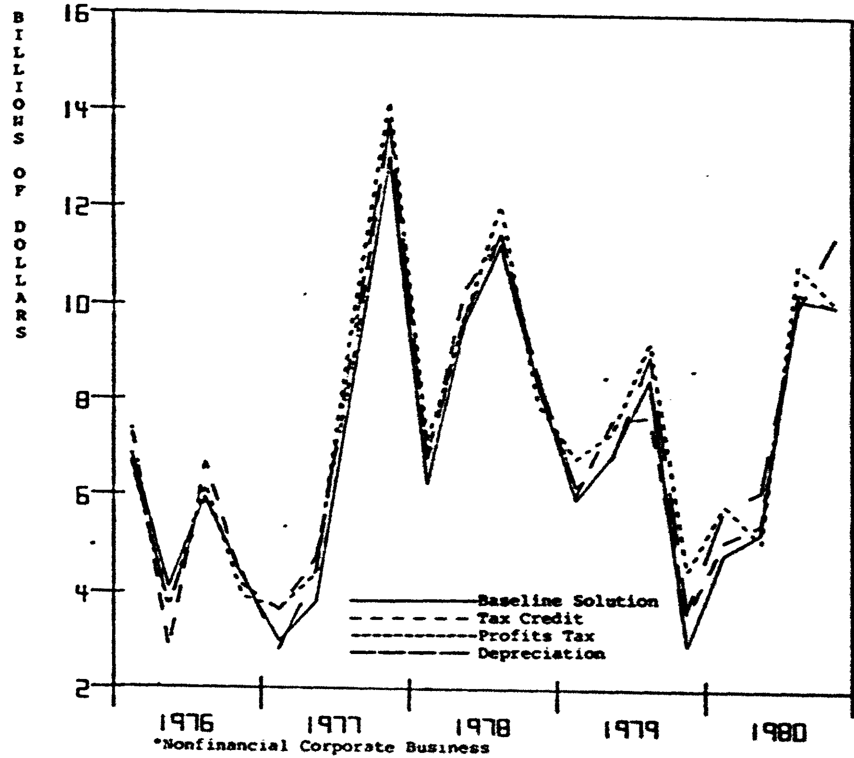
Chart 16. - Tax Incentives and the Financing of Business Capital Outlays: New Bond Issues*
BILLIONS OF DOLLARS
40
35
30
25
20
15
10
5
Baseline Solution
Tax Credit
Profits Tax
Depreciation
1976
1977
1978
1979
1980
*Nonfinancial Corporate Business

Chart 17. - Tax Incentives and the Financing of Business Capital Outlays: Bank Loans*



*Nonfinancial Corporate Business

Chart 18. - Tax Incentives and the Financing of Business Capital Outlays: New Issues of Equity*



*Nonfinancial Corporate Business

Chart 19. - Effects of Tax Incentives on the Federal Government Budget Deficit (NIA) as a Ratio of Nominal GNP

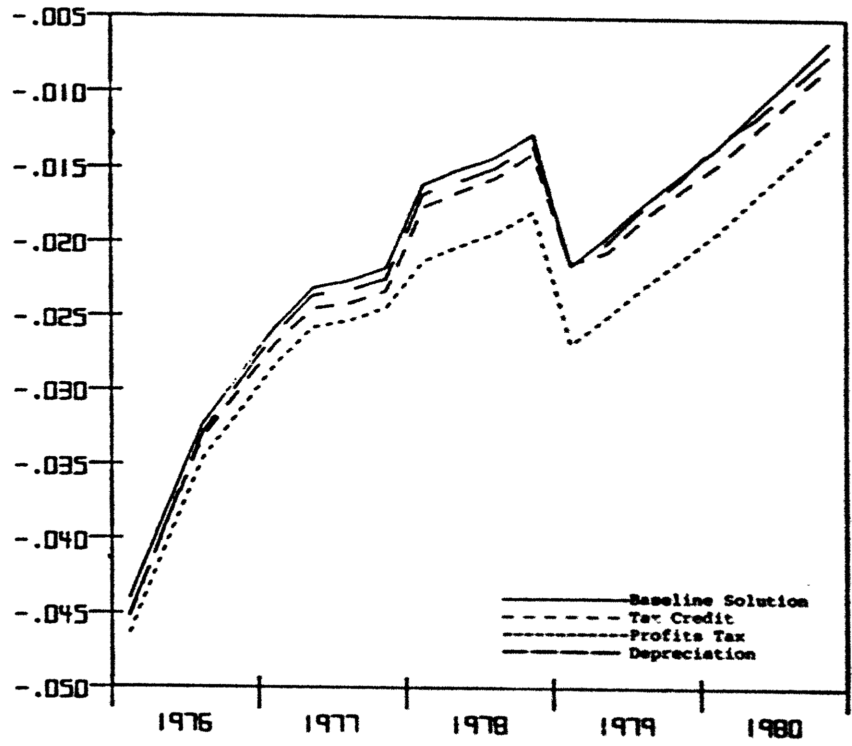
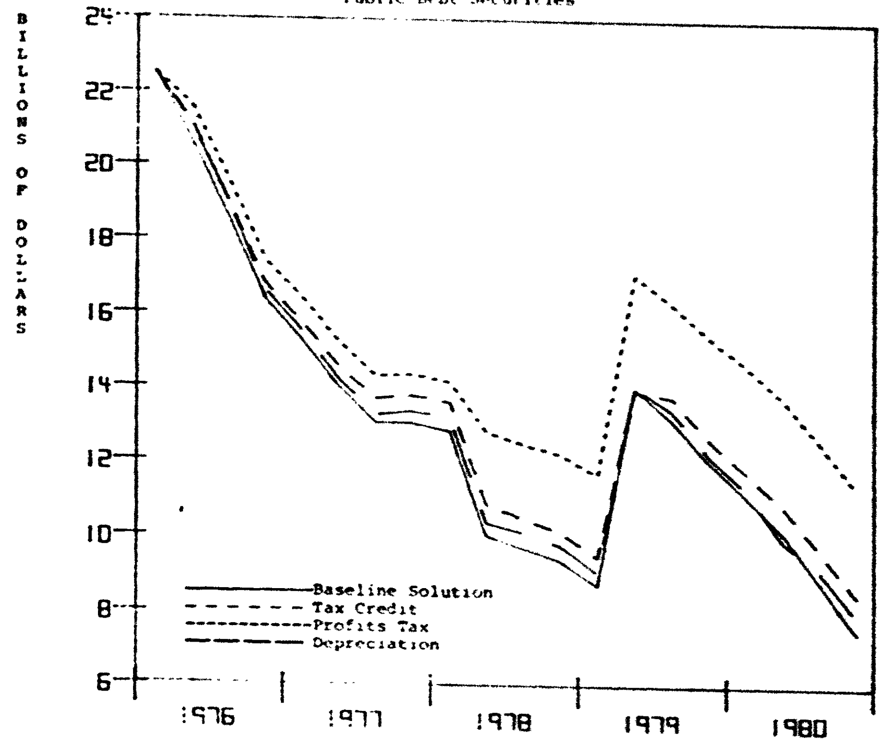
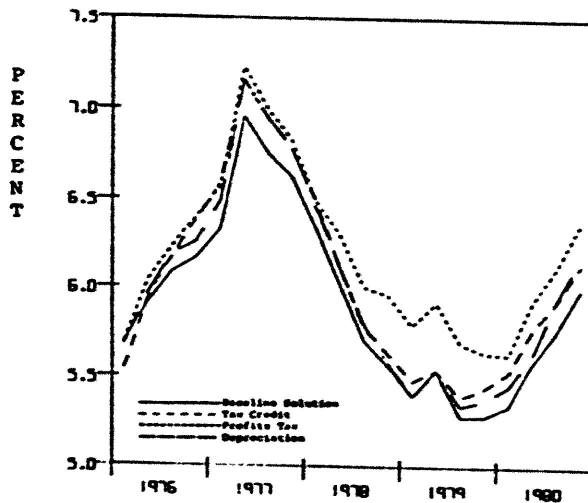
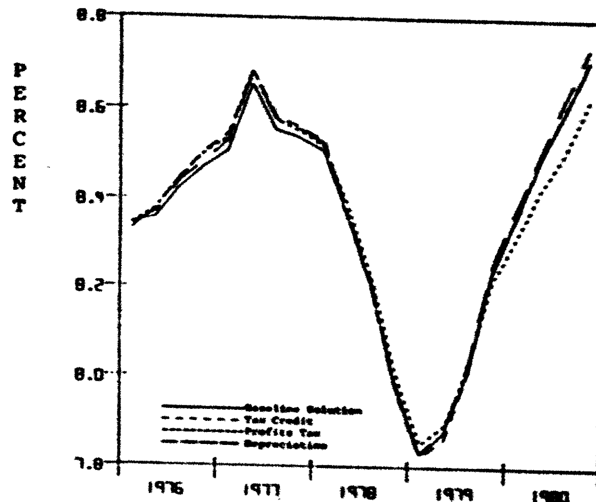


Chart 20. - Effects of Tax Incentives on Federal Government Financing: New Issues of Public Debt Securities



Charts 21.-22. - Tax Incentives and Interest Rates: 3-Month Treasury Bills and New Issues of High-Grade Corporate Bonds*





*nonaccommodating monetary policy

Chart 23. - Effects of Tax Incentives on Fixed Private Nonresidential Investment as a Ratio of Nominal GNP

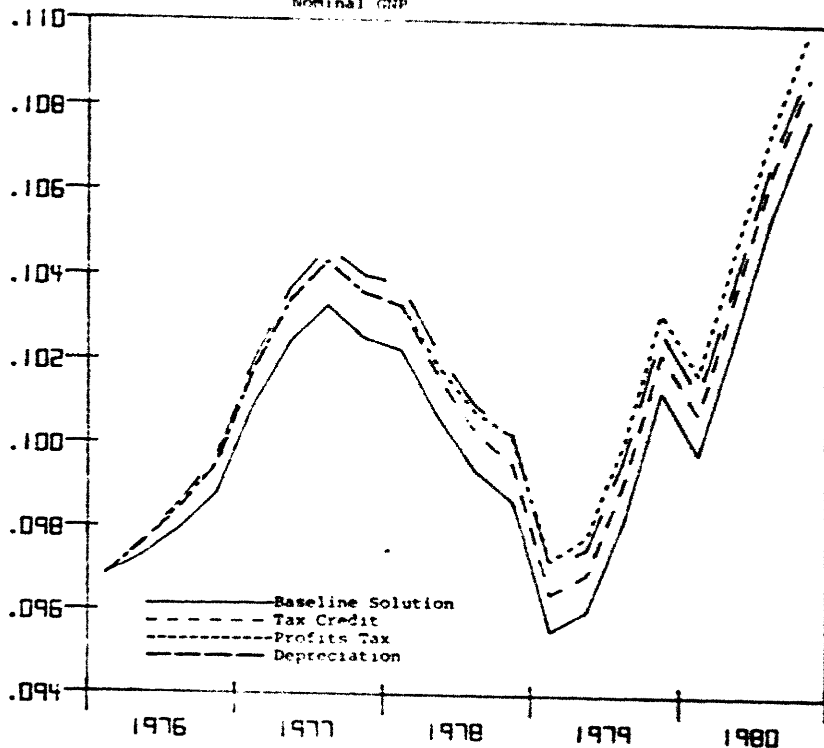


Chart 24. - Effects of Tax Incentives on Residential Construction as a Ratio of Nominal GNP

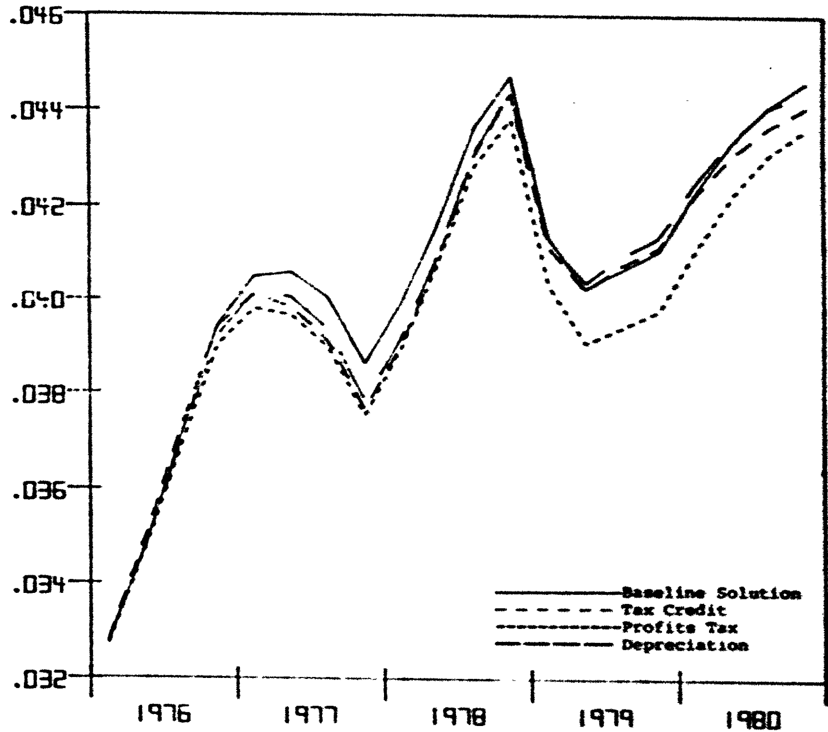


Table 1. - Effects of Tax Incentives on Business Capital Formation
(entries relative to baseline solution)*

	1976	1977	1978	1979	1980
Business Fixed Investment (Bils. of $'s)					
Tax Credit	0.8	1.8	1.9	2.2	2.6
Profits Tax	0.7	1.8	2.7	4.0	5.1
Depreciation	0.9	2.6	3.3	3.8	3.8
Capital Stock-Plant (Bils. of 1958 $'s)					
Tax Credit	0.1	0.2	0.3	0.4	0.5
Profits Tax	0.1	0.4	0.8	1.4	2.1
Depreciation	0.1	0.4	0.7	1.2	1.6
Capital Stock-Equipment (Bils. of 1958 $'s)					
Tax Credit	0.2	0.8	1.6	2.3	3.2
Profits Tax	0.1	0.6	1.2	2.2	3.3
Depreciation	0.2	0.9	1.9	2.9	3.8
Fixed Investment/Gross National Product (%)					
Baseline	9.8	10.2	10.0	9.8	10.4
Tax Credit	9.8	10.3	10.1	9.9	10.5
Profits Tax	9.8	10.3	10.2	10.0	10.6
Depreciation	9.8	10.4	10.2	9.9	10.5

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

Table 2. - Tax Incentives and the Economy
(entries relative to baseline solution)*

	1976	1977	1978	1979	1980
Real Gross National Product (Bils. of $'s)					
Tax Credit	0.8	0.2	-0.1	1.2	0.8
Profits Tax	0.2	-0.1	0.2	0.7	1.4
Depreciation	0.5	0.7	0.6	1.8	1.2
Potential Gross National Product (Bils. of 1958 $'s)					
Tax Credit	0.1	0.6	1.3	1.9	2.6
Profits Tax	0.1	0.5	1.2	2.3	3.7
Depreciation	0.1	0.7	1.7	2.9	3.9
Inflation (Implicit Gross National Product Deflator, %)					
Tax Credit	----	----	----	----	----
Profits Tax	----	----	----	----	----
Depreciation	----	----	----	----	----
M1 Growth (%)					
Baseline	8.5	8.6	7.9	8.4	8.4
Tax Credit	8.5	8.5	7.9	8.4	8.3
Profits Tax	8.4	8.5	7.9	8.2	8.4
Depreciation	8.5	8.5	7.9	8.5	8.3

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

Table 3. – Tax Incentives and Sector Shares of Gross National Product
(nonaccommodating monetary policy)*

	1976	1977	1978	1979	1980
Business Fixed Investment as a Ratio of Gross National Product (%)					
Baseline	9.8	10.2	10.0	9.8	10.4
Tax Credit	9.8	10.3	10.1	9.9	10.5
Profits Tax	9.8	10.3	10.2	10.0	10.6
Depreciation	9.8	10.4	10.2	9.9	10.5
Residential Construction as a Ratio of Gross National Product (%)					
Baseline	3.6	4.0	4.3	4.1	4.4
Tax Credit	3.6	3.9	4.2	4.1	4.3
Profits Tax	3.6	3.9	4.2	4.0	4.3
Depreciation	3.6	3.9	4.2	4.1	4.4
Federal Budget (NIA) Deficit as a Ratio of Gross National Product (%)					
Baseline	-3.6	-2.3	-1.5	-1.8	-1.0
Tax Credit	-3.7	-2.5	-1.6	-1.9	-1.1
Profits Tax	-3.8	-2.6	-2.0	-2.4	-1.6
Depreciation	-3.6	-2.4	-1.5	-1.9	-1.0
Consumption as a Ratio of Gross National Product (%)					
Baseline	63.2	62.9	62.6	62.6	62.1
Tax Credit	63.2	62.8	67.6	62.6	62.1
Profits Tax	63.2	62.8	62.6	62.6	62.1
Depreciation	63.2	62.8	62.6	62.5	62.0

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

Table 4. - Effects of Tax Incentives on Business Capital Formation
(entries relative to baseline solution, accommodating monetary policy)*

	1976	1977	1978	1979	1980
Business Fixed Investment (Bils. of $'s)					
Tax Credit	0.8	2.4	3.7	3.6	3.2
Profits Tax	0.8	2.6	4.8	7.3	9.0
Depreciation	0.9	2.9	4.6	5.2	4.1
Capital Stock-Plant (Bils. of 1958 $'s)					
Tax Credit	0.1	0.3	0.5	0.8	1.0
Profits Tax	0.1	0.4	1.0	1.9	3.0
Depreciation	0.1	0.4	0.9	1.5	1.6
Capital Stock-Equipment (Bils. of 1958 $'s)					
Tax Credit	0.2	0.9	2.1	3.3	4.0
Profits Tax	0.1	0.8	2.0	3.6	5.5
Depreciation	0.2	1.0	2.3	3.7	3.9
Fixed Investment/Gross National Product (%)					
Baseline	9.8	10.2	10.0	9.8	10.4
Tax Credit	9.8	10.3	10.2	9.9	10.5
Profits Tax	9.8	10.4	10.2	10.1	10.7
Depreciation	9.8	10.4	10.2	10.0	10.6

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

Table 5. - Tax Incentives and the Economy
(entries relative to baseline simulation, with accommodating monetary policy)*

	1976	1977	1978	1979	1980
Real Gross National Product (Bils. of $'s)					
Tax Credit	0.8	1.9	2.6	1.5	0.3
Profits Tax	0.4	2.0	3.7	5.2	4.6
Depreciation	0.5	1.7	2.9	2.7	1.2
Potential Gross National Product (Bils. of 1958 $'s)					
Tax Credit	0.1	0.6	1.7	2.8	3.7
Profits Tax	0.1	0.6	1.8	3.6	5.8
Depreciation	0.1	0.7	2.0	3.5	3.9
Inflation (Implicit Gross National Product Deflator, %)					
Tax Credit	----	----	----	----	0.1
Profits Tax	----	----	----	----	0.1
Depreciation	----	----	----	----	----
M1 Growth (%)					
Baseline	8.5	8.6	7.9	8.4	8.4
Tax Credit	8.5	8.7	8.0	8.3	8.3
Profits Tax	8.5	8.7	8.0	8.5	8.4
Depreciation	8.5	8.7	8.0	8.4	8.1

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

83-308 O - 76 - 81

Table 6. - Tax Incentives and Sector Shares of Gross National Product (with accommodating monetary policy)*

	1976	1977	1978	1979	1980
Business Fixed Investment as a Ratio of Gross National Product (%)					
Baseline	9.8	10.2	10.0	9.8	10.4
Tax Credit	9.8	10.3	10.2	9.9	10.5
Profits Tax	9.8	10.4	10.2	10.1	10.7
Depreciation	9.8	10.4	10.2	10.0	10.6
Residential Construction as a Ratio of Gross National Product (%)					
Baseline	3.6	4.0	4.3	4.1	4.4
Tax Credit	3.6	4.0	4.2	4.1	4.2
Profits Tax	3.6	4.0	4.2	4.1	4.3
Depreciation	3.6	4.0	4.3	4.1	4.4
Federal Budget (NIA) Deficit as a Ratio of Gross National Product (%)					
Baseline	-3.6	-2.3	-1.5	-1.8	-1.0
Tax Credit	-3.7	-2.4	-1.5	-1.9	-1.1
Profits Tax	-3.8	-2.5	-1.9	-2.2	-1.5
Depreciation	-3.6	-2.3	-1.4	-1.8	-1.0
Consumption as a Ratio of Gross National Product (%)					
Baseline	63.2	62.9	62.6	62.6	62.1
Tax Credit	63.2	62.8	62.6	62.6	62.1
Profits Tax	63.2	62.8	62.5	62.5	62.0
Depreciation	63.2	62.8	62.5	62.5	62.0

*tax credit: permanent increase in rate of investment credit on equipment from 10 to 12%, beginning in 1976:1

profits tax: two-stage reduction of corporate profits tax rate from 48 to 42% (22 to 19% for profits between $25,000-50,000 and 20 to 17.5% for profits below $25,000) in 1976:1 and 1978:1

depreciation: indexing depreciation at historical cost to inflation rate for plant and equipment

Senator NELSON. We will now hear from Mr. William Penick, chairman of the Federal Division of the American Institute of Certified Public Accountants.

STATEMENT OF WILLIAM PENICK, CHAIRMAN, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PENICK. Thank you, Mr. Chairman.

I'm a tax partner in the firm of Arthur Andersen & Co., and somewhat in line with Mr. Asbill's comments, I've spent quite a period of time in tax practice on the accounting side.

With me here today representing the Tax Division of the American Institute of CPAs is Mr. Malcolm Mintz on my left, who is a member of our executive committee and also a member of Mr. Alexander's Advisory Committee on Small Business, which was referred to earlier, and Joel Foster, who is our tax director, is sitting behind me.

In the short time we have available, I'd like to comment on three of the major areas included in our written statement, and to some extent these touch on points that other speakers have made, but I don't think there will be too much repetition.

I'd like to talk first about capital needs and sources, particularly as it relates to the small business sector.

You've heard from many witnesses in the course of your hearings of the need for capital to keep U.S. business competitive and to develop the productive facilities that we need to create job opportunities for American labor.

These capital needs have been thoroughly described and I won't attempt to repeat what you've already heard. Suffice it to say that we believe our needs will exceed available capital by many billions of dollars over the next few years.

The tax laws by themselves are not going to solve these problems. Nevertheless we think that there are some positive steps that have been taken and some others that should be continued to partially eliminate the problems created by the tax system in this area.

We've concentrated our consideration of capital needs area along three lines. First, the importance of business profits and retained earnings in the creation of capital; second, the significance of capital recovery methods to preserve the capital now available—I might as an aside say that these two are extremely significant to small business.

And, finally, basic changes in our tax system that may eliminate some of the present bias against savings, particularly equity securities.

Let's talk first about the importance of profits in this equation. We think that, to some extent, an increase in the corporate surtax exemption and the reduction of tax rates at lower income levels permits the retention of more earnings in a business, which in turn will help supply some of the capital needed.

We generally approve the action recently taken by the Ways and Means Committee, although we see some merit in further increases in the surtax exemption in recognition of this problem.

We also applaud the objectives of your bill, S. 2149, which was cosponsored by other members of your committee several months

ago. This bill would make permanent the corporate rate and surtax changes adopted earlier this year.

Turning now to capital recovery techniques, we strongly advocate retention of the investment credit and the accelerated depreciation methods.

While neither of these steps solves completely the problems created by inflation, on which I will comment later, nevertheless by permitting quicker recovery of capital invested in plant expansion and modernization, this can preserve some of the capital required to keep business operations going.

Senator NELSON. What do you mean by "accelerated depreciation?" The current law?

Mr. PENICK. The current law. The ADR system, and I'll comment in a moment about the need to consider alternatives to this.

But what I am referring to here is what is in the present law.

While we have not considered specifically further changes in the ADR depreciation system, we do think that attention should be given to this since even our present capital recovery measures fall short of what other major countries are permitting.

Aside from this factor, a point that Mr. Asbill made earlier of the need for a simpler system for smaller business, we would certainly agree with that.

The ADR system, I think, is accomplishing a great deal in eliminating some of the uncertainties in the depreciation area, but without question its rules are complex and compliance with those rules is a burdensome thing.

Turning to the final portion of our capital needs considerations, the multiple taxation of corporate earnings have given us a great deal of concern for many years, and we applaud the initiative taken by the Treasury Department in suggesting that we review the present system where corporate earnings are taxed once at the corporate level and again as dividend distributions to shareholders.

We've had a special task force working on this problem for some time, and hope to have a report completed within the next few months. Copies will be given to your committee when it is completed.

At its worst, our present scheme for taxing corporate profits imposes total taxes of nearly 85 cents on each dollar of earnings that are distributed as dividends. This practice clearly creates a bias against investments in equity securities.

I mentioned earlier the problems created by inflation and this has concerned our division greatly over the last few months.

The very high rate of inflation we experienced last year had significant impact on business earnings—and on the level of business taxation.

While most economic indicators reflected a period of almost no real growth last year, corporate tax collections for the year ended June 30, 1975, were up nearly $5 billion from the previous year.

Individual taxes were up more than $10 billion and a substantial part of this undoubtedly related to the partnership and proprietorship operations.

In our view, the increases in these taxes represent to a great extent a levy on fictitious profits. The two principal factors that create inflated business profits during the period of high inflation are (1) the failure to recognize price level changes in fixed asset costs which

results in inadequate charges for the real capital consumed and (2), the inventory profit caused by inflated inventory prices.

With respect to the underdepreciation of asset costs, a lot of consideration has been given to some form of price level adjustment to asset costs that would permit a more realistic depreciation charge against earnings. Again, we've had a special group studying this matter for some time and while its considerations are not as far along as we would like, we would hope to get their position paper within the next year.

With respect to inventory profits, present tax laws permit the LIFO method of inventory costing which does provide at least partial relief against taxing such profits.

Basically, the LIFO method makes an arbitrary assumption as to the flow of goods through a business under which the most current costs of goods acquired or manufactured will be charged against current revenues.

This tends to understate the carrying value of inventory for balance sheet purposes, but it does present a better matching of current costs against current revenues.

Unfortunately, present LIFO procedures for tax purposes are rather complex and create substantial recordkeeping and management problems for businesses which adopt the LIFO method.

Several suggestions have been made for a simplified LIFO system, particularly for smaller taxpayers, and we think this is an area that deserves serious consideration.

As one of the speakers noted earlier, we were pleased to see in Senator Bentsen's recent bill a requirement that Treasury study this problem.

The final subject I'd like to comment on in my oral remarks is the impact of the estate taxes on small business and farmers.

In our view, this subject has not received the attention it deserves. We realize that extensive studies have been made in the entire area of estate and gift taxes and the Ways and Means Committee has announced that reform in this area would be considered in its next phase of hearings.

Aside from the overall reform of estate and gift taxes, I would like to comment on two fairly specific areas of estate taxes that have significant impact on farmers and small businesses.

The present estate exemption of $60,000 has been in the law for over 30 years. If $60,000 was a fair level of exemption in 1942, the great inflation we have experienced makes it clearly inadequate today.

Several suggestions have been made to increase this to $150,000 to $200,000. We think serious consideration should be given to some substantial increase in this area.

The next area of concern is the liquidity problem that faces small estates when an owner or major shareholder of a small business dies.

We've seen many cases where the business interest was the principal asset of a person's estate, and because of the lack of liquid assets to satisfy estate taxes and settlement costs, the businesses were forced to be sold, sometimes at less than true values.

Section 6166 of the Internal Revenue Code provides partial relief in this area by permitting the payment of estate taxes for certain closely held business interests over a 10-year period.

Furthermore, until recently this provision had coupled with a favorable interest rate—4 percent—that would apply to payments deferred under this section.

With the change in interest rates that was enacted as part of the Tax Reduction Act of 1975, the 4 percent rate was increased to 9 percent, and this has changed dramatically the benefits available under section 6166.

We urge that serious consideration be given to cutting back the interest rate applicable to estate taxes deferred under this section. We propose that it be pegged at a level at least one-third less than whatever normal rates apply to tax deficiencies or deferred tax payments.

Finally, we believe that the present provisions of section 6166 which define the types of situations that are eligible for deferred payments are too restrictive, and we think that consideration should be given to broaden the provisions of this section to permit greater applicability to closely held businesses.

I've been given a note from Mr. Spira that I will comment on in a minute.

There is one matter on which I would like to comment which is not part of my written remarks and is not part of the remarks prepared for oral presentation, and it just came to my attention this morning.

In the area of the imposition of recordkeeping requirements and reporting for small businesses under the ERISA Pension Plan Act, as an example of the complexities that can be created, a few days ago, proposed regulations were issued by the Department of Labor that would eliminate a prior exclusion from having an independent audit made of data furnished under the pension plan reporting requirements for plans with less than 100 employees.

I have not seen the text of the proposal, but I understand it will eliminate that exemption and would now require that independent audits be made of all plans, regardless of the number of employees.

I guess in the self-interest of my profession I should not protest this, but to me it's almost the height of folly to extend it that far.

There are desirable elements in having independent verification made of large plans that affect many people, but I think it is a step backward in implementing the requirements of the ERISA Act.

Mr. Chairman, that completes the remarks I wanted to make. I have a couple of points here from Mr. Spira. I don't know whether you want me to cover these now or perhaps you or Mr. Roth might have questions you might like to ask first.

Senator NELSON. Go ahead if you wish to and the others may want to comment on them.

[The prepared statement of Mr. Penick in full follows:]

AICPA American Institute of Certified Public Accountants

FEDERAL TAX DIVISION

of the

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Statement on Tax Problems of Small Business

Submitted to

The Select Committee on Small Business of the United States Senate

November 13, 1975

FEDERAL TAX DIVISION

of the

AMERICAN INSTITUTE OF CERTIFICD PUBLIC ACCOUNTANTS

Statement
on
Tax Problems of Small Business

Submitted to
The Select Committee
on
Small Business
of the
United States Senate

November 13, 1975

The American Institute of Certified Public Accountants is pleased to present the following comments and recommendations regarding the taxation of small business.

The American Institute of Certified Public Accountants is the sole national organization of professional CPA's. It was established in 1887 and currently has more than 110,000 members.

CAPITAL NEEDS AND SOURCES

Ovor the last few months, many prominent economists and other observers of our economic scene have expressed increasing concern over the capital shortage facing our country. Various estimates of the shortage have been made, and it seems likely that it could amount to many billions of dollars each year.

At your hearings in September 1975, Dr. Norman Ture testified on capital formation and capital recovery. This testimony a.ong

with other testimony you have received emphasizes the importance of capital consumption allowances and retained earnings in preserving and accumulating capital.

The Institute's Tax Division has also been quite concerned with these problems. We have concentrated our considerations in three major areas; (1) the importance of business profits in the creation of capital; (2) the significance of capital recovery methods to preserve present capital; and (3) basic changes in our tax system, such as the integration of corporate and shareholder taxes, to encourage investment in equity securities. In our view, all three of these concepts are relevant to small business and deserve your careful attention.

To some extent, an increase in the corporate surtax exemption and the reduction of tax rates at lower income levels permits the retention of more earnings in a business, which in turn will help supply some of the capital needed. We approve the action recently taken by the House Ways and Means Committee in this regard, although we see merit in further increasing the surtax exemption in greater recognition of this problem. We also agree with the increase in the basic accumulated earnings credit enacted earlier this year. By today's standards, however, even the increased level of $150,000 seems inadequate.

In the area of capital recovery, we strongly advocate retention of the investment credit and accelerated depreciation methods. While we have not officially taken a position with respect to

liberalizing the ADR system (such as providing a 40% range), steps in this direction should be encouraged. Other countries that compete with us in worldwide markets have much more liberal capital recovery methods. Serious consideration should be given to an entirely new capital recovery system for tax purposes.

With respect to the investment tax credit, we were pleased with the decision of the Ways and Means Committee to continue the 10% investment tax credit through 1980. This provides greater certainty to business in planning capital expenditures, and should encourage plant modernization and expansion.

The AICPA Tax Division has a special task force studying the possible integration of corporate and shareholder taxes. Our present system of multiple taxation of corporate earnings creates a bias against investment in equities that concerns us greatly in this period of capital shortage. Our task force is nearing completion of its study, and a full report should be released within the next few months. We will provide your committee with copies of the report when it is finished.

Our tentative conclusions favor reduction in the overall impact of our present dual taxation system, working toward eventual elimination of the system. This can be accomplished by permitting a deduction at the corporate level for dividends paid or at the shareholder level by imputation of corporate tax paid before profits are distributed. Both systems work towards solving the problem. From an administrative viewpoint, it appears that the dividends paid - deduction approach may create fewer problems, although there are arguments on both sides.

THE IMPACT OF INFLATION

The high rate of inflation experienced last year had a significant impact on business earnings and also on the level of business taxation. In spite of a downturn in the economy, and basically a period of no growth in Gross National Product, corporate tax collections for the year ended June 30, 1975, were up $5 billion from the previous year. Individual taxes also increased over $10 billion, and a substantial part of this undoubtedly related to partnerships and proprietorship operations. To a large extent, increases in business taxes represented a tax on "phantom profits."

The two principal factors that inflate business profits are (1) the failure to recognize price level changes of fixed assets, resulting in the understatement of real capital consumed, and (2) the artificial inventory profit element caused by inflated inventory prices.

Recovery of Asset Cost. Where assets are held for long periods of time, the accumulated effects of inflation are particularly acute when they are sold or replaced. The United States Department of Labor Consumer and Wholesale Price Indexes, using 1967 as the base year, indicated the following changes.

Year	Consumer Price Index	Wholesale Price Index
1957	84.3	93.3
1962	90.6	94.8
1967	100.0	100.0
1972	125.3	119.1

In 1974 the consumer price index rose to nearly 148, a rise of about 10 percent for the year. For the first nine months of 1975, it has risen by another 5 percent. The consumer price index has risen almost 70 percent in the last 15 years, and almost 35 percent in the last 5 years.

The impact of inflation is particularly significant in the area of depreciation of business assets. Based on the above price indexes, if a businessman purchased a machine five years ago for $100,000, he would now have to expend $135,000 to replace the same machine. However, his depreciation allowance to offset taxable income is based on his cost of $100,000. His actual replacement cost is not considered, although he may have to replace the asset in order to continue in business. Furthermore, even with present accelerated depreciation methods, he will have substantial capital invested for a rather long period of time, during which erosion due to inflation will continue. This is a simple example, but, it points out a serious problem in this area of capital recovery and emphasizes the need for positive action.

The AICPA Tax Division currently has a task force appointed to study the effects of inflation on depreciation accounting. One objective of this study will be to review the adequacy of current capital recovery techniques. The techniques currently in use may be inadequate in view of today's inflation and, in this regard, we are studying what other countries in similar circumstances have done to alleviate the problems business is faced with in recovering its capital investment.

<u>Inventory Profits</u>. Partial relief from the taxation of inventory profits is available through the LIFO method which is elective for tax purposes. Unfortunately, present LIFO tax rules involve a number of complexities which make it difficult for many small businesses to comply. Substantially increased record keeping is required and the careful management of inventory levels can significantly affect the benefits derived from the LIFO system.

Several suggestions have been made for a simplified LIFO system for smaller businesses, and we urge that serious attention be given to the development of simplified procedures that would achieve the desired benefits without the complexities now involved.

<u>Other Inflation Matters</u>. We have also considered a number of fixed dollar amounts in the Internal Revenue Code. Many have been in the law for a long time and, if appropriate when adopted, should be reviewed in light of today's economic conditions. Our preliminary study indicates there are approximately 100 such dollar limitations in the Code. Most of these need updating to reflect inflation. Several of them are in the current Ways and Means Committee draft tax reform bill (H.R. 10612) - the $50,000 corporate surtax exemption and the $100,000 limit on the amount of used property qualifying for the investment tax credit.

ESTATE TAX CONSIDERATIONS

The impact of estate taxes on closely held businesses is becoming much more significant. Here again, inflation has created problems by increasing values subject to estate taxes, thereby subjecting estates to higher estate tax brackets. The two princi-

pal problems that seem most relevant to small business in this area are (1) the size of the estate tax exemption, and (2) lack of liquidity when a closely held business passes through an estate.

The present exemption of $60,000 has been in the statute for over 30 years. If that level was desirable based on economic conditions existing in 1942, a substantial increase is required if the same objective is to be met today. Several proposals have been made that would increase the exemption to $150,000 or $200,000. We think these should receive serious attention when consideration for estate and gift tax reform commences.

A very real problem of liquidity exists for many small businesses when an owner dies and the business must go through an estate. In many cases sales of businesses are forced by the burden of estate taxes and sometimes the beneficiaries do not realize full value like they would if the business could be continued.

There are several provisions in the statute to mitigate this problem to some extent, including Section 6166 for the deferral of payment of estate tax if certain conditions are met. Unfortunately, when Congress changed the traditional pattern of interest rates to be charged on tax deficiencies and late tax payments, proper recognition was not given to the effect this would have on the deferred payment of estate taxes. Accordingly, effective July 1, 1975, the rate on deferral of tax under Section 6166 increased from the statutory 4% rate to 9%. If the 4% rate was appropriate when the general rate was 6%, it seems to us equitable that whatever statutory rate applies to deficiencies normally should be reduced by at least 1/3 when applied to taxes deferred under Section 6166.

Our Tax Division has also had under consideration a series of position papers on various estate and gift tax issues. These too are nearing completion and copies will be submitted to your committee when they are released.

PROPOSALS CURRENTLY BEFORE CONGRESS

Investment Tax Credit. The Ways and Means Committee in H.R. 10612 has adopted the following changes in the investment tax credit:

- Extension to 1980 of the temporary increase in the credit to 10 percent made by the Tax Reduction Act of 1975.
- Extension also to 1980 of the temporary increase in the maximum amount of used property qualifying for the credit to $100,000.

The Institute supports the general concepts of extending the increase in the investment tax credit. The need for capital investment by business is acute, and the investment credit has proven to be an effective incentive.

Corporate Tax Rates. Under H.R. 10612, the temporary changes made to the corporate tax rate and surtax exemption would be continued through 1977. The first $25,000 of a corporation's taxable income would be taxed at 20 percent and the next $25,000 at 22 percent. The 48 percent rate would apply on income above $50,000.

The Institute agrees that a reduction of the corporate tax rate should provide a stimulus to the economy and will be helpful to small businesses. We feel that the stimulus provided should be reviewed and adjusted periodically as conditions warrant.

Extension of the increased corporate surtax exemption will benefit both the small and the large businesses. While there is no immediate benefit from the increased exemption for corporations whose income is less than $25,000, it attempts to recognize the effects of inflation upon the definition of small business. For a corporation with taxable income of $50,000 or more, the increased exemption means a direct tax reduction of $6,500. The AICPA supports this provision.

OTHER SMALL-BUSINESS TAX PROPOSALS

Part I of Title II of the Ways and Means Committee's six-title tax reform package of 1974 was specifically directed toward lessening the tax burden of small business. It contained five sections (Sections 211-215) which would affect the tax treatment of small business. One of these provisions, increasing the accumulated earnings credit to $150,000, was enacted in the 1975 Tax Reduction Act. The remainder of the items will no doubt form the basis for the Committee's decisions when they take up the subject of small business tax problems in Phase II of their tax reform work. The items they will consider are:

Changes in additional first-year depreciation. With respect to the additional first-year depreciation allowance, the committee would:

- Increase the dollar limit on the amount of property which may qualify for the allowance from $10,000 to $15,000 ($30,000 on a joint return); and
- Eliminate the requirement that the property eligible for the allowance have a useful life of 6 years or more.

<u>Ten-year carryover of net operating losses</u>. In the case of new businesses, the period over which net operating losses may be carried would be increased from 5 years to 10 years during the first 10 years of operation.

<u>Closing of partnership taxable year</u>. The successor in interest of a deceased partner would be able to elect to close the taxable year of the partnership with respect to the interest of the deceased partner as of the date of his death, instead of waiting until the close of the partnership taxable year or the date his interest is sold, exchanged, or liquidated.

<u>Changes relating to Subchapter S corporations</u>. The committee would make four changes dealing with subchapter S (the election of certain small business corporations not to be taxed as corporations).

- <u>Increase in number of shareholders</u>. The maximum number of shareholders which a subchapter S corporation may have would be increased from 10 to 15.
- <u>Certain trust ownership</u>. In three types of situations, trusts would be permitted to be qualified shareholders, in subchapter S corporations: In the case of (1) voting trusts; (2) grantor trusts (where the grantor is treated as the owner for tax purposes); and (3) instances where the holding by the trust is only temporary (e.g., where it passes through a residuary trust to individual beneficiaries).
- <u>Estate of deceased spouse not to be treated as shareholder</u>. When subchapter S stock has been held by a husband and wife, the estate of one of the spouses will not be considered a shareholder for purposes of determining the number of shareholders of the subchapter S corporation.

- New shareholders must affirmatively elect to terminate election. A subchapter S election is to be terminated only upon a new shareholder's affirmative refusal to consent to a continuation of the subchapter S election (instead of upon the failure of a new shareholder to consent to the election).

The Institute endorses the approach by the Ways and Means Committee to provide small business tax relief. Several of the proposed changes are similar to proposals suggested by the Institute in its booklet "Recommended Tax Law Changes," which are attached to this statement as Appendix A.

Our booklet was recently distributed to all members of Congress and contains over 100 recommendations for changes in the existing tax law. Only those recommendations which seem particularly relevant to the tax problems of small business are included in the Appendix. We believe that adoption of these recommendations would alleviate some of the critical problems faced by small business, particularly with regard to "start up" costs and the continuing difficulties encountered in the formation and preservation of adequate capital.

62-309 O - 78 - 52

Selected Items from "Recommended Tax Law Changes"
Submitted in Conjunction With Prepared Statement on
Tax Problems of Small Business
Small Business Committee, United States Senate
November 13, 1975

CONTENTS

Internal Revenue Code Section	Description	Page
Sec. 48	Used Section 38 Property	A-3
Sec. 172	Eight-Year Carryover of Initial Losses	A-4
Sec. 212	Deduction for Preliminary Investigation of Business or Investment Opportunities	A-5
Sec. 248	Deductions for Organizational and Reorganizational Expenditures	A-6
Sec. 303	Distributions in Redemption of Stock to Pay Death Taxes	A-7
Sec. 331	Installment Method Reporting in Section 337 Liquidations	A-8
Sec. 333	Time Securities Considered Held in Section 333 Liquidation	A-9
Sec. 333	Liquidating Distributions Acquired Before December 31, 1953	A-9
Sec. 351	Securities Received in Exchange Transactions Governed by Subchapter C	A-10
Sec. 357	Treatment of Accounts Payable as Liabilities Upon Incorporation of a Cash-Basis Taxpayer	A-11
Sec. 534	Burden of Proof	A-12
Sec. 703	Partnership Organizational and Reorganizational Expenditures	A-13
Sec. 703	Deficiency Elections for Partnerships	A-13
Sec. 706	Closing of Partnership Year	A-14
Sec. 754	Basis Adjustment of Partnership Property for Gift Tax Paid	A-15

Internal Revenue Code Section	Description	Page
Sec. 1244	Qualification as Section 1244 Stock	A-16
Sec. 1371	Treatment of Corporate Joint Ventures	A-17
Sec. 1375	Distributions of Previously Taxed Income	A-18
Sec. 6015	Installment Payments of Estimated Tax by Individuals and Corporations	A-19
Sec. 6166	Extension of Time for Payment of Estate Tax	A-20
Sec. 6425	Quick Refunds (Forty-Five Days) as to Certain Corporate Quarterly Overpayments	A-21

SECTION 48

Used Section 38 Property

Investment credit should normally be allowed to a purchaser in a transaction if the seller sustained an investment credit recapture as a result of disposing of the property in that transaction. [Section 48(c)(1)]

Under existing law, it is not infrequent for one party to a transaction to suffer a recapture of investment credit without the other party to the transaction being allowed any investment credit. The used property limitations were designed to prevent obtaining an investment credit in each of a succession of transactions involving related parties, but were apparently not intended to result in a complete or partial denial of investment credit (subject to the used property dollar limitations) solely because of such transactions.

The recommendation contemplates allowance to a buyer of investment credit in all such transactions, in the maximum amount of the investment credit recaptured by the seller, subject to the used property dollar limitations as to utilization.

SECTION 172

Eight-Year Carryover of Initial Losses

A carryback-carryover period of eight years should be allowed in the case of corporations which have been in existence less than three taxable years. [Section 172(b)(1)]

It frequently happens that new corporations, particularly small businesses, undergo a substantial period of operating losses at the beginning of their existence and may find that the inability to carry back such losses, coupled with the five-year carryover limitation, results in a period insufficient to permit taxable income to reach a level where initial losses can be fully absorbed.

In order to provide relief to new corporations, it is recommended that a combined carryback and carryover period of eight years be provided. Thus, a loss sustained in the first year should be eligible as a carryover for eight years following the loss year; a loss sustained in the second year should be eligible for a one-year carryback and a seven-year carryover, and so forth. This would provide equality of treatment with existing corporations in that an eight-year period would be available to all.

SECTION 212

Deduction for Preliminary Investigation of Business or Investment Opportunities

Expenses paid or incurred by an individual during a taxable year with respect to expenditures incurred in search of a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957, the IRS followed I.T. 1505 (I-2 CB 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constituted a transaction entered into for profit and that upon abandonment of the enterprise the expenses incurred became a loss deductible in the year of abandonment.

I.T. 1505 was based upon Section 214(a)(5) of the Revenue Act of 1921 and related regulations. This section of the 1921 Act corresponds to Section 165(c)(2) of the Internal Revenue Code of 1954, which allows a deduction by individuals for "losses incurred in any transaction entered into for profit, though not connected with a trade or business. . . ."

Revenue Ruling 57-418 (1957-2 CB 143) revoked I.T. 1505 after reviewing the history of the application of the rule and established a new rule that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those which are admittedly deductible where the taxpayer *has* engaged in material activity. See *Charles T. Parker,* 1 TC 709 (1943), distinguished by the IRS in Revenue Ruling 57-418.

There appears to be no equitable justification for limiting the deduction of investigatory expenses to situations where the prospective business or investment was actually entered into and subsequently abandoned. If a taxpayer makes a good faith investigation of a business prospect which is clearly identifiable and incurs expenditures reasonable and necessary thereto, then ordinary standards of equity and fairness should permit deduction of those expenses. The requirement of material activity in the business before deduction of those expenses is permitted places an arbitrary and unbusinesslike burden on individuals interested in development of new economic opportunities.

SECTION 248

Deductions for Organizational and Reorganizational Expenditures

Organizational expenditures should be amortizable free of any election, and such treatment should be expanded to cover stock issuance and reorganization expenses (including stock dividends and stock splits), expenses incurred in mergers and acquisitions, costs of obtaining equity capital, registration and stock listing costs, and similar expenses of partnerships.

Section 248(a) provides that organizational expenses may, at the election of the taxpayer, be amortized over a period of not less than sixty months to be selected by the taxpayer. The regulations require that this election be made in the return for the taxable year in which the taxpayer begins business and that all of the expenditures subject to the election be specifically identified.

The election requirement of Section 248(a) constitutes an unnecessary complication of the Code. The ded ctibility of an item should be determined by the nature of the item rather than by strict compliance with the requirements of an election. Organizational expenses and expenses of a like or similar nature should be deductible over a period of not less than sixty months, free of any election.

In addition, the deduction under Section 248 should be expanded to cover stock issuance and reorganization expenses, including the costs of stock registration and stock listing and the cost of printing certificates, whether for original issue, stock dividends, or stock splits. There should be no statutory distinction between creating the legal entity and its reorganization or recapitalization, however accomplished, nor between the cost of creating the entity and the costs incurred in obtaining the equity capital with which to carry out the entity's purposes, either initially or subsequently.

The scope of Section 248 should be broadened to cover partnerships as well as corporations, since such expenses are incurred by partnerships as well as corporations, and there seems no sound reason for discriminating against them.

Assuming the validity of Revenue Ruling 73-580 (1973-2 CB 86), requiring capitalization of salaries of officers and employees and of other expenses in mergers and acquisitions, it should be made less onerous by allowing amortization of such items under Section 248 to the extent that they would otherwise qualify as organization and reorganization expenses if paid to outsiders.

SECTION 303

Distributions in Redemption of Stock to Pay Death Taxes

The present provisions of Section 303(b)(2)(B), permitting the benefits of Section 303(a) in situations where the decedent's estate includes stock holdings of two or more corporations, seem unduly restrictive. The percentage of ownership as to the stock of each corporation required in order for the 35-50 percent tests to apply should be calculated using constructive ownership rules.

This section of the Code now provides for aggregating the values of stock in two or more corporations if the estate owns more than 75 percent in value of the outstanding stock of each of such corporations. In *Estate of Otis E. Byrd* v. *Commissioner*, CA-5, 388 F2d 223 (1968), it was held that this test applies only to directly owned stock. Thus, it is possible for an estate to own beneficially most of the stock of several corporations and yet not qualify for aggregation of the values, simply because some of the stock might be held by other corporations in the same group. It seems equitable that the constructive ownership rules of Section 318 be applied for determining qualification under Section 303(b)(2)(B). These rules now apply to redemptions under Section 302, and there is no logical reason why they should not also be considered in Section 303 redemptions.

SECTION 331

Installment Method Reporting in Section 337 Liquidations

The installment method of reporting gain should be extended to gain attributable to the receipt of an installment obligation originally received by a corporation in a sale of property under Section 337.

Section 337, which was designed to insure that gain on the sale of corporate property is taxed no more than once, operates in conjunction with the rules under Section 331. The provisions of Section 331 require that property, including installment obligations originally received by the corporation in conjunction with the sale of assets and, in turn, received by shareholders in exchange for stock of the liquidating corporation, be valued at fair market value in determining gain or loss recognized on the liquidation.

The present law does not allow a shareholder receiving an installment obligation upon a complete liquidation to report his gain on the installment method notwithstanding that the obligation was originally received by the liquidating corporation pursuant to a sale of property under Section 337. The only allowance made for the receipt of an installment obligation is consideration given to the terms and maturity date in valuing the obligation. This results in a situation where no gain may be recognized on the corporate level, but a tax will be due on the shareholders level. Substantial taxes may be payable, although liquid assets may not be received. On the other hand, taxes can be deferred by selling the corporate stock on the installment method.

It is recommended that Section 331 be amended to allow a shareholder to report on the installment method that portion of gain on the liquidation of a corporation attributable to receipt of the installment obligation. Satisfaction of the installment reporting rules under Section 453 would have to be met at the time of liquidation. It is anticipated that the recapture of depreciation and investment credit would continue to be taken into account at the corporation level. This recommendation is consistent with the purpose of Section 337 and is more reflective of the economics of a liquidation in which installment obligations are the principal assets distributed to shareholders.

SECTION 333

Time Securities Considered Held in Section 333 Liquidation

The carryover holding period for stock or securities acquired in tax-free exchanges should not be limited only to liquidations which occurred in 1970, but should be made a permanent part of the Code.

Section 917 of the Tax Reform Act of 1969 provides, in general, that for 1970 liquidations only, stock or securities acquired in a Section 351 exchange which had been held by the transferor in any period prior to 1954 are to be considered as pre-1954 property. However, based upon the purpose of Section 333 and the tacking of holding periods permitted under numerous other circumstances in the Code, there do not appear to be any policy reasons to restrict tacking to Section 351 transfers. Limiting applicability to 1970 liquidations should also be eliminated.

SECTION 333

Liquidating Distributions Acquired Before December 31, 1953

The cutoff date with respect to the acquisition of stock or securities distributed by a corporation liquidating under Section 333 should be revised. [Sections 333(e)(2), 333(f)(1)]

In determining the amount of realized gain that is to be recognized by a shareholder in a Section 333 liquidation, present law provides that realized gain may be recognized to the extent that the shareholder receives money or stock or securities acquired by the liquidating corporation after December 31, 1953. Originally, this cutoff date was necessary in order to prevent the investment of cash in stock or securities in anticipation of a liquidation under Section 333. The date is now unrealistic. The statute should be changed to fix a cutoff date five years prior to the date on which the corporation adopts its liquidation plan.

SECTION 351

Securities Received in Exchange Transactions Governed by Subchapter C

The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such corporation. The term "securities," for purposes of Subchapter C, should be defined by statute to include a note, bond, or other evidence of indebtedness with a maturity of five years or more. Section 385 would be amended to conform to this definition of "securities."

One of the problem areas under Subchapter C is to determine the meaning of the term "securities." The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such corporation. The phrase stock or "securities" is also found in other provisions of Subchapter C, such as Sections 312(d), 354, 355, and 361. A statutory definition of "securities" would provide guidance to taxpayers and eliminate unnecessary conflict. The definition should provide that a note, bond, or other evidence of indebtedness with a maturity of five years or more would qualify as a security under Subchapter C. Section 385 would also be amended to recognize the new definition of "securities."

SECTION 357

Treatment of Accounts Payable as Liabilities Upon Incorporation of a Cash-Basis Taxpayer

Section 357(c) should be amended to make it clear that accounts payable of a cash-basis taxpayer are not liabilities within the intent of the section for purposes of determining gain upon incorporation of a business in a Section 351 transaction.

Section 357(c) provides, in part, that in an exchange to which Section 351 applies, if the sum of the liabilities assumed exceeds the adjusted basis of a property transferred, then gain will be recognized to the extent of the excess. In the case of a cash basis taxpayer (that never received tax basis nor deductions for trade accounts payable), a literal interpretation of the section leads to an inequitable result clearly not within the intent of Congress. In many cases substantial income may be realized. See, for example, the following decisions: *David Rosen*, 62 TC 11 (1974); *Peter Raich*, 46 TC 604 (1966); *Wilford E. Thatcher*, 61 TC 28 (1973).

However, in *John P. Bongiovanni*, CA-2, 470 F2d 921 (1973), the Second Circuit reversed the Tax Court. It analyzed the legislative history of the provision and, consistent with its interpretation of Congressional intent in enacting Section 357(c), concluded that such trade accounts payable are not "liabilities" for this purpose, drawing a distinction between tax liabilities and accounting liabilities.

The Second Circuit's analysis and interpretation of the section in *Bongiovanni* seems to arrive at an equitable result. It is therefore recommended that in order to prevent litigation, the wording of the statute should be amended to make it clear that the *Bongiovanni* holding reflects the correct interpretation of the law.

SECTION 534

Burden of Proof

Section 534 should be amended to provide that the burden of proof is always on the Secretary or his delegate irrespective of the court in which the case is tried or any pleading by the Secretary or his delegate.

Under present law, Section 534 shifts the burden of proof to the Secretary or his delegate in an accumulated earnings tax case in the Tax Court if the taxpayer files "a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any of the earnings" have not been unreasonably accumulated.

In cases having arisen to date involving the Sec. 534(c) statement, the Secretary or his delegate, in answering the taxpayer's petition to the Tax Court, has generally denied the sufficiency of the grounds and adequacy of the facts set forth in the Section 534(c) statement and has generally pleaded an affirmative answer. Only in rare instances has the Tax Court found a taxpayer's statement sufficient to shift the burden of proof. Experience has shown that more often than not the taxpayer's statement of facts in support of the stated "grounds" for the accumulation was found wanting.

It has been a traditional concept of tax procedure that the taxpayer should be allowed to select the forum that is most convenient to him. Accordingly, if the burden of proof can be shifted to the Secretary or his delegate in deficiency proceedings, it should also be possible to shift it to the government in refund proceedings.

The tax imposed by Section 531 on corporations improperly accumulating surplus is a penalty tax rather than a tax on income. In any proceeding, the burden should be on the Secretary or his delegate to show that a penalty is warranted, rather than on the taxpayer to show that a penalty should not be assessed. Accordingly, it is recommended that the filing by a taxpayer of a Section 534(c) statement in an accumulated earnings tax proceeding should shift the burden of proof to the Secretary or his delegate in all cases irrespective of (1) the court in which the case is tried and (2) any pleading the Secretary or his delegate may file with respect to the sufficiency of the statement. The requirement of a statement of facts in a Section 534(c) statement should be eliminated.

SECTION 703

Partnership Organizational and Reorganizational Expenditures

Section 703 should be amended to permit partnerships to deduct organizational and reorganizational expenditures.

Present law in Section 248 provides for deduction of corporate organizational expenditures. Section 703 should be amended to provide parallel treatment for partnerships. This would include a deduction for expenditures incident to the creation of the partnership and preparation of the partnership agreement.

The recommendation for Section 248 suggests expanding the deduction under Section 248 to cover reorganizational expenditures. Partnerships should receive parallel treatment.

SECTION 703

Deficiency Elections for Partnerships

Section 703(b) should provide that elections permissible at the partnership level will be considered timely if made in connection with a determination that a partnership in fact exists, notwithstanding the failure to have made such elections on a timely filed partnership return.

Code Section 761 provides only a brief definition of a partnership. It is possible that an examination by the IRS may result in the determination that an operational format utilized by taxpayers was in fact a partnership under Section 761. Where taxpayers have acted in good faith in reporting taxable income or loss predicated on the belief that a partnership did not exist, they should not be penalized for failure to make otherwise allowable elections on a partnership return. Accordingly, the concept of an elective deficiency remedy, similar in intent to that of Section 547 regarding deficiency dividends, should be made applicable under Section 703(b). It should cover situations in which an IRS determination that a partnership exists would have the effect of nullifying good faith elections made at the taxpayer level, or would prevent elections at the partnership level which would otherwise have been valid if a timely partnership return had been filed.

SECTION 706

Closing of Partnership Year

The taxable year of a partnership should close with respect to a partner who dies unless his personal representative elects otherwise. [Section 706(c)(1)]

Present law provides that the taxable year of a partnership does not close with respect to a partner who dies, unless as a result of such death, the partnership is terminated or a sale or exchange of the decedent's interest in the partnership occurs on the date of death. This provision prevents bunching of income in the final return of a decedent partner where otherwise two partnership years could close in such year. However, the inability to include such income in the decedent's final return many times results in the loss of deductions and exemptions which could otherwise be offset against the decedent's share of partnership income to the date of death.

It is recommended that the present rule be amended to provide that a partnership year with respect to a deceased partner shall close as of the date of such deceased partner's death, unless the deceased partner's personal representative or other person responsible for filing the decedent's final tax return elects to continue such partnership year for the decedent partner's interest.

SECTION 754

Basis Adjustment of Partnership Property for Gift Tax Paid

The Section 754 election should be applicable to transfers by gift where the donor's basis is increased by the gift tax paid on transfer of the partnership interest.

The optional adjustment to basis of partnership property pursuant to election under Section 754 is designed to reflect basis in partnership assets on transfer of a partnership interest when the transeferor's basis does not carry over to the transferee, such as in the case of a distribution of property under Section 734(b) or the transfer of a partnership interest by sale or exchange or on death under Section 743(b). Although transfer of a partnership interest by gift involves carryover of the donor's basis, the adjustment to basis in the hands of the transferee as a result of the gift tax paid, can be substantial. Accordingly, it is recommended that transfer by gifts be covered by the Section 754 election, subject to an exclusion for *de minimus* gift taxes, in order to enable such additional basis to be reflected in partnership assets on behalf of the transferee.

63-200 O - 76 - 53

SECTION 1244

Qualification as Section 1244 Stock

The requirement that Section 1244 only applies if a plan exists should be eliminated. [Sections 1244(a), 1244(c)]

Section 1244 was added to the Internal Revenue Code of 1954 by the Small Business Tax Revision Act of 1958. The purpose of the Act as set forth in H. R. Rep. No. 1298, 85th Cong., 1st Sess., reprinted in 1959-2 CB 709, 711, was to aid and encourage small business. Admittedly, it was not an attempt to settle all of the tax problems of small businesses. Specifically, the House Committee on Ways and Means summarized the primary goal of the bill as follows:

> The bill is designed to increase the volume of outside funds which will be made available for the financing of small business. Encouragement of external financing is provided by the ordinary loss treatment accorded investments in small business which do not prove to be successful. In this manner the risk element in small-business investment will be decreased for all such investments, including the enterprises which ultimately succeed as well as those which fail.

During the period since the adoption of Section 1244, a number of cases have been litigated, most of which have denied ordinary loss treatment to shareholders of small business corporations. In these cases, the stock qualified as Section 1244 stock within the meaning of Section 1244(c), except that the corporate records did not document the existence of a plan at the time of issue.

The limitations of the benefits of Section 1244 to taxpayers who insert certain phraseology in corporate records places undue emphasis on form and is inconsistent with the objectives of the 1958 Act. Rather than encourage additional investment in small business, these continuing limitations serve to stifle investment and increase the risk factor.

Accordingly, Sections 1244(a) and (c) should be amended to broaden the scope of a qualified investment entitled to ordinary loss treatment and to eliminate the requirement that a plan be adopted. Loss on investments in small businesses in the form of stock or capital contributions held by a shareholder otherwise qualifying under the limitations of Section 1244(a) and meeting the definitional requirements of Section 1244(c)(1) (as amended) and Section 1244(c)(2) should be treated as Section 1244 property eligible for ordinary loss treatment.

SECTION 1371

Treatment of Corporate Joint Ventures

Joint ventures of corporate shareholders should be allowed under the Internal Revenue Code to "flow through" current profits or losses to the coventurers regardless of the legal organizational form used for the ventures.

It is fairly common practice for two or more nonrelated corporations to participate in a particular business venture of mutual interest to all participants. Under existing provisions of the Internal Revenue Code, it is possible to "flow through" current profits or losses to all participants only if a partnership or joint venture type of organization is used. This may be satisfactory in some cases, but the continued prevalent use of corporate form indicates that, in spite of the tax treatment, there are overriding reasons for use of corporations, particularly in foreign operations where doing business in an unincorporated form may not be feasible. Another widespread reason is the limited liability afforded through a corporate form of organization.

The Internal Revenue Code should be changed to permit the current profits or losses of the joint venture to be included in the gross income of the participants where the venture is conducted in corporate form. The availability of the "flow through" should be limited to corporate shareholders whose stock ownership in the "joint venture corporation" is at least 20 percent but less than 80 percent.

The change probably could best be accomplished by adding a new section to the Code (possibly Section 1380) rather than through the amendment of Section 1371.

SECTION 1375

Distributions of Previously Taxed Income

Section 1375 should be amended to prescribe that the distribution of property other than money should be recognized as the distribution of previously taxed income.

The Subchapter S election has proved to be substantially less useful than was originally intended because of complex and restrictive rules in the statute and in regulations issued by the Treasury Department. In particular, only a limited opportunity is granted for distribution of previously taxed income in later years. In this respect, the rules vary substantially from partnership treatment where withdrawal of earnings is not a taxable event.

This problem should be remedied by amending Section 1375 to provide that the distribution of property other than money should be permitted as a distribution of previously taxed income.

SECTION 6015

Installment Payments of Estimated Tax by Individuals and Corporations

Sections 6015(a) and 6154(a) should be amended to raise the minimum amount required for individuals and corporations to pay estimated income tax.

Section 6015 provides, in effect, that individuals are required to file a declaration of estimated tax and pay such tax if they reasonably expect the estimated tax to exceed $100.

Section 6154(a) provides that corporations that reasonably expect their estimated tax for the year to be $40 or more shall make payments of estimated tax.

The complexities of computation and the burden of payment requirements upon small businesses and individual taxpayers with limited resources, coupled with the expense of professional advice in order to understand and comply with these statutory requirements, necessitate the amendment of these sections of the Internal Revenue Code.

It is therefore recommended that estimated income tax payments for individuals be required only when it is reasonably expected that estimated tax will exceed $500 and that corporations be required to pay estimated income tax only when income tax payments are reasonably expected to exceed $1,000. These changes will not materially affect the revenue collections but will help reduce the paperwork, filing requirements, and technical complexity existing throughout our tax system.

SECTION 6166

Extension of Time for Payment of Estate Tax

An extension of time for the payment of estate tax where the estate consists largely of an interest in a closely held business should be permitted in more situations.

Section 6166(a) currently provides that deferment may be elected if the value of a closely held business that is included in determining the gross estate of a decedent exceeds either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

However, the term "interest in a closely held business" as defined in Section 6166(c) limits the application to partners with 20 percent or more of the partnership capital, unless the partnership has no more than ten partners, and to stockholders with 20 percent or more of the value of the voting stock, unless such corporation has no more than ten shareholders. These limitations should be eliminated.

The 35 percent and 50 percent standards conform to the similar standards of Section 303 permitting redemption of stock to pay death taxes.

The present limitation to situations where there are ten or less partners or stockholders, or where there is a 20 percent voting stock equity or 20 percent partnership capital, is an unreasonable limitation. A deceased 5 percent partner in a ten-man partnership could qualify, but a deceased 15 percent partner in a fifty-man partnership would not qualify, even though the amount involved, the percentage of the estate, and the need for deferment of estate tax could be greater in the latter instance.

A similar inequity can occur in closely held corporations. It is not unusual for such a nonqualifying equity to constitute the bulk of a decedent's estate. Such interests are frequently not marketable, and the ten-year deferment of estate tax could permit an orderly realization of the moneys to pay the tax liabilities. Of course, the application of Section 6166 should be limited to instances where the decedent's stock is not readily marketable.

SECTION 6425

Quick Refunds (Forty-Five Days) as to Certain Corpora.o Quarterly Overpayments

Section 6425 should be amended to allow a corporate taxpayer to file, prior to the end of the taxable year, for a "quick refund" (forty-five days) as to certain overpayments of estimated installments.

Section 6425 provides that a corporation may, after the close of the taxable year and on or before the fifteenth day of the third month thereafter, and before the day on which it files a return for such taxable year, file an application for an adjustment of an overpayment of estimated income tax for such taxable year. Within a period of forty-five days from the date on which an application for an adjustment is filed, the IRS may credit the amount of the adjustment against any liability in respect of any tax on the part of the corporation and shall refund the remainder to the corporation provided the amount of the adjustment equals or exceeds (a) 10 percent of the amount estimated by the corporation on its application as its income tax liability for the taxable year and (b) $500.

Section 6425 was added in 1968 in order to try to avoid corporate overpayments as a result of the phase-out of the $100,000 exemption and the increase of the 70 percent test to 80 percent.

However, there is no present provision which would allow a corporate taxpayer to request a "quick refund" as to the overpayment of a specific estimated installment; the corporation must wait until the close of its taxable year. This does not permit the prompt refund of overpayments needed by a corporation faced by a sharp reduction of income from sudden business reversals.

Therefore, Section 6425 should be amended to allow a corporate taxpayer to file, prior to the end of the taxable year, for a "quick refund" (forty-five days) as to certain overpayments of estimated installments. The same 10 percent and $500 limitations applicable to past year-end applications (Form 4466) should apply to these refunds.

Mr. PENICK. I'll simply read the questions.

"Can you compare the 10-year carry-forward suggested by Treasury with the 8-year provision in our statement?"

Our written statement does suggest that under certain conditions an 8-year provision will be appropriate. Frankly, I have not studied the Treasury bill to that extent and I don't think I really could comment on it at this point.

Senator NELSON. Anybody else familiar with the issue raised by Mr. Spira?

Mr. PENICK. We will be glad to consider that and give you our written views on it.

Senator NELSON. All right.

Mr. PENICK. The next question which I guess cuts across a lot of comments many of us have made, "Can you also comment on the simplification of paperwork possibilities?"

I would applaud the suggestions that were made by Mr. Asbill, particularly of some approach on an organized basis to review the tax laws to simplify it in terms of the tax reporting requirements, the design of the tax form and things of this type.

I'm really not optimistic. We've had a task force active in our tax division for a number of years. Mr. Mintz has been heavily involved in this, and each year we review the tax forms before they are released with the idea of making them as understandable as possible.

Perhaps I should let him comment on this, but I'd say that our general view is that the Internal Revenue Service does a pretty good job of trying to accommodate all of the complexities they have to accommodate somehow on the form.

But the real solution, I think, is a basic, new approach to simplification. One point which we suggested in our testimony before the Ways and Means Committee several weeks ago in the area of simplification was that, as a new concept is being considered by the taxwriting committees, it be measured against some sort of a standard of the complexity it will create.

If you have a certain objective that you're trying to accomplish, perhaps you could accomplish 90 percent of the objective with, let's say, 10 percent of the complexities.

But I think it's something all of us have to constantly keep in mind, and I approve the idea of having a group of people, whether part of the joint committee or however it is structured, a group that would concentrate on this orea.

And as Mr. Asbill suggested, it should be taken aside from the day-to-day frustrations and pressures. I think it is going to take an organized effort on the part of you gentlemen and certainly those of us who are in tax practice to try to achieve this.

Senator NELSON. Do you have any questions?

Senator ROTH. No.

Senator NELSON. You commented, I think, and made reference to the question of recovery of asset costs, and you mentioned the problem of inflation.

I suppose that you are referring to the fact that a piece of equipment you buy today at $5,000, 10 years later would have appreciated and would then be worth $25,000.

Mr. PENICK. In most sectors I don't think the rate of inflation has been quite that drastic, but it can certainly be pretty bad.

And that is one of the very real problems.

Senator NELSON. Then let's make it $10,000.

Mr. PENICK. That's not unrealistic.

Senator NELSON. Do you agree with that? Was that the problem you were referring to?

Mr. PENICK. Yes, sir.

Senator NELSON. Are you familiar with what the Canadians have done with the depreciation question for 2 years?

Mr. PENICK. The indexing technique? Yes, sir. I am somewhat familiar with it.

Senator NELSON. If my recollection of it is correct, they allow a writeoff of 50 percent in one year, and 50 percent the second year, or at the option of the company if it wishes to stretch it out.

A Treasury representative was asked about it in the hearing in February before the Small Business Committee. Well, I think they think it will cost the Treasury money, which in short term it would. But, I can't see how it would in long term.

But in any event, how would you view that? The Canadians have had this system about 3 years, I guess. And they tell us that they are happy with it.

They put it in 3 years ago for a 2 year trial, now the Government has made it permanent. Anybody have any comments on that?

Mr. PENICK. I would give my view, but I've been doing too much talking. I'll give these gentlemen a chance to say something.

The advantage of that type of a capital recovery system, and I think in the United Kingdom you get a complete charge-off in the first year, but the advantage of this is to return through a reduction of taxes a significant amount of capital that can then be put to work in the business.

To some extent, that's what our ADR system and the declining balance do provide, a quicker recovery of capital. And obviously, the quicker the recovery, the quicker you have that money back to put back into the business.

This does not completely solve the problem that you illustrated, the $5,000 machine that you buy today that may cost you $10,000 to replace.

But nevertheless you have recovered your original investment quicker and have had a chance to earn on that investment by the time you do have to replace it, the item of equipment.

Senator NELSON. That means you can recover it very close to the equivalent value dollars.

Mr. PENICK. Correct.

Senator NELSON. Anybody else?

Dr. SINAI. The idea is quite correct. It's absolutely essential to begin to get the depreciation accounting on a basis that reflects inflation because we are not going to get rid of the kind of inflation that we've had, so the laws of depreciation will have to be changed. But writing the asset off in 2 years seems a little too rapid to me because it would induce a misallocation of resources.

Two years for writing off the asset is far from the lifetime of any asset, and I would think that some indexing scheme that raised depreciation allowances more in line with current rates of inflation or capital list prices would not only be helpful, it would also not cause the Treasury to lose so much revenue so quickly.

So it seems to me that the Canadian plan is a little too accelerated. The idea is right, and I would urge the committee to consider very high on its agenda the catching up of depreciation accounting with inflation.

Senator ROTH. Would you carry that a step further and say that—would you support indexing in general, then we won't have this problem with depreciation with just the average taxpayer.

Dr. SINAI. We've done a little bit for the average taxpayer. We haven't done anything for business yet.

Senator ROTH. I guess the question you are really asking, you are familiar with this concept of indexing?

Dr. SINAI. Yes.

Senator ROTH. What is your view on it?

Dr. SINAI. I would favor policies that would reduce the rate of inflation to 2 or 3 percent a year. We haven't been able to manage that, and if we can't then I'm going to have to fall back and say that we ought to do a lot more indexing in this country than we are doing.

In fact, that's what we are talking about when we talk about changing the depreciation allowances from original cost to replacement cost. That's what we talk about when you say that an exemption for real estate taxes is too low. That's what we talk about when we raise the standard tax exemptions for individual taxpayers.

This trend toward indexing shows we are slowly throwing in the towel on inflation. I hate to see that.

Senator ROTH. You feel that indexing means that you are sort of throwing in the towel?

Dr. SINAI. Yes, you are. I could talk for a long time about what we ought to do about inflation, but I will not. We have had 6 or 7 years of it, pretty intolerable rates of inflation.

The cost to business in terms of their capital formation and the inability to finance is even greater for small businesses. It is so great that at some point you have to bite the bullet and say, "If we can't get the inflation down to rates that we want, then we have to do something to index taxes or business will forever be in financial difficulty."

Senator NELSON. What about reverse indexing?

Dr. SINAI. I favor that. If the prices of capital goods drop, then depreciation accounting should also fall.

Senator NELSON. I've had letters from constituents over some period of time suggesting that salaries of Congressmen should be cut in direct proportion to the increased inflation.

I thought that if that is a good idea for us, why not do it with profits, interests, prices, and to solve it overnight, all wages, everything?

Dr. SINAI. None of our salaries have been rising fast enough to keep up with inflation. If we ever get downturns in prices to the extent we are arguing to maintain purchasing power if prices go up, we ought to be willing to take a reduction when prices go down. It is pretty safe to assume, though, that prices will not go down for quite a while anyway, so it won't be a practical problem.

Senator NELSON. OK.

Mr. ASBILL. Mr. Chairman, may I make one brief comment on the capital recovery thing. This is an area in which I'm really not an expert, but I think it is important for us to keep in mind the overall picture and to keep in mind something Senator Haskell said a while ago about the desirability of making the tax laws conform to the generally accepted accounting principles, if you will, and to business standards.

And I simply note that if you permit writeoffs at will, if you let taxpayers deduct capital expenditures immediately, you are moving a long way from matching income and expense in any real scientific sense. You are doing it in order to achieve a stimulus which you think is necessary or desirable.

But that is the kind of thing which, if carried too far, I think leads a fellow who doesn't have a capital-intensive business to say, "Well, you did that for that guy; I want you to do something similar for me."

I think I would agree with the remarks here that if you move to 1 year or 2 years, that would be a serious and drastic move.

Senator NELSON. Well, maybe we'll find out before very long what, in fact, the impact is in the real-life situation, because that's what Canada has been doing for 3 years.

We want to explore the question further, and some staff members have been talking with appropriate Canadian officials about it.

Thank you very much, gentlemen. We appreciate your time in coming over and giving us the benefit of your views on these important subjects. We appreciate it.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

APPENDIXES

APPENDIX I

AUTOMOTIVE SERVICE INDUSTRY ASSOCIATION,
Chicago, Ill., September 26, 1975.

Hon. GAYLORD NELSON,
Chairman, Senate Select Committee on Small Business, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The following remarks were made in my capacity as President of the Automotive Service Industry Association. You should also know that I am Vice-President of Fochtman Motor Company, Inc., wholesaler-distributors of automotive parts and equipment with our main store and ten branches operating in northern Michigan.

The Automotive Service Industry Association is the automotive world's largest and most comprehensive organization, with its membership encompassing more than 7,000 independent automotive wholesalers, warehouse distributors, heavy-duty parts and equipment distributors, automotive electric service distributors, manufacturers and remanufacturers of replacement parts, tools, equipment, chemicals, paint, refinishing materials, supplies, and accessories.

ASIA enjoys affiliation with the Automotive Booster Clubs International, and maintains close and constant liaison with the Automotive Service Council; National Congress of Petroleum Retailers; Equipment and Tool Institute; Automotive Wholesaler Association Executives; Production Engine Remanufacturers Association; and the Automotive Industries Association of Canada, giving ASIA representation at every point of the automotive service market from the manufacturer to the ultimate consumer.

First of all, we wish to express our support for the statement before your Committee on "Capital Formation and Capital Recovery" on behalf of the National Association of Wholesaler-Distributors, by Norman B. Ture. We believe that Dr. Ture's extensive research and analysis presents a sound case for the permanent increase of the corporate surtax exemption to $100,000. As I am sure you have noted, Dr. Ture's studies show that by 1977 such an increase will provide approximately 720,000 additional jobs in the private sector and increase real wages by about $10 billion over the amount that would otherwise be reached in that year.

ASIA was a strong supporter of the Congressional increase of the corporate surtax exemption earlier this year from $25,000 to $50,000 for the one year period. We believe this was a step in the right direction, but would urge you to increase the exemption to $100,000 and make it permanent to keep pace with the devaluation of the dollar since the exemption was first enacted in 1950 at its $25,000 level. This type of relief is vital for our industry because of the need for growth capital.

Our members are all small businessmen which, unlike large corporations, do not have a wide variety of sources from which to obtain capital. Our members are limited to only a few sources which include the owner's equity, retained earnings, and bank loans. An increase in the corporate surtax exemption to $100,000 would aid our after-tax profit picture and help our members to convince financial institutions to lend them funds for capital improvements based on the profit-generating potential of the company. As many other small wholesale businesses, all of our members' assets consist of current assets, largely inventory and accounts receivable. According to data compiled for the entire wholesale-distribution industry, current assets account for approximately 75% of the total assets of the average member.

We would urge your Committee recommend to the full Senate Finance Committee that there be an increase in the corporate surtax exemption to $100,000 as the most equitable way to spur the economy. Dr. Ture's studies show that by far the largest proportion, almost 60%, of the tax savings realized through such an increase in the surtax exemption would be by corporations with net incomes of $100,000 or less.

We would also like to briefly comment on a proposal to increase the estate taxation exemption. As you know, the exemption was set at the first $60,000 of net personal worth of a deceased in 1942. That in no way relates to today's dollar. The effects of inflation have altered that amount considerably. Statistics have been presented to your Committee showing that were the estate tax exemption adjusted for change in the purchasing power of the dollar the exemption in 1974 would have equaled $192,000. Taxes on that $192,000 estate would now be $30,300 versus no federal estate tax due on the same amount of purchasing power in 1942. Because of this erosion of the dollar due to inflation, we would urge your Committee recommend that Congress increase the estate tax exemption to $200,000. This is an essential increase if we are to perpetuate small business firms such as our members.

The results of the erosion of the dollar since 1942 have been an actual increase in the effective rate of estate taxation although we do not believe Congress intended that to occur when the initial tax was implemented. As a simple matter of equity we would again urge your Committee recommend estate tax exemption be increased to a level comparable in today's dollars to the initial estate tax exemption set by Congress in 1942.

The most frightening proposal which we have heard expounded upon before your Committee is that of the possible imposition of a capital gains tax on assets transferred at death. This taxing of a firm's capital gains as though it were sold at the time of the owner's death would unquestionably make it impossible for our members' heirs to continue to operate the firms.

We would urge you to carefully consider the differences between capital gains taxation on a "portfolio" of regularly traded and instantly marketable stock in a public corporation, with a so-called "portfolio" which consists only of stock in one small, closely-held family business. If our members are faced with paying a capital gains tax on top of estate taxes on a firm valued as though it were sold at the time of the owner's death, the resultant tax liability would force the heirs to sell the firm.

For most of our members, the appreciation in the value of capital assets is not only unrealized, but unrealizable. As you know, the valuation of the assets of a closely-held firm is inherently arbitrary and imprecise.

We believe that should proposals to revise the present tax treatment of capital gains be enacted to implement a tax on assets transferred at death it would sound the death-knell of the small automotive aftermarket firm. These small, closely-held family businesses could not survive such a tax liability.

In summary, Mr. Chairman, the Automotive Service Industry Association would like to urgently request your Committee recommend to the full Senate Finance Committee that the corporate surtax exemption be made permanent and raised to $100,000; the estate tax exemption be brought in line with today's value of the dollar versus the 1942 dollar which would increase it to $200,000; and finally, reject out of hand any proposals to impose a capital gains tax on assets transferred at death.

We respectfully request that this letter be made part of your current hearings on tax reform.

Sincerely,

VINCENT A. FOCHTMAN,
President, ASIA.

APPENDIX II

Testimony of Jack Pester, Senior Vice President
of the National Oil Jobbers Council
Offered Before the
Senate Select Committee on Small Business
Subcommittee on Financial Markets of the Senate Finance Committee
September 25, 1975

Mr. Chairman, my name is Jack Pester, I am President of Pester Derby Oil Company of Des Moines, Iowa. I am testifying today as Senior Vice President of the National Oil Jobbers Council whose 42 state and regional members represent almost 15,000 independant petroleum marketers. These marketers distribute approximately 25% of the gasoline and 75% of the home heating oil consumed in the United States.

Our members share the concerns and problems of other small businessmen and therefore we are heartened by the efforts aimed at bolstering the viability of America's small businessmen being made by this committee. I would like to do two things in my testimony today. First, I wish to join with the other small business representatives you have heard to express NOJC's support of S. 2149, and second, I would like to draw your attention to, and hopefully enlist your support on, a special problem which many of our members are having with the Internal Revenue Service.

S. 2149's proposed extension of both the 20% tax rate on small businesses (under $25,000) and the $50,000 corporate surtax provision are necessary measures which serve to assure the small business community that it will not face a return to the previous higher federal tax burdens at a time when inflation, business necessities and regulatory changes require increased capital investments.

Our industry, like most others, has been faced with a tremendous new cost rise. Much of this rise is being caused by inflation, but a substantial portion is the result of new federal and state regulations of the environment, occupational health, and public safety to name only a few. In addition, compliance with the recently ended federal regulation of the petroleum industry has cost our members much time and money. We believe all of these things make the extension of the small business rate reductions and the investment tax credits imperative. Our only comment is that increased assistance to allow small businesses to face all of these challenges should be considered.

The oil marketer's rising expenses are best illustrated by example. Let me use environmental costs for this purpose. In 1970 the Congress rightfully singled out the automobile as a major source of many air pollutants. EPA then proposed the catalytic muffler as a means to alleviate this problem. The costs for this device were to be shared by all purchasers of new cars and the capital costs were to be placed on the automakers. Small business, it seemed, would not be overly affected. Unfortunately, the catalytic muffler requires unleaded gasoline, and EPA mandated most service station operators to carry unleaded. Thus these small business marketers had to make a huge investment in pumps, storage, trucks and other equipment to handle unleaded gasoline.

The average investment was 6,600 dollars per station or $702 million nationally. This expense amounted to 6% of the total cost ($101,200) for the construction of an average service station. This expenditure was made solely for environmental purposes. No economic benefits have accrued to the dealer or supplier-lessor from the sale of unleaded gasoline, and none are anticipated.

Currently, the control of hydrocarbon vapors at service stations is under EPA study. These vapors are present in the automobile gasoline tank when a motorist drives into a service station for gasoline. They are forced into the atmosphere by the pressure of the gasoline being dropped into the tank at the station. To effectively capture these vapors, a tight seal is needed between the auto fill neck and the pump nozzle. The best way to accomplish this would be federally mandated standardized fill pipes and pipe access on automobiles which would enable a simple balance system to recover the vapors. EPA has refused to require this standardization of fill pipes and access ways and is currently planning to require service stations to install not a simple vapor balance system at a cost of approximately $6,000, but the more complex vacuum assisted system which will cost the small businessmen who own these stations approximately $12,000.

The expenditures required for handling non-leaded gasoline and vapor recovery show the increased start-up cost for any small businessman wishing to enter or stay in the gasoline business. The expenditures in these two examples alone can amount to as much as 20 percent of the total cost for setting up a service station. The increased paper work required by EPA is also a great impediment to the small businessman who must employ sophisticated and expensive assistance in order to comply. These costs are especially difficult for the small nonproducer who has no profits on crude oil to off-set them. Compliance with EPA and other regulations thus threatens the viability of small businessmen who have great difficulty in financing the material and personnel costs involved. I have used EPA regulations for my example, but I could have used OSHA, FEA or the FTC as well.

Earlier I stated that many petroleum marketers had a specific problem with the Internal Revenue Service which requires your immediate assistance. This issue is whether contract operators of service stations who operate on a commission basis are independent contractors or employees of their respective distributor. It has become a major area of dispute between small business independent distributors and Internal Revenue Service. The dispute revolves around recent IRS actions in this area which depart from long standing practice.

The primary issue involves a determination of the factors or circumstances which indicate that operators of gasoline retail sales outlets are independent contractors (as opposed to employees) for purposes of the Federal Insurance Contribution Act (FICA), the Federal Unemployment Tax Act (FUTA), and the collection of income tax at source on wages (WT). It has been common practice in the industry for gasoline jobber-wholesalers to either own or lease the premises on which the gasoline service station is located. This jobber-wholesaler will enter into a written lease agreement with the individual who is to operate the particular station. Because the operator-lessee generally does not have adequate capital, the jobber-wholesaler will often enter into a consignment

agreement wherein the gasoline is delivered to the particular operator-leasee for resale and the operator-leasee agrees to pay for the products at a stated price when the products are ultimately sold. The only general rules issued by the Internal Revenue Service dealing with the question of whether the operator-leasee is an independent contractor or an employee of the jobber-wholesaler are set forth in Internal Revenue 69-305, 1969-1 which was originally published in 1939 and has been republished in 1969, and Revenue ruling 70-443 which was originally published in 1938 and was republished in 1970.

The problem with the small businessman in attempting to fulfill the intent of both parties (i.e., namely that the operator-leasee is intended to be an independent contractor) is that neither ruling deals with a true consignment fact situation nor does either ruling provide any precise guidelines under present marketing practices employed by the industries throughout the country. Both rulings really discuss two extreme situations and do not attempt to advise the small businessman concerning handling of matters that lie somewhere in between. This problem has been discussed at length over a period of several years with the Joint Tax Committee staff, IRS, and officials in the Treasury Department. While initially staff of the Joint Tax Committee thought the problem could be handled through administrative procedures and partially through legislative action, it appears that the staff has now concluded that legislation is the only means to satisfactorily resolve the problem. Discussions with IRS have resulted in no relief being granted.

In view of the fact that the problem is attaining such complexity and is creating a financial burden for so many oil jobbers throughout the country and that the IRS has refused to grant administrative relief of any nature, our members have come to the conclusion that remedial legislation is the only means of relief. We ask this committee to assist us with this situation and work with the appropriate House committee in drafting and passing such legislation.

What is needed are specific instructions to the Internal Revenue Service to treat gasoline marketers who market on a commissioned basis as independent businessmen. Alternatively, any treatment of such marketers as employees should be required to be made on a prospective not retroactive basis. This should occur only after formal notice of such action has been published (with appropriate guidelines) in the Federal Register.

Thank you very much for your time today, we appreciate the interest which this committee has shown in the past, and I am sure will show in the future, to the problems of small businessmen.

APPENDIX III

(312) 485-9505

LAND IMPROVEMENT CONTRACTORS OF AMERICA

9515 Ogden Avenue • Brookfield, Illinois 60513

PAUL A. SUCHA • Executive Secretary

October 1, 1975

Honorable Gaylord Nelson
U. S. Senate
Washington, D.C. 20510

Dear Senator Nelson:

One of your constituents, Mr. Francis Flesch of Janesville, Wisconsin, has been kind enough to share with other members of our association a recent letter he received from you endorsing a Federal use tax exemption for conservation vehicles. A copy is enclosed.

The Land Improvement Contractors of America, of which Mr. Flesch is a Director, has been working with members of the Finance and Ways and Means Committees for some months to develop background information on S. 17 which would provide such an exemption. Some of that material was sent to you in our letter of May 2 to all Finance Committee members. (An additional copy is enclosed.)

In light of your continuing interest in such a tax provision, we wanted to share with you new information and key endorsements which have developed recently. These include a lost-revenue statement from the Joint Committee on Internal Revenue Taxation; an endorsement from the Soil Conservation Service, U.S. Department of Agriculture; and two letters to Chairman Long from state officials in Illinois and South Dakota where special state exemptions are now provided for conservation vehicles. These last two letters point out that state privileges for these vehicles have not been abused and have not been burdensome to administer.

It is our understanding that the Ways and Means Committee will consider "Small Business Tax Problems" in the second phase of tax reform. We also understand your committee on small business will be making comprehensive recommendations to the Ways and Means Committee shortly on this same subject. Since the average company this exemption would affect is 6 employees, and would foster more conservation for the tax dollar, we hoped it could be considered a part of the Committee's recommendations.

Honorable Gaylord Nelson
October 1, 1975
Page Two

I plan to stop by your office in a few days and perhaps can supply any further information which might be of help to you or your staff.

Most sincerely yours,

Michael E. Strother
Washington Representative
700 Seventh Street, S.W. #613
Washington, D.C. 20024
488-0904

Enclosures

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., September 3, 1975.

Hon. ROBERT DOLE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DOLE: This refers to your letter of August 5, 1975, in which you ask us to assess revenue impact of two bills in which you are interested.

1. S. 17 (94th Congress) would exempt highway motor vehicles used exclusively in soil and water conservation and in transportation of equipment used for soil and water conservation from the highway use tax. It is estimated that enactment of this proposal would reduce the excise tax liability for the first full year by about $7 million.

2. S. 1105 (93rd Congress) would permit an immediate deduction for expenditures to remove architectural and transportational barriers to handicapped and elderly. It is estimated that enactment of this proposal would reduce the income tax liabilities for the first full year by about $10 million.

Sincerely yours,

LAURENCE N. WOODWORTH.

U.S. DEPARTMENT OF AGRICULTURE,
SOIL CONSERVATION SERVICE,
Washington, D.C., July 31, 1975.

Hon. ROBERT DOLE,
U.S. Senate.

DEAR SENATOR DOLE: This is in response to your letter of July 17, 1975, concerning the impact of the Highway Use Tax on vehicles used exclusively in soil and water conservation work.

Most contractors who install ponds, terraces, waterways, and other soil and water conservation measures are small, local operators. They usually own a few pieces of earthmoving equipment, and trucks to transport the equipment from one farm or ranch to another.

These contractors, in most states, seldom travel for long distances over paved highways. Many times travel is over unpaved roads that parallel or cross major highways.

Since these small operators use highways considerably less than other truckers, some feel they should not have to pay the same rate of highway tax (according to Title 26 of the Internal Revenue Code, Section 4481, now based on a taxable gross weight of more than 26,000 pounds at the rate of $3 per year for every thousand pounds of taxable gross weight or fraction thereof). We must recognize; however, that to exempt only these vehicles, when farmers and others use highways on a comparable basis but would continue to pay the tax would also be unfair.

In recent years, there has been a shortage of contractors to perform soil and water conservation work approved by conservation districts with Soil Conservation Service technical help. Any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

Today, when full farm production is a major national thrust, resource protection is vital. Most acres now being brought into crop use to meet food and fiber needs will require careful conservation measures for sustained production and protection against air and water pollution. Thus, there is a need for more conservation contractors to place the practices on the land.

Your concern for soil and water conservation work is greatly appreciated.

Sincerely,

R. M. DAVIS, *Administrator.*

OFFICE OF THE SECRETARY OF STATE,
Springfield, Ill., September 12, 1975.

Re S. 17 and H.R. 2260.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee, U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: I have been requested by the Illinois Land Improvement Contractors Association to write you about S. 17 and H.R. 2260, which provide

that any motor vehicle used exclusively in soil and water conservation work and in the transportation of equipment used for soil and water conservation is exempt from the Federal highway use tax.

In 1968 the Illinois General Assembly passed the following law:

"3-809.1 § 3-809.1 Vehicles of second division used for transporting soil and conservation machinery and equipment—Registration fee. Not for hire vehicles of the second division used, only in the territory within a 75 mile radius of a designated point, solely for transporting the owner's machinery and equipment used for soil and water conservation work on farms, other work on farms and in drainage districts organized for agricultural purposes, form the owner's headquarters to a farm, from farm to farm, and returning to the headquarters, shall be registered upon the filing of a proper application and the payment of a registration fee of $325 shall be paid in full and shall not be reduced even though such registration is made during the second half of the registration year." (Ill. Rev. Stat. 1973, ch. 95-1/2, § 3.809.1.)

We refer to the license as the "conservation plate."

The law was enacted following a survey which clearly indicated that vehicles used for soil and water conservation work travelled a relatively small number of miles on the highway when compared with other vehicles. In addition, those using the conservation plate make a great contribution in the areas of soil, water and natural resource conservation. Further, there is a shortage of land improvement contractors in Illinois. It is hoped that the plate will encourage young people to enter the field.

This privilege has not been abused. Only 233 vehicles in Illinois have the conservation plate. The plate has not resulted in a significant loss of revenue and has not caused administrative problems.

The Illinois Land Improvement Contractors Association has carried on an effective educational program to ensure that the plate is used only on vehicles it was intended for.

If S. 17 or H.R. 2260 should become law, this office can provide representatives of the Federal Government the names and addresses of the persons in Illinois who have the conservation plate. It appears to me that if either one of these bills become law, the vehicles in Illinois entitled to the exemption would be those with the "conservation plate."

Sincerely,

MICHAEL J. HOWLETT,
Secretary of State.

SOUTH DAKOTA HIGHWAY PATROL,
September 12, 1975.

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

DEAR MR. LONG, This office has been contacted regarding pending legislation. This action involved certain exemption and fee reductions for vehicles utilized for soil and water conservation construction projects.

From an enforcement viewpoint, our Division has experienced only very minor problems with the special exemption granted to these vehicles by our State Legislature. We have not found that the exemptions granted are difficult to enforce. In fact, the members of the State Conservation Contractors Association do a commendable job of self-policing.

The only area that enforcement encounters any difficulty is an unclear or insufficient legal definition as to precisely what soil and water conservation practices entail. If legislative action could more clearly define this, it would help enforcement considerably.

If we can be of further service, please communicate with us.

Kindest personal regards,

Colonel DENNIS EISNACH, *Superintendent.*

LAND IMPROVEMENT CONTRACTORS OF AMERICA,
Brookfield, Ill., May 2, 1975.

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

MY DEAR SENATOR LONG: The Land Improvement Contractors of America is a national organization of some 2,500 conservation contractors from 33 states.

The average LICA member is a relatively small businessman. He is primarily engaged in work for the Agriculture Department's Soil Conservation Service, Agricultural Stabilization and Conservation Service, and local farmers constructing terraces, waterways, erosion control structures, stream bank stabilizations, and watershed projects.

We are writing to bring to your attention the fact that there are approximately 15,000 conservation vehicles in this country which pay full highway use tax and never travel on the Federal Interstate System for which the tax is collected. These trucks belong to conservation contractors—some of the first field-deployed environmentalists in this country—who are participating in government conservation projects under the Agricultural Conservation Program (ACP-REAP) and others. These vehicles transport earth moving and digging machinery to and from conservation sites, and remove earth from these projects.

In an effort to assemble the broadest spectrum of information possible on this subject, LICA has taken the following steps: (A) conducted a comprehensive nationwide survey of the industry; (B) compiled statistics and state law information through our state chapters; and (C) prepared and given testimony to a Congressional committee. We wanted to share the results of our investigations with you so we've pulled them all together here in a concise form. The complete summary of our survey results is enclosed. The following passages are excerpted from the testimony given by an LICA spokesman before the Senate Agriculture Subcommittee on Production, Marketing and Stabilization of Prices on June 27, 1974:

"We want to bring to the committee's attention the fact that conservation contractors doing work for SCS pay the same Federal highway use taxes as do over-the-road commercial haulers. They pay the same even though they often travel fewer miles in a whole year than a commercial rig does in a single week. The average contractor probably uses Federal highways in only 10–20% of his mileage a year. Many never use the Federal highway system at all. But because they own certain class vehicles, they must pay these taxes into the Highway Trust Fund for construction of Federal-aid roads. And many state highway use taxes are far steeper than Federal ones. Yet these contractors are primarily engaged in conservation work which will prevent floods, save valuable wet lands, conserve soil, and reduce food costs.

"Five states that we know of now have laws on the books which help alleviate this situation: Illinois, Kansas, Nebraska, South Dakota, and Texas. We would seek the Committee's advice on how to get the Federal Government to take the lead in exempting bona fide conservation vehicles from the highway use tax. Such as initiative, in turn, would encourage other states to follow suit on their own use taxes, and thus significantly increase the incentives to attract and hold new contractors for SCS work.

"The Federal highway use tax ranges up to several hundred dollars, and state taxes into the thousands. A contractor can pay taxes of $1,000 a year on a tractor-trailer combination that carries a bulldozer from field to field logging under 1,000 miles a year. Hence, use tax outlays can be significant to the small contractor."

House and Senate bills designed to accomplish this very exemption have been introduced in the 94th Congress. They are S. 17, and H.R. 2260, now pending before the Senate Finance and House Ways and Means Committees respectively. We feel, however, that such an exemption should rightfully be part of proposed major tax reform legislation to be taken up by Congress this year. As the committees and the whole Congress consider tax reform for the nation in the coming months, we hope that you will take a close look at the tax inequity born by this small but important group of conservationists. If the Congress will take the lead in exempting bona fide conservation vehicles from the Federal highway use tax, we are certain efforts to remove state highway use taxes on these vehicles would also be successful. Your leadership could provide the incentive and help further all our efforts to preserve the nation's soil and water resources.

We sincerely appreciate your review of our proposals, and if we can be of any further help, please don't hesitate to call on us.

Respectfully yours,

PAUL A. BUCHA, *Executive Secretary.*

Enclosure.

Position Statement on Federal Highway Use Tax

This material has been summarized as a result of a survey conducted by LICA in 1974 among its members.

LICA, the Land Improvement Contractors of America, consists of 2,500 members in 33 states whose primary occupation is performing conservation work for the American farmer. LICA members are representative of conservation contractors in the United States and comprise approximately 15% of all conservation contractors in the United States.

Equipment owned—Conservation contractors pay Federal use tax on low boys and dump trucks which they use on a not-for-hire basis in performing their work on agricultural projects. Their low boys are used to haul earth moving equipment to the job site while dump trucks are used in earth moving work on the job site.

Taxes paid—About 80% of the contractors own equipment on which they are required to pay Federal use taxes. Taxes paid by the contractors ranged from a low of $90.00 to a high of $240.00 per unit owned per year. The average contractor pays an average of $175.00 per year taxes on each piece of equipment they own.

Since the average contractor owns more than one piece of equipment (usually a low boy and a dump truck) his Federal use tax bill amounts to $235.00 per year.

Mileage driven—The survey revealed that conservation contractors drive their equipment an average of 5,000 miles per year. Most of this mileage is over county and state highways. About 30% of the contractors ever use the interstate highway system. 70% drive entirely on county and state roads and never use the interstate system. Those that do use the interstate systems average about 2,000 miles per year per contractor. 80% of conservation contractors drive less than 5,000 miles per year on vehicles on which they pay the Federal use tax. Most contractors engaged in conservation work perform their work within a radius of 50 miles or less and 95% of these contractors do their work within a radius of 100 miles or less.

SUMMARY OF NUMBER OF CONTRACTORS WITHIN CERTAIN ANNUAL DRIVING DISTANCES

	Percent	Cumulative (percent)
Drove less than 1,000 miles	14	
Drove between 1,001 to 2,000 miles	22	36
Drove between 2,001 to 5,000 miles	43	79
Drove between 5,001 to 10,000 miles	14	93
Drove between 10,001 to 20,000 miles	5	98
Drove between 20,001 to 40,000 miles	1	99
Drove over 40,000 miles	1	100

Projected U.S. lost revenue—Assuming that there are between 20,000 and 30,000 land improvement contractors in the United States who use their equipment almost exclusively for work connected with soil and water conservation and each of these contractors, as is true of the LICA member, pays $235.00 per year, the total revenue lost from subject bills S. 17 and H.R. 2260 would be between $4,700,000 and $7,050,000 which is an insignificant sum as far as the U.S. budget is concerned but is a considerable sum to the small contractor business man.

APPENDIX IV

TRAYLOR, PALO, COWAN & ARNOLD
ATTORNEYS AT LAW

CHARLES J. TRAYLOR
DAVID B PALO
GARY R. COWAN
RICHARD W ARNOLD

DAVID L MCKINLEY

THE PROFESSIONAL BUILDING
443 NORTH 6TH STREET
MAILING ADDRESS P O. BOX 2540
GRAND JUNCTION, COLORADO 81501
303-242-2636

October 22, 1975

Select Committee on Small Business
U. S. Senate
424 Russell Building
Washington, D.C. 20510

Gentlemen:

A monthly report from one of our banks indicates that you are interested in hearing from the public concerning the impact of Federal estate taxes on small enterprises. I can comment on two areas:

(1) If the $60,000.00 estate tax exemption has any realistic basis, it would appear logical to tie it to inflationary factors. $100,000.00 to $150,000.00 would, on this basis, be more realistic.

Current law requires filing of a Federal return if the gross tax estate exceeds $60,000.00, even though the estate is non-taxable. For example, an estate of $120,000.00, where the marital deduction is applicable, pays no tax. Under modern probate procedures, e.g., the Uniform Probate Code, the processing of such an unnecessary Federal return extends the probate time from a possible four months to about nine months in our area. We don't file income tax returns when the estate is non-taxable. Why should we be required to file estate tax returns when the estate is non-taxable?

(2) Estate tax returns involving a farm or ranch operation should allow valuation on an income approach rather than using comparable sales, particularly where the beneficiaries are heirs. In Western Colorado, there have been numerous sales of ranch and farm lands at inflated values up to and over $1,500.00 per acre to wealthy outside parties for recreation or speculation. Appraisal for Estate tax purposes consequently puts the value per acre completely out of proportion to valuation as a going ranch or farm business, and can result in putting a family farm or ranch out of business.

For purposes of assessing value in Colorado for ad valorem property taxes, farms and ranches receive special treatment, i.e., the County Assessor appraises basicly on an income approach.

By way of further comment, if the heirs elect to sell, the Treasury will receive a fair share on capital gains tax.

Yours very truly,

TRAYLOR, PALO, COWAN & ARNOLD

David B. Palo

DBP:mjc

APPENDIX V

VANKIRK, MARTIN & ASSOCIATES,
Cincinnati, Ohio, October 22, 1975.

Senator GAYLORD NELSON,
Select Committee on Small Business,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR NELSON: Thank you for the opportunity to present the thoughts of The Cincinnati Institute for Small Enterprises (CISE) in connection with your current hearings on possible legislation to assist small business. CISE represents the interest of small business in the greater Cincinnati area with an SMSA seven county population of 1,200,000.

The primary concerns of CISE members are in the following areas:

1. The ability to be able to handle positive growth.
2. The ability to survive in times of economic crisis.
3. The ability to make a positive contribution towards the long term unemployment problems facing our area and the nation in general.

The creation of one million jobs would save the Federal Government 22 billion dollars.

First, our thought on employment. The economic cost of unemployment and welfare are a continuing burden which small business cannot but fear over the long run. Since we pay the major cost of this burden it is to our advantage and to the advantage of the nation to assist you in some solution. The following facts bear on this problem.

1. It is an empherically documented fact that a large business is relatively capital intensive and a small business is relatively labor intensive. Studies by the Small Business Administration show that on the average it takes about $4,400 of capital to create one new job for a small business. According to L. William Seidman, Assistant to the President for Economic Affairs it takes on the average $35,000 for a large business to create one new job.
2. These figures suggest that the long term employment problems of the nation will be solved largely through the growth of small business. This is not to say that assistance to large business should cease but rather the emphasis should be changed. Most tax and other legislation in recent years has been designed to stimulate large business and it has done little to help cope with chronic widespread unemployment.
3. We support the recent legislation proposed to offer small business a tax credit equal to ½ the salary paid for a maximum of two employees hired during a taxable year. For every million new jobs the Federal Government will gain 16 billion dollars in revenue, 14 billion dollars in taxes and 2 billion in unemployment insurance payments. The total cost to the Federal Government in terms of the tax credit will be about 2 billion dollars.

Another area of importance to small business is the ability to secure funds to sustain growth so that they can remain independent, foster competition, and provide needed jobs for the economy. A small business usually sells out to a large firm because they lack the capital to nourish their growth. A large business is in essence a "Bank" with huge cash resources and offers small growing firms their only capital chance for expansion. There are only four sources of capital.

1. Equity—Target non-existant for Small Business.
2. Debt—Almost always short term for small business since banks are their only, constant source are basically not long term lenders.
3. Depreciation—A limited source since small business is labor intensive, not capital intensive.
4. Retained Earnings—The primary source of funds for most small business.

Institutional changes are needed to allow small business to finance growth methodically over the long run. This dictates access to the long term capital markets. A small business can not be run on 90 day demand notes. There must be legislation tht creates institution that can loan funds long run to small business. SBA loan activities meet a mere fraction of the total need. Freeing Savings and Loans of current restriction on business loans would be useful. They are long term lenders. Could fulfill a current void in the vital long term capital picture. On the

creation of Federally chartered institutions to handle long term obligations up to 5 million dollars per customer is an alternative. Equity funding needs to be encouraged through expansion of subchapters of to 25 shareholders and retention of capital gains provisions for those who invest in small business equity.

Depreciation schedules need to be revised to allow for faster write offs and to allow depreciation of assets by classes rather than by item.

The proposal represents our thoughts on some of the possible moves that could be made by the Congress to help solve the concerns condition of long term unemployment that now exists.

Yours very truly,

JOHN E. VANKIRK, *President.*

APPENDIX VI

NATIONAL TOOL, DIE &
PRECISION MACHINING ASSOCIATION

9300 LIVINGSTON ROAD, WASHINGTON, D. C. 20022

301/248-6200

October 22, 1975

The Honorable Gaylord Nelson
Chairman, Select Committee on Small Business
United States Senate
Washington, D. C. 20510

Dear Senator Nelson:

Per discussion with your committee staff, we are pleased to submit a statement for the hearings record of the committee's investigation into small business ownership and inheritance taxes.

We appreciate your continued interest in this vital area of taxation and are grateful for your indulgence in allowing us to submit our industry's position.

Should you or any members of your staff have any questions relative to the content of our statement, we shall be most happy to respond to them.

Cordially,

William E. Hardman
Executive Vice President

WEH:dk
Enclosure

STATEMENT OF THE

NATIONAL TOOL, DIE & PRECISION MACHINING ASSOCIATION

SUBMITTED TO THE SMALL BUSINESS COMMITTEE

OF THE UNITED STATES SENATE ON THE

EFFECT OF ESTATE TAXATION ON SMALL BUSINESS

October 20, 1975

The National Tool, Die & Precision Machining Association is a trade organization representing 2,100 small businesses each with an average employee work force of between 25 to 30 persons. These tooling and machine companies are independent contract manufacturing businesses which design and produce special tools, dies, jigs, fixtures, molds, gauges and other special machinery and precision machined parts and components. Although the companies comprising this Association may engage in auxillary work such as metal stamping, their primary business is the custom manufacture of special tooling or precision machinery made to the unique requirements of industrial customers.

These companies are generally closely-held or family-owned and are usually dominated by men who have come up from the skilled trades to build their own companies. The industry is a highly capital-intensive and skill-intensive one. Large expenditures are required for machinery which ultimately has a short life due to rapid technological and design changes. Huge expenditures are also required for the specialized training required of personnel. These costs are unusually large when compared to those of companies of comparable size and sophistication in other industries.

American industry is unusually dependent upon the products of members of this Association. The automotive, appliance, aerospace, business machines, electronics, argicultural implements, ordinance, transportation, environmental, construction equipment, and nuclear industries are among its major customers. At one time or another, nearly every manufacturer does business with members of our Association.

Tooling and machining companies function on a "contract" basis to service industrial customers whose needs do not justify their own full-time in-house production of special tooling or precision machines. Generally, our companies are the first to feel a decline in economic cycles and the last to recover, since during these periods industrial customers tend to fill in-house capacity first before sending contract orders outside. A typical example is the situation which has occurred within the automobile industry, traditionally our largest customer. As a result of the reduction in the number of automobile models and the frequency of model changes, much of the demand for new tooling has ceased. This policy change has eliminated a large portion of the overflow which traditionally has provided contracts for our member companies. Now, many businesses either have failed, or are presently floundering. Those which have survived have had to seek new markets.

There is no question that there is a continuing need and demand for special tooling and precision machining. This demand will continue as long as new metal products are developed. We believe that the tax laws should not present a stumbling block to

this development, but rather they should encourage the needed growth our economy requires, particularly at this time. Thus, it is clear that positive tax reform is necessary so that this industry can survive fluctuations in demand to which it is so sensitive and can assume a more competitive position with companies abroad.

We believe that certain income tax revisions will provide this needed economic stimulus and permit our companies to improve their competitive relationship abroad. In addition, certain estate tax revisions are needed to help remove estate tax considerations by owners of member companies from their business decisions. Set forth below are our specific recommendations. We believe these are essential to the revitalization of the economy and the stabilization of small business as effective competitors in our free enterprise system.

INVESTMENT TAX CREDIT AND ADR REFORM

As we all know, both the investment tax credit and the Asset Depreciation Range were devised as incentive devices to stimulate a sagging economy by encouraging the acquisition and modernization of productive business assets. Since companies of the tooling and precision machining industry must make extraordinarily large expenditures for equipment, a capital recovery system is required which will allow these small businesses to continue to modernize, increase production and compete effectively with foreign markets. Presently, domestic companies are at a distinct competitive disadvantage, since most foreign firms are permitted under their respective tax laws to write off capital equipment expenditures in a fraction of the time allowed in the United States

We recommend that a permanent 15% investment credit be established. This permanent increase is necessary so that businesses in general, and small businesses particularly, can make needed capital investments for expansion and growth. Our member companies especially require this increase in the investment credit, since they must make inordinately high capital expenditures as compared to companies of other industries. We further recommend that the temporary $100,000 limitation on used §38 property, on which the investment credit may be claimed, be made permanent.

We believe that the present 20% depreciation range under the ADR system is useful, but inadequate. Current practices allow a businessman to recover only his historical cost; this is particularly inadequate with the impact of inflation on current costs. An editorial in the July 1, 1975, issue of American Machinist graphically illustrates this point. Even though the Caterpillar Tractor Company had used an accelerated method of depreciation, its capital investment in plant, machinery and equipment for 1974 was still more than 2 1/2 times the depreciation taken, indicating that current depreciation practices are not realistic when one considers replacement cost levels.

The Code should be changed to require a 40% range for ADR purposes. A 40% range would permit small businesses to increase the pace of capital recovery and offset, to some extent, the comparable incentives provided by other nations to their domestic businesses. Although these revisions would still provide a lower degree of capital recovery than that of other countries, such improvements would be

extremely beneficial to growing small businesses of the nature of those within our industry.

CORPORATE SURTAX EXEMPTION

The impact of rapid inflation on small businesses was recognized in the Tax Reduction Act of 1975 when the corporate surtax exemption was increased and the effective corporate tax rates reduced. Unfortunately, these revisions were only temporary and did not go far enough. Inflation has continued to rise and small businesses are continually struggling for survival. We recommend that the surtax exemption be permanently increased to $100,000. We further recommend that a graduate rate structure be used for the first $100,000 of corporate earnings and that the maximum corporate tax rate be reduced from 48% to 42%. We recommend the following graduated tax rates:

15% on the 1st $25,000 of corporate earnings
20% on the 2nd $25,000 of corporate earnings
22% on the next $50,000 of corporate earnings
42% on earnings in excess of $100,000

ACCUMULATED EARNINGS TAX CREDIT

Since companies of the tooling and machining industry are not producing for inventory, but rather on a contract basis, projections are often difficult to make as to the amount of working capital required for the needs of the business. More liquid funds are needed by these companies than may be needed by companies of other industries which do not operate in a like manner. This factor, coupled with the unavailability of credit at reasonable prices to small businesses, makes an increase in the accumulated earnings credit essential. We recommend that the credit be increased to

$250,000 so that companies can accumulate up to that amount without concern about the imposition of the accumulated earnings tax. $250,000 is clearly a more realistic figure in light of the current economic situation.

AMORTIZATION OF POLLUTION CONTROL AND ENVIRONMENTAL EQUIPMENT

Tooling and machining companies are especially affected by the newly imposed governmental regulations which require that environmental and pollution control equipment be installed. These requirements are economically devastating to small businesses which already are desperately seeking capital for routine capital replacement, expansion and growth. We recommend that the cost of pollution control and environmental equipment required by government regulations be permitted to be depreciated over a three year period.

CORPORATE DEDUCTIBILITY OF PREFERRED STOCK DIVIDENDS

As previously discussed, small businesses continually experience great difficulty in the financing of their operations. Owners of most of these companies would clearly prefer to obtain additional capital by issuance of a class of preferred stock rather than through debt financing. But these owners are deterred from doing this because of their inability to deduct preferred dividends as business expenses. We believe the Code should be amended to allow a taxpayer to deduct the payment of preferred stock dividends in the same way a taxpayer may presently deduct interest on debt obligations. This would be an incentive for such offerings and would certainly result in more equity investment in American business.

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

The DISC concept was originally instituted to stimulate United States' exports by granting special tax status to corporations that sell abroad products produced or manufactured in the United States. With DISC a company can offer its export products to foreign markets at prices which are more competitive than they otherwise would be. Among our members, the DISC has served as an inducement to enter export activities or to expand existing sales in foreign markets. A further advantage provided by the formation of a DISC is that the parent company can make increased capital investments due to the greater liquidity resulting from the tax deferral permitted under DISC. Tooling and machining companies must compete with foreign markets in order to survive. Tooling and machining companies must also have adequate funds to make the frequent equipment and plant modifications and modernizations required by technological advancements. The Association strongly supports the continuation of the DISC provisions.

SUBCHAPTER S CORPORATIONS

The provisions of Subchapter S are of significant importance to many of the small businesses which comprise our Association. Obtaining adequate capital is one of the most serious problems of small businesses. We support the proposals to change Subchapter S to provide for an increase in the number of allowable shareholders. If Subchapter S corporations are allowed to increase the number of equity investors above the current level of ten, we believe more capital could be obtained for investment and growth of the businesses.

For the same reasons, we also support the revisions which would permit a trust to be a Subchapter S shareholder.

CAPITAL GAINS

As previously stated, our tax laws should encourage capital formation. We believe this can be done by adding an inflation adjustment to the tax basis of a capital asset when it is sold or by decreasing the effective rates of tax on capital gains depending on the length of time the assets are held.

ESTATE TAXES

Our member companies have a vital interest in the impact of estate taxes on the continuation of the small business enterprise. Such taxes have a direct effect on the perpetuation of the small and independent business enterprises and the jobs that they create. The inability of a small business to survive the death of its owner may cause the owner to lose the incentive to operate the business in such a fashion as to anticipate the continuity of the business. This loss of incentive could result in decisions being made which result in short-term tax and cash savings at the expense of long range planning for increased productivity and jobs.

The present estate tax potential burden has the undesired effect of promoting the concentration of business at the expense of the small enterprise. Owners of small business often consider merging with large corporations in order to have marketable stock available to pay estate tax rather than continue to operate as a small business and, in effect, pass the estate tax burden on to the next generation. This pressure, when added to the tendency of larger

consumers of our services to establish in-house operations, further reduces our ability to exist and compete.

As small businessmen, our members are also concerned about their business' inability to generate enough cash after their death to pay estate taxes based on the value of the business determined by a fictitious sale price at date of death as well as have the funds necessary to pay salaries and acquire equipment.

In the area of estate taxes, we recommend the following to help small business exist:

(1) No Capital Gains Tax at Death

We are opposed to the concept of a capital gains tax at death. Typically, our member's investment in his business is small, having been laborously built up over a number of years. Often his investment, for basis purposes, is represented only by the original capital contributed by him to the business. The proposed capital gains tax at death would trigger a tax based on unrealized gain at a time when both the small business and small businessman is least able to pay. The net effect would be even greater attempts at reorganizations during the owner's lifetime to secure a more marketable asset with a more readily determinable value -- stock -- and a further concentration of business in large corporations. Capital gains tax at death would also tend to force liquidations of small business after the death of the owner in order to gain funds necessary to pay the tax.

(2) Liberalize the Redemption Provision of Section 303

Section 303 of the Internal Revenue Code gives the estate of a deceased shareholder capital gains treatment on limited amounts received from the redemption of a deceased shareholder's stock interest. Under present law, for an estate to be eligible under this section, the stock owned by the decedent must comprise more than 35% of the value of the gross estate or more than 50% of the taxable estate. If the decedent owned stock in two or more corporations, only those corporations in which he owns more than 75% of the stock interest can be consolidated in order to determine if the 35% or 50% tests are met. Assuming the percentage tests are met, a qualified redemption under section 303 must, in general, be accomplished within three years after the estate tax return is filed. The percentage restrictions should be reduced to permit increased internal business generation of funds necessary to pay the estate tax and thereby encourage continuity of family owned enterprises. This is especially true of the 75% consolidation requirement. This percentage should be reduced so as to be consistent with the 50% requirement for consolidation for purposes of section 6166 and 6161 discussed infra. In addition, the three year time requirement should be increased to tie into the time periods permitted by section 6166 and 6162 discussed infra.

(3) Extension of Time for Payment of Estate Taxes

Section 6166 of the Internal Revenue Code permits an executor to elect, assuming certain mechanical tests are met, to pay all or part of the Federal estate tax in not more than 10 equal installments. These mechanical test are similar to those under

section 303 insofar as the 35% of gross estate and 50% of net taxable estate are concerned. With respect to consolidation of ownership of two or more corporations, section 6166 requires a 50% ownership in each corporation. In addition, the executor remains personally liable for payment of the estate tax during this period and the Internal Revenue Service frequently requires that the executor post a bond to secure payment.

In the discretion of the Commissioner of the Internal Revenue Service, section 6161 of the Internal Revenue Code permits the granting of an extension of time for payment of estate taxes not in excess of 10 years. This extension is only granted if a determination is made that prompt payment would result in "undue hardship" to the estate. As with a section 6166 extension, the same personal liability and bonding requirements are present.

To make these extension provisions more readily available to executors of deceased owners of small businesses, the percentages of gross estate and taxable estate which must be represented by the small business assets should be reduced. In addition, the word "undue" should be eliminated from the statute in section 6161. Its inclusion suggests something more than hardship is required, and it is our position that "hardship", coupled with the Commissioner's discretion should be enough. Finally, the personal liability of the executor as a prerequisite to the extension and the bonding requirement should be eliminated unless the Service can demonstrate their need in each individual case.

(4) Valuation

In many small businesses, the method used by the Internal Revenue Service in valuing the business is a rule of thumb using some multiple of average earnings. This method does not take into account that the going concern value of a small business is often heavily dependent upon the individual attention, competence and skill of the owner. These businesses generally have no depth of management and the death of the owner may result in the value of the business becoming its liquidation value.

Even though the executor may value assets on the alternate valuation date, this often does not satisfactorily take into account the death of the owner since the predeath earnings figures in the averaging formula will far outweigh the post death earnings factors.

We believe that, at the option of the executor, stock interests in closely-held businesses be included in the estate at their carry-over basis and that such basis be used by the beneficiaries instead of fair market value at date of death.

(5) Increase Estate Tax Exemption

The present estate tax exemption of $60,000 was set in 1942. Since that time, inflation has so eroded the purchasing power of the dollar that an exemption in todays dollars should be $200,000. We recommend increase of the estate tax exemption to $200,000 with provision for future adjustment based on cost-of-living factors.

(6) Marital Deduction

The present marital deduction computed at one-half of the adjusted gross estate should be liberalized to $150,000 plus one-half of the adjusted gross estate.

(7) Interest on Deferred Tax

Effective July 1, 1975, the special four percent (4%) interest rate for extensions under section 6161(a)(2) and 6166 was eliminated. The present interest rate is nine percent (9%), to be adjusted based upon the prime rate. The former reduced rate was designed to better enable estates which qualified for deferred payment to pay the tax, plus interest, out of current earnings. To continue the purpose for which the reduced rate was originally designed, we believe that a preferred rate of two-thirds of the present rate be permitted whenever deferral of tax is permitted under either section 6161(a)(2) or section 6166.

Appendix VII

SOCIAL SECURITY FINANCING SCHEDULE, CALENDAR YEARS 1937–76

Calendar years	Contribution and benefit base	Tax rate, employer and employee, each (percent) OASDI[1]	HI[2]	Total	Maximum employee tax	Tax rate, self-employed (percent) OASDI[1]	HI[2]	Total	Maximum self-employment tax
1937–49	$3,000	1.0		1.0	$30.00				
1950	3,000	1.5		1.5	45.00				
1951–53	3,600	1.5		1.5	54.00	2.25		2.25	$81.00
1954	3,600	2.0		2.0	72.00	3.0		3.0	108.00
1955–56	4,200	2.0		2.0	84.00	3.0		3.0	126.00
1957–58	4,200	2.25		2.25	94.50	3.375		3.375	141.75
1959	4,800	2.5		2.5	120.00	3.75		3.75	180.00
1960–61	4,800	3.0		3.0	144.00	4.5		4.5	216.00
1962	4,800	3.125		3.125	150.00	4.7		4.7	225.60
1963–65	4,800	3.625		3.625	174.00	5.4		5.4	259.20
1966	6,600	3.85	0.35	4.2	277.20	5.8	0.35	6.15	405.90
1967	6,600	3.9	.5	4.4	290.40	5.9	.5	6.4	422.40
1968	7,800	3.8	.6	4.4	343.20	5.8	.6	6.4	499.20
1969–70	7,800	4.2	.6	4.8	374.40	6.3	.6	6.9	538.20
1971	7,800	4.6	.6	5.2	405.60	6.9	.6	7.5	585.00
1972	9,000	4.6	.6	5.2	468.00	6.9	.6	7.5	675.00
1973	10,800	4.85	1.0	5.85	631.80	7.0	1.0	8.0	864.00
1974	13,200	4.95	.9	5.85	772.20	7.0	.9	7.9	1,042.80
1975	14,100	4.95	.9	5.85	824.85	7.0	.9	7.9	1,113.90
1976	15,300	4.95	.9	5.85	895.05	7.0	.9	7.9	1,208.70

[1] Old-age, survivors, and disability insurance.
[2] Hospital insurance.

Appendix VIII

[From American Machinist Magazine, October 29, 1973]

Plant-size Analysis

Small Plants Play Key Role

SMALL PLANTS HAVE HIGHER CONCENTRATION OF EQUIPMENT AND DO BETTER JOB OF KEEPING THEIR MACHINES UP TO DATE; LARGE PLANTS, HOWEVER, LEAD IN SOME MACHINE TYPES

A plant-size factor was again used in calculations on the 11th Inventory. Such a factor was used for the first time in 1968 and has made possible the development of data showing the relationship between plant size and machine-tool holdings.

Plants are classified in three size groups: under 50 employees, 50 to 99 employees, and 100 or more. These divisions were chosen originally because they provided suitable dividing lines for statistical purposes It was believed that there was an essentially homogeneous relationship between the number of employees and the equipment in these groups. The primary purpose of the plant-size factor was to keep large plants, from which a larger percentage return was anticipated, from unduly biasing the results.

Further, it was thought that small plants have a higher concentration of machine tools in relation to employees than large plants (as indeed they do). It was also learned when this division was first made that the small plants have newer equipment than the larger ones.

Both relationships are confirmed in the 11th Inventory. The plant-size data are summarized on the facing page, where the number of units of each major type of equipment is shown in each plant-size group along with the percentage of units under 10 and over 20 years old in each case.

BIGGEST PLANTS ARE OLDEST

A special run was made this time of the plants with more than 1000 employees to see if they differed substantially from the plants with 100 to 1000 employees. The program did not permit doing this for individual machine types, but it was done for metalcutting as a whole, metalforming as a whole, joining, and "other equipment."

In the case of metalcutting machines, 37% of the machines are less than 10 years old, both in the smallest plants and in those with 50 to 99 employees. The percentage of young machines drops to 31% in plants with 100 or more employees. It drops to 30% in the plants with 1000 and more employees.

At the other end of the life span, 23% of the metalcutting machines are more than 20 years old in the two smallest plant-size groups. The percentage of machines more than 20 years old rises to 32% in plants with more than 100 employees and to 37% in plants with more than 1000.

Plants with more than 1000 employees thus have a little less new equipment but are holding on to more of their 20-year-old machines.

With metalforming machines, the percentage under 10 years is 31% in the smallest plants, 29% in the next size, 30% in the plants with more than 100 workers, and also 30% in those with more than 1000 workers. This does not indicate any clear size-related trend.

However, in the case of metalforming machines more than 20 years old, the proportion is 26% in the smallest size group, 28% in the next larger size, 30% in the next size, and 33% in the largest plants.

For joining equipment, the percentages under 10 years old are (from small plants to large) 54, 50, 52, and 49. Again, a clear trend toward less modern equipment in the larger plants. At the other end of the scale, the percentage of joining equipment over 20 years old is 11% in the smallest plants, drops to only 9% in the plants with 50-99 employees, then jumps to 12% in the plants with 100 or more workers and to 16% in the plants with 1000 workers or more.

The trends are similar with "other equipment," covered in the fourth major section of this study. The percent of units under 10 years old, which is 49% for plants with more than 100 employees, drops to 45% for the plants with more than 1000 employees. Conversely, the 15% of units more than 20 years old in the 100 worker and up plants jumps up to 20% in the plants with more than 1000 employees.

SMALL-PLANT CONCENTRATION

In the metalworking universe used for the 11th Inventory, there are 105,000 plants with less than 50 employees. They employ 1 million people. These plants have 9% of the employees. They also have 32% of the metalcutting machine tools, 25% of the metalcutting machines, 22% of the joining equipment, and 20% of the other equipment.

In the medium group, the plants with 50 to 99 workers, there are 10,000 plants with 661,000 employees. This is 6% of the workers in metalworking. These plants have 11% of the metalcutting and joining equipment, 12% of the metalforming equipment, and 9% of the other equipment.

The group with the largest plants, those with 100 or more employees, includes nearly 17,000 plants with 9.3 million employees. This is 85% of the workers in metalworking. These plants have 57% of the metalcutting machines, 63% of the metalforming machines, 67% of the joining equipment, and 71% of the other equipment.

These generalizations do not apply in every case. *The large plants have 86% of the automatic assembly machines, and 66% of these machines* are less than 10 years old against only 61% young in the smaller plants.

The large plants have 90% of the special way-type and transfer machines, but the limited number of these machines in the plants of the smallest size have a lower average age; 67% are less than 10 years against 55% in the large plants.

Broaching machines, planers, gearcutting equipment, mechanical presses, and forging machines are all categories in which the machines are somewhat more concentrated in large plants, though in no case is it in proportion to employment, and the percentage of these machines under 10 years old is higher in the large plants than in the smaller ones. However, in all these categories, the equipment averages much older than it does for most other types of machines.

The final exception is riveting machines, which, in the large plants, are younger than average, with 40% being under 10 years old, and these plants have 73% of the machines.

In all the other categories, the general rule holds true: The percentage of young machines is much higher in the smaller plants.

With turning machines, the percentage under 10 years old is 32% in the small plants but only 29% in the large ones.

For drilling machines, it is 35% in the small plants and only 25% in the large.

For milling machines, it is 43% for the young machines in the small plants and only 33% in the large.

Grinding machines are 41% less than 10 in the small plants, only 33% less than 10 in the large plants.

Among the newest types of machines, the large plants have only 57% of the electrical machining units. Of these, 73% are less than 10 years old. In the smaller plants, the percentage of machines less than 10 years old rises to 81% in the plants with less than 50 workers and to 84% in the plants with 50 to 99 workers.

It seems likely that in many cases the particular machines installed in large plants may be larger and more expensive than those of the same type in small plants. Thus, the division of investment in terms of value will not be the same in every case as it is in units. Some indication of this may be gained from a study of the individual machine types within each category. A larger proportion of profile mills than of vertical ram-type mills, for example, will be found in the large plants.

7. SUMMARY OF 11TH INVENTORY BY PLANT SIZE

[Based on number of employees]

Type of equipment	Under 50 employees			50 to 99 employees			100 or more employees			Total			Percent of equipment in plants with 100 and over
	Total units	Under 10 years (percent)	Over 20 years (percent)	Total units	Under 10 years (percent)	Over 20 years (percent)	Total units	Under 10 years (percent)	Over 20 years (percent)	Total units	Under 10 years (percent)	Over 20 years (percent)	
Turning machines	166,639	32	26	55,868	32	30	270,940	29	33	493,447	30	31	55
Boring machines	12,694	33	31	4,649	33	28	36,823	29	33	54,166	30	32	68
Drilling machines	143,430	35	21	52,113	35	23	260,172	25	40	455,715	29	32	57
Milling machines	105,168	44	19	33,792	40	22	149,199	33	30	288,159	38	25	52
Multifunction machines	3,970	83	2	1,482	76	5	9,276	75	6	14,728	77	5	63
Special way-type and transfer machines	803	67	4	615	44	19	13,436	55	11	14,854	56	11	90
Automatic assembly machines	1,302	67	2	1,153	55	5	14,835	66	40	17,290	66	5	86
Tapping machines	13,722	40	16	4,645	44	14	17,973	31	28	36,340	36	22	40
Threading machines	5,277	25	38	1,617	30	27	8,851	25	37	15,745	26	36	56
Broaching machines	3,193	20	42	1,122	20	34	10,305	26	37	14,620	24	38	70
Planning machines	2,786	4	72	843	3	72	3,983	6	66	7,612	5	68	52
Shaping machines	10,501	10	56	2,707	6	64	15,337	8	60	28,545	8	58	54
Contour sawing and filing machines	8,837	33	20	2,338	30	24	12,409	27	27	23,584	30	24	53
Cutoff and sawing machines	71,021	44	15	25,653	43	15	98,643	34	27	195,317	39	21	51
Grinding machines	148,530	41	19	50,942	41	19	290,128	33	30	489,600	36	26	59
Honing machines	7,779	48	11	2,067	47	18	10,877	46	16	20,723	47	15	52
Lapping machines	3,570	56	6	1,211	57	14	8,539	45	20	13,320	49	16	64
Polishing and buffing machines	36,773	32	34	10,618	40	19	62,825	30	27	110,216	32	29	57
Gear-cutting and finishing machines	6,879	10	47	3,510	19	47	30,998	28	35	41,387	24	38	75
Electrical machining units	3,870	81	1	929	84	---	6,377	73	2	11,176	77	2	57
Other metal cutting machines	896	33	9	356	47	19	14,407	9	80	15,659	11	74	92
Total metal cutting machines	757,640	37	23	258,230	37	23	1,346,333	31	32	2,362,203	34	28	57

Bending and forming machines-power	32,454	34	22	13,456	34	24	52,401	33	24	98,311	34	24	53
Hydraulic and pneumatic presses	14,717	41	19	7,416	44	16	54,666	41	21	76,600	41	20	71
Mechanical presses, power	68,034	25	33	34,108	22	33	188,837	25	36	290,979	25	35	65
Punching and shearing machines, power	28,724	36	24	11,146	31	27	49,158	31	33	89,028	33	29	55
Forging machines	4,702	24	42	3,821	22	46	19,224	24	42	27,747	24	43	60
Wire and metal-ribbon formers	7,391	30	22	4,077	31	41	14,847	26	37	26,315	28	33	56
Riveting machines	9,660	38	16	5,084	33	18	40,607	40	18	55,351	39	17	73
Other metal-forming machines	7,694	39	19	5,347	40	18	25,727	31	24	38,767	34	22	66
Total metal-forming machines	173,376	31	26	84,445	29	28	445,466	30	30	703,297	31	29	63
Total machine tools	931,016	34	23	342,685	35	24	1,791,799	31	32	3,065,500	33	28	58
Electric arc-welding equipment	80,267	59	9	42,462	54	7	240,291	55	10	363,020	56	9	66
Electric resistance-welding equipment	20,173	32	21	11,178	36	16	72,601	41	18	103,952	39	19	70
Gas welding or brazing machines	2,150	67	7	597	50	6	3,114	50	7	5,861	56	7	53
Flame cutting machines	4,851	50	12	2,066	48	10	7,942	46	13	14,850	47	12	53
Metallizing equipment	1,636	72	2	470	68	2	2,611	75	6	4,717	73	4	55
Brazing machines	1,186	37	5	463	47	12	3,944	46	10	5,593	44	10	70
Total joining equipment	110,263	54	11	57,236	50	9	330,503	52	12	498,002	52	11	66
Plastic molding machines	5,406	71	5	2,385	69	11	26,162	61	8	33,953	63	8	77
Diecasting machines	1,915	57	7	1,043	48	7	8,261	49	10	11,219	51	9	74
Inspection and measuring machines	12,779	65	8	4,576	60	4	42,517	50	14	59,872	54	12	71
Heat-treating equipment	10,883	40	17	5,380	46	19	54,502	35	27	70,765	37	25	77
Baking and drying ovens	10,688	46	11	6,497	53	7	41,392	48	13	58,577	48	12	71
Cleaning and finishing equipment	32,768	57	9	16,026	58	9	97,039	52	12	146,013	54	11	66
Total other equipment	74,439	55	10	36,087	56	10	268,873	49	15	380,399	51	14	71
Total equipment	1,115,718	39	21	436,008	39	21	2,392,175	36	27	3,943,901	37	25	61

Source: American Machinist 11th inventory.

8. HOW METALWORKING EQUIPMENT AGES

[Percent under 10 years old]

	1945	1949	1953	1958	1963	1968	1973
Metal-cutting machine tools:							
Turning machines [1]	59	53	42	36	33	32	30
Boring machines [1]	66	57	45	42	36	36	30
Drilling machines	62	59	47	41	37	34	29
Milling machines	63	55	41	39	37	40	38
Tapping machines	(2)	(2)	(2)	(2)	41	42	36
Threading machines (excluding pipe and bolt)	60	56	39	38	28	29	26
Multifunction machines	(2)	(2)	(2)	(2)	(2)	77	77
Special way-type machines	(2)	(2)	(2)	85	62	59	56
Automatic assembly machines	(2)	(2)	(2)	(2)	(2)	72	65
Broaching machines	65	69	50	41	31	26	24
Planing machines	22	25	19	15	11	6	5
Shaping machines	36	37	31	23	17	11	8
Contour sawing and filing machines	(2)	(2)	64	51	41	32	30
Cutoff and sawing machines	66	67	55	49	45	44	39
Grinding machines	70	63	47	40	36	39	36
Honing and lapping machines	87	76	56	55	48	47	48
Polishing and buffing machines	59	61	49	47	37	39	31
Gear-cutting and finishing machines	70	50	42	36	27	26	24
Electrical machining units	(2)	(2)	(2)	(2)	85	83	77
Metal-forming machine tools:							
Bending and forming machines	54	50	49	46	41	36	33
Hydraulic presses	49	67	54	48	49	42	41
Pneumatic presses	(2)	82	67	55	61	54	55
Mechanical presses	39	39	37	34	39	28	25
Punching and shearing machines	(2)	41	39	37	34	34	32
Forging machines	52	28	27	20	20	25	24
Wire and metal-ribbon formers	(2)	33	43	43	44	32	28
Riveting machines (not portable)	65	61	54	48	43	40	40
Equipment other than machine tools:							
Joining equipment	85	71	61	55	53	49	52
Plastics-molding machines	(2)	67	58	56	63	67	63
Diecasting machines	(2)	83	54	70	56	49	51
Inspection and measuring equipment	(2)	(2)	(2)	(2)	(2)	56	54
Heating equipment	66	71	50	48	47	45	37
Cleaning equipment	(2)	64	55	52	53	55	54
Plating equipment	74	72	61	56	61	67	59

[1] Vertical turret lathes and vertical boring mills are included in "Turning machines" starting in 1968. They had been in "Boring machines."

[2] No comparable data exists.

Source: American Machinist 11th Inventory.

But even when allowances are made for this, the evidence is conclusive that plants with less than 100 employees are equipped with substantially more modern machine tools than are plants with more than 100 employees.

And consider the case of multifunction machines. These are the modern, expensive, sophisticated machining centers. Plants with more than 100 employees have 63% of the multifunction machines, and 75% of them are less than 10 years old. However, plants with 50 to 99 employees have 10% of the multifunction machines, and 76% of them are under 10 years old. Finally, the plants with less than 50 workers—plants that have only 9% of the employees—have 27% of the multifunction machines, and 83% of these machines are less than 10 years old.

And on all types of NC machines and equipment covered by the Inventory, the division by plant size is 72% for the plants with more than 100 workers, 6% for those with 50 to 99 employees, and 22% for the plants with less than 50 employees.

The distribution of equipment between plants with more than 100 workers and those with less is the same as it was in the 10th Inventory in 1968. However, in the plants with under 100 workers, the smaller group now includes 9% of the total workers, whereas it was 8% five years ago. These plants now have 32% of the metalcutting machines instead of the 30% they had then. They now have only 25% of the metalforming machines. They had 28% in 1968.

APPENDIX IX

Iowa State University of Science and Technology Ames, Iowa 50010

Department of Economics

October 31, 1975

Mr. Herbert L. Spira, Tax Counsel
United States Senate
Select Committee on Small Business
Washington, D.C. 20510

Dear Mr. Spira:

In response to your letter of October 21, I am enclosing a copy of a recently published regional bulletin that might be of interest.

Our research and educational efforts fall heavily in the farm estate and business planning areas. We are, therefore, deeply interested in the subject matter areas involved.

It should be noted that substantial opportunities exist for planning inter generational property transfers between generations under current law. In the past 10 years, I have made presentations, most of an all-day nature, on farm estate and business planning in, I believe, 29 states and to Bar groups in about 15 states. I have, therefore, become well acquainted with the estate and business planning problems of a broad cross section of farm people. In general, we place farm businesses (in terms of objectives) in two categories: (1) those planning for the continuation of the farm business, and (2) those planning for the termination of the farm business at retirement or death of the parents.

Historically, relatively few farm businesses have been transferred from generation to generation intact. Most farm businesses terminate at retirement or death of the parents. Typically, at the parents' deaths, the children are between 30 and 50 years of age and are either established in farming or are pursuing another occupation. The proportion of farms in which efforts are made for continuation of the parents' operation appears to be rising but traditionally farm firms have been "born" and have also "died" within a lifetime. Thus, it is important to separate concerns about loss of capital passed on to the next generation as a matter of inheritance from loss of capital from going farm businesses. A major part of my work over the past 17 years has been with problems of those farm firms for which the individuals hold as an objective continuation of the farm business into the next generation.

An increase of the federal estate tax exemption in the face of evidence that concentration of wealth has been increasing in the United States raises a question about the relative benefits from such an increase. For example, raising the exemption from $60,000 to $200,000 would be worth $107,800 for an estate in the 77 percent tax bracket. But it would be worth only $28,000 for an estate in the 20 percent tax bracket.

Mr. Herbert L. Spira
October 31, 1975
Page 2

An alternative would be to eliminate the exemption and substitute a credit against the federal estate tax. Federal estate tax law already allows four credits against the tax. This, the fifth credit, could be set at an appropriate level, perhaps $10,000 to $15,000. The "value" of the credit would be the same to all taxpayers.

A plan to provide for special treatment for agricultural assets such as land should be considered with great care. Preferential treatment for one sector of the economy inevitably encourages investment in that sector by outsiders. There is evidence that introduction of substantial amounts of outside equity investment and concomitant control would be objected to by some individuals.

If we can be of further assistance in this matter, please feel free to write or call.

Sincerely,

Neil E. Harl
Professor

NEH:mh

Enclosure

cc: Senator Dick Clark

WHO WILL CONTROL U.S. AGRICULTURE?

DEATH AND TAXES
POLICY ISSUES AFFECTING FARM PROPERTY TRANSFERS

WHY THIS PUBLICATION?

In recent years, changes in federal estate and gift tax laws have been proposed. Congress had not yet acted in mid-1975. Any changes in policies dealing with transfer taxes could affect (1) the transfer of farm property upon death of the owners, (2) the amount of revenue received by the federal treasury, (3) the future control and organization of U.S. agriculture.

In this publication the authors briefly discuss the background of transfer taxes (gift, estate, and inheritance), the current policies and some proposed changes, and the possible consequences of these changes — for the farm owner or operator, the rural community, and the total agricultural sector of the economy. The proposals discussed here are by no means the only kinds of changes that could be made. They are chosen because they have received some serious legislative consideration.

Many policy decisions must be made on judgment and logic without benefit of clear-cut evidence. Death tax policy is no exception. While this publication discusses economic and social implications and identifies alternatives and possible consequences, the authors recognize that further research is needed to more fully evaluate these important issues.

No attempt is made to suggest how to manage individual estates to reduce the tax obligation. While estate planning is an important part of financial management for individual farm families, this publication is not meant to deal with this subject.

Part One

THE CURRENT SITUATION

W. Fred Woods, Economic Research Service, U.S. Department of Agriculture
Harold D. Guither, University of Illinois
Leonard R. Kyle, Michigan State University

THE ISSUES IN BRIEF

Inflation, rising prices, and improved technology in recent years have pushed values of farm property upward. U.S. farm real estate values per acre in early 1975 averaged about eleven times higher than in 1940 and three times higher than in 1960. Since 1940, the average size of farm has more than doubled. Consequently many landowners find that the value of their farm property is greater than they had ever expected it would be.

Medium-sized farm properties that would have escaped estate taxes a few years ago are now of such value as to incur major estate tax payments. An average midwestern farm owner now may have accumulated an estate worth a quarter to half a million dollars. The large western or southern landowner may be worth several millions.

The estate tax has been a permanent part of the federal revenue system since 1916; the present $60,000 exemption has been in effect since 1942 and the present rate scale since 1941. Although all federal tax rates have been changed infrequently and have seriously lagged

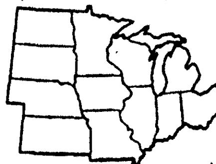
Review assistance was received from J. Carroll Bottum and Otto C. Doering, Purdue University, Hoy F. Carman, University of California, Davis, Neil Harl, Iowa State University; Philip Henderson, University of Nebraska; Wallace Barr and John Moore, Ohio State University. Harold D. Guither, University of Illinois at Urbana-Champaign, served as coordinator and editor.

NORTH CENTRAL REGIONAL EXTENSION PUBLICATION 40

Cooperative Extension Services of Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Wisconsin, and the U.S. Department of Agriculture Cooperating

University of Illinois at Urbana-Champaign
College of Agriculture
Cooperative Extension Service

Special Publication 38   September 1975



behind the general rate of inflation, only the gift tax has remained fixed for as long a time as the estate tax. So the question arises, should exemptions from these taxes or the tax rates be raised, lowered, or remain the same?

Looking ahead, farm owners and their heirs see further proportionate loss of their estate or inheritance to the federal government through the estate tax because of value increases in recent years, unless there is a change in either the exemption or the rates.

Gift taxes are closely linked with estate taxes and prevent holders of large estates from giving away their property to completely avoid transfer taxes. However, gift tax rates are less than estate tax rates. Also, availability of gift tax exemptions makes it possible to reduce the size of estates if planning is done long enough before the owner's death.

Exemptions and rates for gift taxes are different from those for estate taxes. One proposal suggests combining the two schedules into a unified transfer tax. Would this idea encourage more estate planning and use of transfer methods such as incorporation, to facilitate partial transfers that would carry little or no transfer tax?

Rapid appreciation in farm property values has built a high capital gains tax liability into estate values. Some owners are reluctant to sell property because of the capital gains tax they would have to pay. So they may leave it in their estate where it escapes the capital gains tax, although it does become subject to estate and inheritance taxes. The question has been raised as to whether such appreciated value should be taxed separately, as are all capital gains.

Today, inflation has reduced the purchasing power of the dollar by more than 65 percent of what it was when the present tax exemptions were established. If the exemptions were considered reasonable in 1941 and 1942 when they were established, it could be argued that they are too low today. With the uncertainty of inflation and deflation in the years ahead, would some system of adjusting the value of estate and gift tax exemptions for inflation be appropriate for the future?

The present marital deduction has permitted half the value of gifts and adjusted gross estates to pass to the spouse without gift or estate taxation. To increase the 50 percent marital deduction to 100 percent, as has been proposed, would reduce the amount of tax collected by the federal government when one spouse dies. It could encourage placing more wealth in the possession of the spouse who is expected to live longer.

"Generation skipping" is a practice of transferring property, usually through a trust, to grandchildren or others more than one degree in family relationship below the transferor. As a practical matter, it is generally confined to fairly large estates but may result in substantial estate tax savings. The proposal to tax such transfers would amount to applying more uniform taxation on all property transfers.

Understandably, present property owners would like to see their estate and gift tax obligations reduced. Others will disagree and would not favor change in estate tax rates without adjusting other taxes. However, since reductions in estate taxes have been proposed, it is timely to ask just what effect lower estate and gift taxes would have upon (1) the incentive for nonfarm landowners to acquire land in the future; (2) the amount of land coming onto the market for sale; (3) who owns and controls farm real estate; and (4) the future structure, organization, and control of agricultural production and marketing?

WHY DEATH TAXES?

Taxes have three main purposes in our society: (1) to raise revenue, (2) to redistribute wealth, and (3) to direct the course of society. Death taxes may contribute toward achieving all of these purposes.

The right of private ownership of property is vigorously defended in our society; government protects the rights of the individual in his property and supervises its transfer. This function is especially important for transfers of property at death.

Therefore, federal and state governments have long regarded property transfers by a person to his heirs as appropriate objects of taxation. The resulting taxes, called "death taxes," have two major forms: *inheritance* taxes and *estate* taxes. The inheritance tax is levied on the separate shares of an estate that are transferred to the heirs. It is thus considered to be a tax upon the privilege of an heir to receive property. The estate tax is levied upon the entire estate left by a deceased person and is assessed before the estate is distributed to its heirs.

Since gifts made during one's life are an obvious alternative to transfer at death, the gift tax is generally considered together with death taxes. The gift tax is levied upon the person who makes the gift (the donor), based on the amounts in excess of allowable exemptions, and it is paid during the donor's lifetime.

In the United States, the federal government levies an estate tax whereas most of the states levy inheritance taxes. A few states impose both inheritance and estate taxes. The inheritance tax usually applies lower rates to the shares passing to close relatives than to those passing to distant relatives or unrelated persons. Gift taxes are levied by the federal and some state governments. Neither gifts nor inheritances are considered as taxable income to the recipient, although income produced by property so received must be included in gross income when filing income tax returns.

Death taxes were introduced to generate revenue and they still serve this purpose. They also have been regarded as a means to prevent excessive concentration of wealth and power among a few individuals and to redistribute this wealth. Estate and inheritance taxes have been justified because (1) inheritance is an indication of an ability to pay, (2) inheritance represents unearned windfall income to heirs, (3) they serve to equalize opportunity as past unequal holdings of wealth are partially corrected, and (4) they are relatively easy to assess and collect and, moreover, can reach incomes and assets that may have escaped taxation during the owner's lifetime.

In this publication, major attention will be given to federal estate and gift taxes. They apply nationwide and generally take a larger share of a total estate than do state inheritance and estate taxes.

SIGNIFICANCE OF DEATH TAXES

The relative revenue position of federal estate and gift taxes has stabilized at about 2 percent of total federal tax receipts over the last five years, even though the dollars of tax collected increased steadily from about $1.6 billion in 1960 to $4.9 billion in 1973. State death and gift tax collections make up about the same proportion of total state collections as in the federal picture — approximately 2 percent. For fiscal year 1972, state death tax collections were $1.3 billion out of total state tax collections of $59.8 billion. Although some individual state death taxes levy a sizable tax bite, the state death taxes are generally minor when compared with the federal tax.

How then do we justify the considerable current interest in what, from the standpoint of yield, seem to be minor taxes? First, the number of estate tax returns filed has increased from 17,000 in 1940 to 175,000 in 1973. The uptrend in number of estate tax returns is partly explained by an increasing number of older persons in the U.S. population. But the filing of estate tax returns seems even more closely related to the growing dollar value of personal wealth components. This growth in personal wealth has, of course, been intensified by the inflation of recent years.

Second, although wealth transfers are only a small multiple of annual income and occur by death only once in each generation, estate and gift taxes do present complex legal, economic, and social problems. It has been charged that the various provisions of the death tax laws produce complexities in estate planning, encourage disposition of assets contrary to the best interests of taxpayers, beneficiaries, and the economy, and work inequities among taxpayers.

These reasons are particularly applicable to recent trends in American agriculture. The increase in farm size and rapid appreciation in value of farm assets have made many more farm estates and their heirs face the potential payment of death taxes than has been the case in the past. The average value of farm assets per farm rose from $51,440 in 1960 to $169,744 in 1974. In 1960 there were 800,000 farms that had gross sales of $10,000 or more and their total assets averaged almost $150,000 per farm. By 1970, the number of farms with $10,000 or more of gross sales had increased to about one million, with assets approaching $200,000 per farm. Of this one million farms about 600,000 had gross sales of $20,000 or more and average total assets of $250,000. There were 240,000 farms that grossed $40,000 and over in 1970 and had average assets of some $350,000.

RATES, EXEMPTIONS, AND INFLATION

Although used as an emergency measure in previous periods, the estate tax became a permanent part of the federal revenue system in 1916. The first estate tax carried an exemption of $50,000 and tax rates ranged from 1 to 10 percent. Today's exemption of $60,000 has been in effect since 1942 and the present rate scale of 3 to 77 percent was adopted in 1941.

First introduced in 1932, the federal gift tax is levied at rates three-fourths those of the companion federal estate tax. The gift tax has also remained unchanged since 1942 in regard to rate scale, lifetime exemption, and annual exclusion. Under present law each individual has a lifetime exemption of $30,000 ($60,000 per husband and wife). In addition to the exemption, each person may claim an annual exclusion of $3,000 ($6,000 per husband and wife) for each complete gift to each different individual. Between spouses there is, in addition to the amounts above, a marital gift exemption of 50 percent.

The period since the federal estate and gift tax exemptions and rates were set has been one of more or less continual inflation, which has accelerated at a rapid rate in recent years. The purchasing power of the dollar in 1975 is 65 percent less than when the present tax exemptions were established.

Using a price deflator to adjust for inflation, the $60,000 personal estate tax exemption authorized in 1942 is worth only $18,000 in 1975 (in terms of 1942 dollars). To establish the exemption at a level equal in real terms to $60,000 in 1942 would require that the exemption level be set at approximately $200,000.

RELATING DEATH TAXES TO FARM ESTATES

Taxes on estates and gifts have a direct impact on individual farm estates. Table 1 relates the federal estate tax schedule to four sizes of farm estates. Credits for estate and inheritance taxes and prior transfers have not been included in this example. The tax impact is greater for two farm transfers (owner to spouse and from spouse

Table 1. Percentage of Net Farm Estate Paid in Federal Estate Taxes.

Net Value of Farm Estate[1] (dollars)	Single Transfer from Owner to Farm Heir (percent)	Two Transfers—One from Owner to Spouse Using the Marital Deduction and the Second from Spouse to Farm Heir (percent)
125,000	8.7	9.3
250,000	19.0	23.4
500,000	25.3	34.8
1,000,000	30.4	43.0

[1] Net after all debts and expenses are paid but before exemptions on federal and state death taxes are calculated.

to farm heir), even when the marital deduction is used for the estate of the first spouse to die. Obviously, the tax liability creates a financial obligation for heirs although technically the estate tax is levied on the estate itself. The heir must draw on other sources, sell some of the land, or incur indebtedness to pay the tax.

Death taxes also may have a larger total potential impact upon farm than nonfarm estates because more of them had been operated as single proprietorships or partnerships. So estate management tools have come into use to minimize the future taxes and to facilitate transfers from one generation to the next. Farm ownership can be shared by family members and not concentrated into only one estate with high death tax obligations. This is accomplished through partnerships, corporation organization, and joint deeds in common with family members owning an individual interest. Farm transfers may be made more frequently prior to death, resulting in smaller farm estates for the older family members and also lower taxes.

The federal gift tax exemptions offer one way of making tax-free transfers prior to death. How much of an estate can be transferred this way depends upon how long before death an owner wants to begin disposing of his estate, how many persons he wants to give it to, and how satisfactorily certain estate assets such as land can be partitioned into gifts. Table 2 shows the tax-free transfers possible for a given number of years and receivers.

A married couple can combine their individual exemptions and so receive twice the exemption of a single person. So they can give twice the amounts tax-free that are shown in Table 2.

Awareness of the potential impact of death taxes also has brought greater use of wills, installment sales contracts, trusts, joint deeds in common, and life insurance to aid in farm transfers and reduce eventual tax obligations.

Table 2. Tax-free Gifts Possible from Farm Property Owners to Farm Heirs.

Years to Make Gifts	One Giver		
	One Recipient (dollars)	Two Recipients (dollars)	Three Recipients (dollars)
5	45,000	60,000	75,000
10	60,000	90,000	120,000
15	75,000	120,000	165,000
20	90,000	150,000	210,000

Since estate management and prior planning can affect the total tax obligation upon the death of the owner, steps are being taken by many who see that, without advance planning, a moderate-sized farm estate could have 20 to 30 percent of its value taken by federal death taxes. The tax impact can be even greater for larger estates.

CRITERIA FOR ANALYSIS OF POLICY CHOICES

If we agree that death tax policy, particularly at the federal level, should be examined in response to changing conditions, what basis should we use to evaluate the policy alternatives? Such an evaluation should consider the goals and objectives of the taxes and the consequences to various groups and the total society. The following should be considered:

1. Does the proposed policy promote efficiency in the use of resources? Does it permit the establishment and maintenance of operating units that can produce at the lowest cost? Or does it maintain high-cost units or divide low-cost units into higher-cost units? If the policy encourages or perpetuates production units that are too small or too large for most efficient use of land, labor, and capital, then some change may be desirable.

2. Does the proposed policy encourage or promote equity and equality of opportunity for farm operation and ownership? Death tax policies place pressure upon large estates through a tax obligation when the owner dies. Some farmland or other assets may be forced onto the market rather than being retained within the farm family. Any land offered for sale on the open market provides the opportunity for nonowners to acquire land. Otherwise, a farmer might have to be born into a landowning family to acquire land.

3. How does the proposed policy affect government revenues? Although its revenue yield is not large in relation to the federal income tax, the federal estate tax does have a role in the U.S. tax system. The state death taxes

also yield some revenue. The 1973 Administration message on tax reform asked that changes considered in federal death taxes be balanced in a way that does not change the overall estate and gift tax revenues. However, if other goals or objectives are seen as more significant, the amount of revenues generated by these taxes might not be a major consideration.

4. How does the proposed policy affect the structure and organization of agricultural production? Proposed changes in death taxes could affect the number of family farm owner-operators, the number of total farm units, and the concentration or dispersion of production on few or many production units. The structure of agricultural production may also affect the social structure of the rural community. Consumers have a vital stake in a continuous and abundant supply of food. Rural communities and local agri-businessmen also have a stake in the policies that affect the organization and structure of farm production.

In a discussion of policy choices, it should be recognized that there are some benefits from knowing that policies and regulations are firmly set. Those who must make decisions can live with and adjust to the existing structure. But uncertainty leads to frustration. Many people have planned on the basis of the current system. Major changes would alter their expectations. This reasoning does not suggest that change should not be made, but only that change comes with a cost. The present system provides substantial opportunity for planning farm property transfers.

IDENTIFICATION OF SPECIFIC POLICY ISSUES

Pressure for major revision of federal death tax policies has been building for several years and there is a desire to begin consideration of reform proposals at an early date. Several suggested proposals have potential major impact on U.S. farms. These proposed changes will be discussed in the following section.

Part Two

PROPOSED CHANGES IN DEATH TAX POLICIES — CONSEQUENCES FOR FARM ESTATES

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Several changes in the federal estate and gift tax laws have been proposed in recent years. Some of these are rather far-reaching while others would affect only a part of the present system. Below is a list of some of the proposals:

1. Increase the present $60,000 federal estate tax exemption.
2. Give a special exemption for, or preferential valuation to, farm property included in a decedent's estate.
3. Replace the dual federal estate and gift tax structure with a single unified transfer tax.
4. Tax the appreciation in the value of assets transferred by gift or at death.
5. Permit almost all transfers of property between spouses to be tax-free by increasing the marital deduction from 50 percent to 100 percent.
6. Tax generation-skipping transfers.
7. Relax the tax payment time schedule.

Following is a general discussion of the proposals and their possible effects on farm estates. The analysis will look only at the possible effect each proposal might have on the individual estate. A combination of one or more of the proposals or the insertion of new ideas may substantially change the impact of these proposals.

CHANGING ESTATE AND GIFT TAX EXEMPTIONS AND RATES

PRESENT LAW

Federal Estate Tax. The federal estate tax, on transfers at death, is computed on a "taxable estate" after deduction of a $60,000 specific exemption (and other deductions to be discussed later). The tax rate varies from 3 to 77 percent as shown in Table 3.

Federal Gift Tax. The federal gift tax on lifetime transfers is also a progressive tax, imposed after allowable deductions, exclusions and exemptions, at rates three-fourths as high as the estate tax rates (Table 4).

PROPOSED CHANGES

Various proposals have been made to change the exemptions and rates. Proposals have included increasing the exemption from the federal estate tax to $100,000, $120,000, $180,000, or $200,000. Another proposal, which may receive serious consideration, would leave the existing federal estate tax exemption unchanged but would "zero-rate" (that is, reduce to zero) some of the lower estate tax brackets. For instance, in lieu of increasing the exemption to $100,000, the tax rate on taxable estates of $40,000 and less would be reduced to zero. Tax rates on amounts over $40,000 would remain unchanged.

EFFECT ON FARM ESTATES

Increasing the exemption would exclude smaller farm estates from taxation and reduce the estate tax on larger farm estates. The alternative of zero rating some of the lower estate tax brackets would restrict its benefits to

Table 3. Federal Estate Tax Rates on Transfer at Death after $60,000 Exemption.

Taxable Estate (After Deducting the $60,000 Exemption) From (dollars)	To (dollars)	Tax = (dollars)	+(%)	Of Excess over (dollars)
0	5,000	0	3	0
5,000	10,000	150	7	5,000
10,000	20,000	500	11	10,000
20,000	30,000	1,600	14	20,000
30,000	40,000	3,000	18	30,000
40,000	50,000	4,800	22	40,000
50,000	60,000	7,000	25	50,000
60,000	100,000	9,500	28	60,000
100,000	250,000	20,700	30	100,000
250,000	500,000	65,700	32	250,000
500,000	750,000	145,700	35	500,000
750,000	1,000,000	233,200	37	750,000
1,000,000	1,250,000	325,700	39	1,000,000
1,250,000	1,500,000	423,200	42	1,250,000
1,500,000	2,000,000	528,200	45	1,500,000
2,000,000	2,500,000	753,200	49	2,000,000
2,500,000	3,000,000	998,200	53	2,500,000
3,000,000	3,500,000	1,263,200	56	3,000,000
3,500,000	4,000,000	1,543,200	59	3,500,000
4,000,000	5,000,000	1,838,200	63	4,000,000
5,000,000	6,000,000	2,468,200	67	5,000,000
6,000,000	7,000,000	3,138,200	70	6,000,000
7,000,000	8,000,000	3,838,200	73	7,000,000
8,000,000	10,000,000	4,568,200	76	8,000,000
10,000,000	——	6,088,200	77	10,000,000

smaller estates; no estate tax reduction would occur for estates falling into non-zero rate brackets. In the above example, estates of less than $100,000 would pay no tax; the tax for larger estates would be unchanged. In Table 5, raising the exemption to $100,000 is compared with the present structure and the alternative of zero-rating estate tax brackets less than $40,000. Changes in rates with no corresponding change in the exemption level would result in a larger or smaller tax impact depending upon the direction and degree of rate charge.

PREFERENTIAL VALUATION OR EXEMPTIONS FOR FARM ESTATES

PRESENT LAW

Present law provides no preferential valuation or special exemptions for farm estates. Like all estates, farm property is valued for estate tax purposes at the fair market value of the property at the date of death or six months later. The executor chooses the valuation date.

Table 4. Federal Gift Tax on Lifetime Transfers after Allowable Deductions.

Taxable Gifts From (dollars)	To (dollars)	Tax = (dollars)	+ (%)	Of Excess over (dollars)
0	5,000	0	2¼	0
5,000	10,000	112.50	5¼	5,000
10,000	20,000	375	8¼	10,000
20,000	30,000	1,200	10½	20,000
30,000	40,000	2,250	13½	30,000
40,000	50,000	3,600	16½	40,000
50,000	60,000	5,250	18¾	50,000
60,000	100,000	7,125	21	60,000
100,000	250,000	15,525	22½	100,000
250,000	500,000	49,275	24	250,000
500,000	750,000	109,275	26¼	500,000
750,000	1,000,000	174,900	27¾	750,000
1,000,000	1,250,000	244,275	29¼	1,000,000
1,250,000	1,500,000	317,400	31½	1,250,000
1,500,000	2,000,000	396,150	33¾	1,500,000
2,000,000	2,500,000	564,900	36¾	2,000,000
2,500,000	3,000,000	748,650	39¾	2,500,000
3,000,000	3,500,000	947,400	42	3,000,000
3,500,000	4,000,000	1,157,400	44¼	3,500,000
4,000,000	5,000,000	1,378,650	47¼	4,000,000
5,000,000	6,000,000	1,851,150	50¼	5,000,000
6,000,000	7,000,000	2,353,650	52½	6,000,000
7,000,000	8,000,000	2,878,650	54¾	7,000,000
8,000,000	10,000,000	3,426,150	57	8,000,000
10,000,000	——	4,566,150	57¾	10,000,000

Table 5. Effect on Farm Estates, Present Federal Estate Tax Exemption Compared with Increasing Exemption to $100,000 and Zero-rating Estate Tax Brackets $40,000 or Less.

Taxable Estate before Exemption (dollars)	Tax with Present $60,000 Exemption[1] (dollars)	Tax with $100,000 Exemption[1] (dollars)	Tax with Present Exemption and Zero Rates for Brackets $40,000 or Less (dollars)
100,000	4,800	——	——
200,000	32,700	20,700	32,700
400,000	94,500	81,700	94,500
750,000	212,500	198,200	212,500
1,000,000	303,500	288,700	303,500

[1] Without state tax credit.

PROPOSED CHANGE

One proposed change is to increase the exemption for family farm estates passing to individuals closely related to the decedent or the decedent's spouse. A second proposal provides that only farm property owned and oper-

ated by the decedent for a five-year period prior to death and then owned and substantially controlled and supervised by a qualified heir(s) for a similar period would qualify for the exemption.

Another approach would permit (at the estate executor's choice) qualifying real property devoted to farming, woodland, or scenic open space to be assessed, for estate tax purposes, at its value for those uses if that value is less than its fair market value. To qualify, the land would have to be in the approved use at the date of the decedent's death and for the preceding five years. Should the land be sold, or its use transformed to a nonapproved use within five years after the estate tax return is filed, additional taxes would become due.

EFFECT ON FARM ESTATES

Any change in tax regulations to give agricultural assets a preferential (lower) value for tax purposes will reduce the estate tax burden on farm estates. Regulations to make the preferential valuation available only to "qualified" farmers could result in overwhelming and costly administrative problems. It will be important in the consideration of any such bill to determine what effect the proposal will have on the ability of the farmers, over time, to compete with nonfarmers for the purchase of farm property. England attempted a preferential tax rate for farm property but recently eliminated most of the relief, at least partly because nonfarm investors drove land values above what could be regarded as agricultural value.

UNIFICATION OF ESTATE AND GIFT TAX RATES AND EXEMPTIONS

PRESENT LAW

Under present law, progressive federal estate and gift tax rates are imposed on property transfers during lifetime or at death. The two transfer taxes are separate from each other with each having a separate exemption and rate schedule. Nominally, the gift tax rate is three-fourths of the estate tax rate. The exemptions for lifetime gifts and estate transfers are as follows:

Gifts. A person is allowed to give up to $3,000 a year to as many individuals as he wishes. For example, a father could give $3,000 to each of his children every year without becoming liable for gift tax A husband and wife who make gifts jointly may each take the exclusion, even if one of them owns no property. Thus, a husband and wife, together, could give each child up to $6,000 annually without becoming liable for a gift tax.

In addition to the $3,000 annual exclusion, each person has a $30,000 lifetime exemption. The $30,000 exemption is depleted only when a gift to an individual exceeds the $3,000 annual exclusion. A husband and wife who make gifts jointly are allowed a $60,000 lifetime exemption. Thus a husband and wife with four children could make total tax-free gifts in one year of $84,000 ($21,000 to each child) by using both the annual exclusion and the lifetime exemption.

One-half of the value of a gift from one spouse to the other is exempt from gift tax. This provision in the law, sometimes referred to as the marital deduction, does not apply to gifts of life estates or other limited interests unless the estate or interest is coupled with broad powers to use the property and designate the next person who will receive the property.

Estates. The present $60,000 of property exempt from the federal estate tax is not dependent on the relationship of the person giving the property to the individuals receiving it.

PROPOSED CHANGE

One unification proposal suggests a one-time exemption of $60,000 for transfers made either during lifetime or at death. A single (unified) transfer tax, at a lower rate than presently in effect for the estate tax, would also be instituted. For example, under the present estate tax rate a taxable estate of $250,000 is subject to a maximum 30 percent tax rate. The same estate under the unified structure would be subject to a maximum tax rate of 24 percent (see Table 6). It would be necessary to keep an exact record of all lifetime transfers so that the correct transfer tax bracket and exemption would be used at death.

EFFECT ON FARM ESTATES

The effect of such a proposal on farm estates would depend upon the extent to which lifetime gifts are presently used in intergeneration farm transfers. Up to now, it is believed that such usage has been limited.

A substantial opportunity for tax-free transfers would still exist if the $3,000 per person annual gift exclusion were not eliminated Over a 30-year period, a farmer and his wife each transferring $3,000 per year to each of three children could transfer approximately $540,000 worth of assets free of any transfer tax.

The total tax obligation on an estate of a given size would be higher if only a single $60,000 exemption were allowed. This is illustrated in Table 7.

A high percentage of all farm production units is presently operated under the sole-proprietorship form of business organization. If the proposed changes were to become law, the corporate form of business enterprise might become more popular. One of the main reasons for the increased popularity would be the ease of transferring small portions of the business ownership (that is, $3,000 per person per year or less).

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Table 6. Proposed Transfer Tax Rates under Uniform Exemption and Rates.

Taxable Transfer	Present Estate Tax Rate (percent)	Unified Transfer Tax Rate (percent)	Tax at Top of Bracket	
			Present (dollars)	Proposed (dollars)
0 to $5,000	3	3	150	150
$5,000 to $10,000	7	7	500	500
$10,000 to $20,000	11	11	1,600	1,600
$20,000 to $30,000	14	11	3,000	2,700
$30,000 to $40,000	18	14	4,800	4,100
$40,000 to $50,000	22	16	7,000	5,700
$50,000 to $60,000	25	16	9,500	7,300
$60,000 to $80,000	28	18	15,100	10,900
$80,000 to $100,000	28	20	20,700	14,900
$100,000 to $150,000	30	22	35,700	25,900
$150,000 to $250,000	30	24	65,700	49,900
$250,000 to $350,000	32	25	97,700	74,900
$350,000 to $500,000	32	27	145,700	118,400
$500,000 to $750,000	35	29	233,200	180,900
$750,000 to $1,000,000	37	31	325,700	258,400
$1,000,000 to $1,250,000	39	33	423,200	340,900
$1,250,000 to $1,500,000	42	35	528,200	428,000
$1,500,000 to $2,000,000	45	37	753,200	613,000
$2,000,000 to $2,500,000	49	41	998,200	818,000
$2,500,000 to $3,000,000	53	44	1,263,200	1,038,000
$3,000,000 to $3,500,000	56	47	1,543,200	1,273,000
$3,500,000 to $4,000,000	59	49	1,838,200	1,518,000
$4,000,000 to $5,000,000	63	53	2,468,200	2,048,000
$5,000,000 to $6,000,000	67	56	3,138,200	2,608,000
$6,000,000 to $7,000,000	70	59	3,838,200	3,198,000
$7,000,000 to $8,000,000	73	61	4,568,200	3,808,000
$8,000,000 to $10,000,000	76	63	6,088,200	5,068,000
$10,000,000 and up	77	65	—	—

Source: U.S Treasury Department, "Tax Reform Studies and Proposals," February 5, 1969, p. 356. U S Government Printing Office.

INCOME TAXATION ON APPRECIATED VALUE OF PROPERTY TRANSFERRED BY GIFT OR THROUGH AN ESTATE

PRESENT LAW

The appreciation in the value of capital assets such as land and inventory items owned by the farmer and held until death is not presently subject to income tax. These assets are given a new value at the death of the owner, and the heirs use that value as a basis for determining gain or loss on the subsequent sale of the asset. For example, assume Farmer A purchased 100 acres of land at $100 per acre and, at his death, the land is a part of his estate and has a value of $1,000 per acre. Under present law, the $900 in appreciation is not subject to income tax. The heir or heirs would use the $1,000 per acre as the new income tax basis.

Gift transfers by the property owner during his lifetime are not presently subject to income tax at the time of the gift transfer. However, the tax basis of the previous owner (donor) is transferred to the new owner (donee) in gift transfers ($100 per acre in the above example).

Table 7. Tax on Estates of Varying Size with $60,000 Estate Exemption Alone and with Additional $30,000 Lifetime Gift Exemption.

Taxable Estate before the Exemption (dollars)	Estate Tax if Only $60,000 Exemption Is Available[1] (dollars)	Estate Tax if Present $60,000 Estate Exemption and $30,000 Lifetime Gift Tax Exemption Is Used[1] (dollars)
100,000	4,800	500
200,000	32,700	23,700
400,000	94,500	84,900
750,000	212,200	201,700
1,000,000	303,500	292,400

[1] Assumes no estate tax rate change.

PROPOSED CHANGE

The suggested change would impose an income tax on the appreciation in value of the capital assets, whether the property was transferred during life time or at death. Some minimum basis, perhaps $60,000, would not be subject to the appreciation tax, thereby giving relief to small estate owners. An exemption for property transferred to a spouse or to charity might accompany such a change. Generally the gains would be considered as capital gains and any tax paid would be treated as a debt of the estate. One possible relief provision would tax only appreciation occurring after enactment of the law. (For more information on these suggested changes see "Tax Reform Studies and Proposals," U.S. Treasury Department, February 5, 1969. U.S. Government Printing Office.)

EFFECT ON FARM ESTATES

The total amount of transfer taxes on moderate-sized and large farm estates could be substantially increased because of the appreciation income tax. However, the impact in the short run would be reduced by taxing only the appreciation occurring after the effective date of the act. But taxing appreciation in this way would create problems of property valuation on the specified date. The impact of such a tax also would be reduced if the tax were treated as a debt of the estate, thereby reducing the taxable estate.

If there is a substantial appreciation tax, one debatable result may be reduced investments in assets that tend to increase in value but that earn only moderate or small amounts of income. The consequence could be that the

selling price of farmland would be more in line with income possibilities than with the speculative value of the real estate.

MARITAL DEDUCTION

PRESENT LAW

A special deduction is permitted for both estate and gift tax purposes for transfers of property from one spouse to another. This deduction is commonly referred to as the "marital deduction." There are limitations on the amount of deduction that may be claimed. In the case of the gift tax the deduction is generally limited to one-half of the amount transferred, and in the case of the estate tax, the deduction is limited to one-half of the adjusted gross estate. (The adjusted gross estate is the gross estate minus debts of the estate and various administration costs.) Generally, one spouse may transfer up to one-half of his or her property to the other spouse free of tax.

Several conditions must be met to qualify for the marital deduction. When the transfer is made at death, the property must be transferred from the decedent to the surviving spouse. The surviving spouse must be given outright ownership of the property or its equivalent and the value must be included in the decedent's gross estate. For example, a transfer of a life estate in farmland to the spouse (who has income and possession rights only) would not qualify for the marital deduction because the spouse is not given outright ownership or its equivalent. A life estate plus the general power of appointment would be considered equivalent to outright ownership.

PROPOSED CHANGE

To reduce the tax burden in small and medium-sized estates and to provide more flexibility in planning transfers between spouses, one alternative would be to eliminate the 50 percent limitation, eliminate the restrictions upon the types of interests that qualify for the deduction, and give the surviving spouse the opportunity to determine the extent to which the marital deduction should apply.

EFFECT ON FARM ESTATES

Any proposal to liberalize the marital deduction would provide the opportunity to reduce the estate percentage paid in federal estate and gift tax (see Table 8).

Table 8. Comparison of Estate Taxes after 50 Percent and 100 Percent Marital Deductions.[1]

	Husband's Estate (dollars)	Wife's Estate (dollars)
Husband Dies First — 100 Percent Marital Deduction, All Property to Wife		
Gross estate	300,000	300,000
Debts and expenses	(15,000)	(15,000)
Adjusted gross estate	285,000	285,000
Marital deduction	(285,000)	——
$60,000 exemption	(60,000)	(60,000)
Taxable estate	——	225,000
Federal estate tax	——	58,200
Combined taxes = $58,200		
Husband Dies First — 50 Percent Marital Deduction, All Property to Wife		
Gross estate	300,000	300,000
Debts and expenses	(15,000)	(15,000)
Adjusted gross estate	285,000	285,000
Marital deduction	(142,500)	——
$60,000 exemption	(60,000)	(60,000)
Taxable estate	82,500	225,000
Federal estate tax	15,800	58,200
Combined taxes = $74,000		

[1] This tables assumes that the wife has property of her own equal to the taxes, debts, and expenses of her husband's estate, and that the wife lives for at least 10 years after her husband's death. If the husband has planned his estate and restricted the kind of interest in property transferred to his wife, then the above tax comparisons would be different.

TAX ON GENERATION-SKIPPING

PRESENT LAW

A property owner may now transfer property to his or her children for their lifetime with the remainder interest transferred to the grandchildren and avoid a transfer tax on such property in the estate of the children. Although the value of this property will be included in the estate of the property owner, the children (the skipped generation) will have possession and income rights only during their lifetimes. They do not have sufficient ownership interest to cause such property to be included in their estates at death.

PROPOSED CHANGE

The proposal would generally prohibit such generation-skipping by imposing a substitute tax at the time of a generation-skipping transfer. A generation-skipping transfer would, under the proposal, be a transfer to a person more than one degree (father to son is one degree) in family relationship below the transferor (person transferring the property). If the transfer is to a nonrelative, it is generation-skipping if the person who is receiving the property is more than 25 years younger than the transferor. The substitute tax would apply whether the tax was in the form of an outright gift or through a trust.

EFFECT ON FARM ESTATES

Little generation-skipping is used in small and average-sized estates and the proposal would probably have little

effect on those farm estates. For large farm estates, taxing generation-skipping would probably result in more taxes paid on these estates and a reduction in the planning opportunities.

RELAXATION OF THE TAX PAYMENT TIME SCHEDULE

PRESENT LAW

Generally the federal estate tax must be paid within nine months of the decedent's death. The Internal Revenue Service Code presently contains three provisions that assist in solving estate tax payment problems created by this requirement.

1. The payment of estate taxes can be extended for up to 10 years in instances in which the payment in nine months would cause undue hardship. Regulations have defined one example of undue hardship as being the sale of a small business at a sacrifice price.

2. Payment of estate taxes can be extended for a period of up to 10 years when an estate contains a farm or closely held business, the value of which exceeds either 35 percent of the gross estate or 50 percent of the taxable estate. However, the executor or administrator remains liable for the taxes until paid. In addition, certain dispositions of the farm business make the deferred tax immediately due. Finally, the deferred tax is only that portion relating to the farm or closely held business.

3. Capital gains treatment is accorded certain redemptions of corporate stock, to pay death taxes and funeral and administration expenses This only applies to a corporation whose stock comprises more than 35 percent of the value of the decedent's gross estate or more than 50 percent of the value of the taxable estate, and the time for such redemption is limited.

PROPOSED CHANGES

1. Make it easier for estates containing farms or other closely held businesses to qualify for the installment payment of death taxes. One possibility is to reduce the percentages from 35 and 50 to 25 and 40.

2. In addition to liberalizing the installment payment, permit executors and fiduciaries to obtain a discharge from personal liability for death taxes, provided adequate security is furnished.

3. Provide additional time for redeeming stock in closely held businesses, to pay taxes attributable to the inclusion of that stock in the gross estate.

EFFECT ON FARM ESTATES

It is expected that these modifications could make it much easier for the owners of any viable farming operation or closely held business to generate the resources needed to pay the transfer taxes that become due at the time of death.

Part Three

ECONOMIC AND SOCIAL PERSPECTIVES FOR TAX POLICY

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In the final analysis, tax policy, like all public policy, must be judged according to its effects on not only those persons or organizations involved directly, but on the entire population.

As noted in Part One, taxes serve three purposes. They raise revenue, they redistribute wealth and income, and the form in which they are levied affects how our society functions. In agriculture, the last purpose relates to the structure of agriculture — who is going to own and control it.

The first purpose is easily served. Tax experts can calculate approximately how much any change in taxes would affect the revenue received by the federal or state government.

The second and third objectives strike hard at conflicting interests among the public, and at our value systems. This is particularly true of policy for death taxes in agriculture. Lower taxes are appealing, but farm people also have subscribed to democratic values such as equality of opportunity.

Taxation of property transferred between generations historically has had as one purpose the "equalization of fortunes" (1). When President Theodore Roosevelt asked Congress to enact a progressive inheritance tax (which Congress declined to do at that time), he declared that "the prime objective should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate" (6).

Paarlberg (4) points out that it has been our national wish to keep a "free and open system of tenure" in our agriculture. In its early years, our nation took steps to "prevent the development of a hereditary land-owning class." Examples are laws prohibiting primogeniture — the "bequeathing of the farm, intact, to the eldest male heir" — and entailment — "specifying . . . that a piece of property must stay in the family through subsequent generations."

POLICY EVALUATION CRITERIA

The criteria for analyzing choices in transfer tax policy have been set forth as efficiency, equity, governmental revenue, and organizational structure. The criteria can be applied to the transfer of farm and nonfarm property alike. With regard to organizational structure, for ex-

ample, it is just as fitting to ask how a death tax policy affects continuity of a small nonfarm business as of a farm. These effects are summarized in Table 9.

EFFICIENCY

Efficiency in production and marketing has always been esteemed in agriculture. Death tax levies have the possibility of affecting efficiency primarily through their bearing on availability and cost of liquid assets and on size of operating unit. It should be recognized that capital requirements in agriculture per worker and per dollar of sales are higher than for other industries. In general, however, it is difficult to show that modest changes in death tax rates would have much net effect on efficiency.

Modern farming indeed requires large amounts of capital, whether equity or borrowed. If transfer taxes were to be reduced, part of the tax savings would remain in agriculture. The problem of refinancing to hold estates intact would thereby be eased. It is difficult to show, nevertheless, that the present system of private and cooperative credit is inadequate for financing economically organized farms. Moreover, much of the resistance to refinancing comes from the traditional notion that farmers ought to own their farms essentially debt-free. This does not apply so generally today, nor is it usually possible.

It is sometimes argued that present death taxes force the breaking up of farms into units too small to be economic. To the extent that is true, there is some loss of efficiency. But no particular farm size is more efficient under all circumstances than all other sizes. In fact, the desirable size is governed in large measure by the managerial ability of the operator. Even if the "best" size could be named, it could not be assumed that all farms subject to transfer tax are near that size.

Furthermore, if slices of a farm must be sold to pay taxes, the acreage sold may be attached to an undersized unit and add to its efficiency. Thus, for agriculture as a whole, there may be no net loss in efficiency under present or proposed transfer tax policies. In fact death taxes may occasionally lead to the breaking up of farms that have reached too large a size for best efficiency.

Do death taxes interfere with continuity in management? They probably do. However, whether an heir is a better manager than a new buyer is a debatable question. A special case arises when farm families convert to a corporate structure with several owners to circumvent death taxes. It is difficult to say whether quality of management may be improved or might be poorer.

EQUITY

Equity has many dimensions. Each is hard to explain, yet each is basic.

Consider equality of opportunity first. High exemption or low taxes on death transfer of farm property give an advantage to the heirs of the farmer over all other people, including young persons who would like to buy farmland. So the equality of opportunity principle is violated.

Furthermore, if it is true that young farmers can more readily enter farming on a holding somewhat smaller than many retiring farmers have built up, some division of large holdings at the time of transfer may particularly improve equality of opportunity. The aspiring young farmers would then find it easier to buy a modest-sized farm.

A second dimension of equity relates to equality of tax

Table 9. Effects of Proposed Property Transfer Tax Proposals.

Policy	Efficiency	Equity: Wealth Concentration	Equity: Farmland Buying Opportunities	Revenue Generation	Structure: Farm Size	Structure: Amount of Nonfarm Landholding and Tenancy
Changes in Estate and Gift Tax Exemptions and Rates						
(a) Increased exemption and/or decreased rates on all kinds of property[1]	No change	Increase	Decrease	Less	Larger	Increase
(b) Increased exemption and/or decreased rates on farm property only	No change	Increase	Decrease	Less	Larger	Large increase
Unified Gift and Estate Tax	No change	Decrease	Increase	More	Smaller	Less
Unlimited Marital Deduction	No change	No change	No change	Less	No change	——
Tax on Capital Gains of Gifts or at Death	No change	Decrease	Increase	More	Smaller	Less
Tax on Generation-Skipping	No change	Decrease	Increase	More	Smaller	Less
Extension of Time for Payment	No change	Increase	Decrease	No change	Slightly larger	Slightly more

[1] Decreased exemption or increased rates, or both, would have effects opposite to those shown here.

levies on farmers and farming compared with other taxpayers and other businesses. It is complicated by the fact that farm estates frequently have several origins. They may involve any of the following:

1. Property previously inherited and left almost unchanged. This is rare, however.
2. Accumulation of physical assets, as a farmer chose to retain them rather than convert them to current income.
3. Cumulative capital gains, on which no income tax has been paid, and which in turn may come from:
   a. General price inflation in the economy.
   b. Exceptional increases in the price of farm assets.

The principle of equity is readily applied to point 3 above, where it calls for the same rates on deferred as on currently paid taxes.

With respect to differences between points 3-a and 3-b, insofar as capital gains arise from general price inflation there is no basis for treating agriculture differently from any other industry or property holding. General price inflation results in dollar gains that have no increase in purchasing power. They extend across the economy and are no different in agriculture than in industry or trade. How to tax inflationary capital gains is a separate issue.

On the other hand, insofar as agriculture has outdistanced other sectors (due, presumably, to the intrinsic scarcity of land) and thereby has yielded a special "unearned wealth," the principle of equity suggests higher taxes than those levied, for example, on the earned income represented in point 2 above. Capital gain in excess of general price inflation is "real" in the sense that the same quantity of farm asset now represents a greater purchasing power than before.

It hardly need be added that selective favorable treatment of agriculture in death taxes is not consistent with equity unless there is some fully counterbalancing benefit to society.

REVENUE GENERATION

Federal property transfer taxes (estate and gift) generated $4.9 billion in 1973 — about 2 percent of total federal tax receipts (8). Although they are not a major component of central government finance, any tax dollar lost to lower levies must be replaced by some other government revenue, and any additional inheritance or other transfer tax dollar collected can reduce some other tax levy.

There is, however, an interconnection with equity. If, for example, any revenue lost through lower death taxes were to be made up by a sales tax or other "regressive" tax, the effect would be inequitable. If a replacement tax were instead to be placed on higher-bracket incomes, equity would likely be improved.

THE STRUCTURE OF AGRICULTURE

Not least among the criteria for judging any proposed changes in death taxes is how they would affect the organizational structure of agriculture. Various characteristics are of interest — size of holding, financial control, marketing arrangement, and ownership and control generally. Often the question is phrased as whether the "family farm" will survive. In a series of North Central Extension reports, this is defined as a "dispersed" agriculture (3). It gives proprietary status to the operating farmer and is based on access to open markets (2, 5, 7).

Most transfer tax policies would have only an indirect effect on certain structural characteristics such as the terms of access to markets. On the other hand, they could have a direct and significant effect on the size of farm and on ownership and operatorship structure.

Transfer tax policies with high exemptions or low rates, or both, facilitate the transfer of larger farms as a single unit. They thereby are more likely to discourage individuals from nonlandholding families from entering into farming, particularly as owners, acting instead to keep land in the same family hands from generation to generation. Low exemptions and higher rates might force splitting up of some farms, resulting in a larger quantity of real estate being forced on the market.

Likewise, selective concessions for agricultural estates could attract investments of well-to-do nonfarmers in farmland and tend toward transfer of ownership and control out of the hands of operating farmers. It might be possible to enact laws to restrict these concessions to "bona fide" farmers but these would involve significant administrative costs and the potential for abuses.

Although transfer taxes could be chosen in connection with a comprehensive program to establish a specified structure such as dispersed family holdings, it is doubtful that tax policy alone can exert a controlling influence over structure.

The effect of death taxes on size of farm parallels the effect on equity examined above. Low death tax exemptions or higher tax rates tend to restrain continued growth in size of farm from generation to generation, while higher exemptions or lower rates make it easier to keep farms large. It is doubtful, however, that the actual practical effect is very great. Although heirs naturally prefer to use tax exemption to finance keeping an estate intact, in most cases sufficient credit is available for that purpose.

Death taxes can have a substantial effect on who owns and who operates farms. In a broad sense, any concession in favor of current owners works toward moving land

into the hands of a separate landowning class. This is likely because ownership as such then becomes particularly attractive. Consider, for instance, that portion of farm estates that is built up from deferred capital gains. If high death tax exemptions then allow sizable amounts of such capital gains to escape taxes, high-bracket taxpayers from everywhere will compete to buy farm property that offers such a tax haven.

Whether a particular kind of organizational structure — family farm or any other — is preferred is a separate issue. It is not considered here. The only point to be made is that low death tax exemptions and relatively high rates have some tendency to preserve an agriculture where operators own at least part of their land. Higher exemptions and lower rates have an opposite effect. They facilitate moving toward a financially elite landholding class in agriculture, and landholding by other than farm operators.

EVALUATION OF SELECTED PROPOSALS

Part Two presented six selected proposals to change death taxes Four criteria for judging social effects have been set forth above. The six proposals will now be evaluated according to the criteria.

Foremost attention will be given to how each proposal would affect (1) equity and (2) structure of agriculture. The effect of each on tax revenue will be noted briefly. No further attention will be given to operating efficiency. It was pointed out earlier that moderate changes in death taxes would have scarcely any effect on aggregate efficiency of food and fiber production in the United States.

PROPOSAL ONE: CHANGING ESTATE AND GIFT TAX EXEMPTIONS AND RATES

Equity. If the larger estates subject to death taxes are held in families enjoying above-average incomes, then any increase in the minimum exemption or reduction in tax rate (for a particular size of estate) would on balance tend to increase the relative proportion of all wealth held by the more wealthy persons. That is, it would not contribute to a more nearly equal distribution of wealth and income.

When this principle is applied specifically to estates in agriculture, an increased exemption or reduced rate could also reduce equality of opportunity to own farmland, for it would facilitate holding property in a single family's hands. But if the exemption and rates were held at or near their present levels, they might force somewhat more landholding units into sale, as a whole or in parcels.

Equity arises in a different sense when the separate sources of farm estates, listed earlier, are considered. To the extent that estates arise from deferred capital gains taxes, equity calls for the same tax treatment as applied to current capital gains — and the same for agriculture as for all other parts of the economy. If, for example, capital gains were to be "indexed" (adjusted for changes in the price level), the procedure should be the same in agriculture as everywhere else.

To the extent that estates arise from *disproportionate* appreciation of asset values in agriculture, no case can be made for tax concessions on grounds of equity. They would be unfair to all persons who made equivalent incomes from their labor — the so-called earned income.

Revenue Generation. The amount of revenue generated is directly proportional to the value of the minimum exemption and the schedule of tax rates.

It has been estimated that an increase in the minimum exemption from the present $60,000 to $100,000 would reduce revenue to the federal treasury by about $650 million. An increase of $200,000 would result in an estimated revenue loss of $1.25 billion.

Adjustments in the size of exemptions have a big effect on tax revenue because a large proportion of all taxable estates have values of $60,000 to $200,000, which would be most affected by currently proposed changes in exemptions.

Structure of Agriculture. A higher death tax exemption or lower rates could lead to larger farms in the United States, as there would be less pressure for selling all or part of a large farm estate in order to pay taxes. However, larger farms kept intact following death might be operated more frequently by tenants than by owners. Frequently the heirs will not be operating farmers. Furthermore, if present laws for deferring capital gains taxes are retained, nonfarm investors would find a relaxation of death exemptions to be doubly attractive. An influx of outside investment could be expected.

The present exemption level and rates may encourage some families to convert farms into corporations in which all heirs are stockholders. The land may be farmed by one heir or by a tenant. Presumably, if the exemption were made higher there would be somewhat less incentive to follow this route.

In other respects it is doubtful that changed exemption and tax rates would have much effect on the structure of agriculture.

PROPOSAL TWO: PREFERENTIAL VALUATION OR EXEMPTION FOR FARM ESTATES

The proposal to allow farmers alone the concession of a higher exemption (or a lower rate) would have the same effects as a similar change for all estates, discussed above, *with one major exception.* That exception is that *selective exemption for farm estates would increase the incentive for nonfarm investment in agriculture.* This inflow of outside capital could be forestalled only if non-

farmers were to be prohibited from investing in farming.

It might be possible to grant increased exemptions to farm estates, provided those estates were retained in a "family farm" or other desired structure and if agreement would be reached on what structure was desired. However, it would be necessary to state exactly what kind of structure would be permitted. Continuous careful administration of such a law would be necessary and substantial costs would be involved. That is to say, death tax concessions could be built into a policy to control the future structure of agriculture, but they would be an adjunct to that policy and not its major feature.

PROPOSAL THREE: UNIFYING ESTATE AND GIFT TAX RATES AND EXEMPTIONS

Equity. A key component of the unification proposal is the single exemption for lifetime and death transfers.

The present separate exemption for gift taxes encourages transfer of property before death, and tends toward extended family (father-son-grandson) ownership of farm property. Allowing only one exemption for both gifts and estate transfers, if less than the present two exemptions, could increase the tax liability for larger estates, and would reduce opportunities to concentrate wealth within the family structure. It would thereby increase the equality of opportunity to buy farmland, because more real estate would be on the market when deathtime transfers occurred.

Any reduction in the tax rate would partially offset the impact of a decreased one-time exemption.

Revenue Generation. The revenue generation impact of the unification proposal is unclear. A lower one-time exemption would certainly increase the tax revenue from larger estates where both gifts and transfers at death have been used in the past. However, simultaneous reductions in the tax rate would partially, if not completely, offset the increased revenue generation resulting from the changes in exemptions. On balance, tax revenue would probably be unaffected or decline somewhat.

Structure. Lifetime transfers of property from parents to children are frequently used to facilitate the transfer of farm units between generations. Properly planned, this procedure enables families to maintain control of farm units of increased size virtually unaffected by transfer taxes. The unification proposal would certainly not eliminate lifetime transfers. However, it would reduce the tax incentive to make transfers before death. Thus, more property may be transferred at death, and become available for purchase by non-family members. The structural result might be fewer extended family farm holdings and more opportunities for small- and medium-sized farmers to acquire real estate.

PROPOSAL FOUR: ADJUSTING THE MARITAL DEDUCTION

Equity. Allowing the surviving spouse a deduction for the full value of property received, rather than up to 50 percent of the adjusted gross estate as currently exists, would have little impact on equality of opportunity but possibly some on equity. If the 100 percent marital deduction were used, the tax payment would be postponed until the surviving spouse dies. Funds that might have been used to pay death taxes upon the death of one spouse could provide interest until the second spouse dies and estate taxes become due.

Under current law, a tax incentive exists to transfer up to one-half of the estate to the surviving spouse. The tax consequences of transferring the remaining one-half to the spouse or other heirs are essentially the same. The proposed regulation could appear to provide an incentive to transfer the entire estate to a surviving spouse at death but eventual tax liability may not be less. Thus, the property would not be distributed among the family members or nonfamily recipients as may now occur. However, if one considers the family unit rather than the individual as the relevant decision-making body, the proposed change would not significantly affect wealth concentration or equality of opportunity compared to present law. However, it might result in very different distribution patterns within the family unit than exist under current regulations.

Revenue Generation. The unlimited marital deduction will enable the taxpayer to transfer more property to the surviving spouse tax-free. If this incentive actually results in a larger portion of most estates being transferred to the surviving spouse, then tax revenues would be decreased. But since the surviving spouse would eventually die, the property value not consumed would then be subject to tax. Due to graduated tax rates, the result could be an increase in revenues.

Structure. If the farm family is considered as the decision-making unit, the structural impact on the unlimited marital deduction will be minimal.

PROPOSAL FIVE: TAXATION OF CAPITAL GAINS TRANSFERRED BY GIFT OR THROUGH AN ESTATE

Equity. To tax capital gains at the time of transfer of property, whether by gift or at death, would improve equity between those whose wealth comes from earned and unearned sources, provided the rates were the same as any person's tax on capital gains. (Whether it is equitable to tax *any* capital gain [increase] at less than earned income is not considered here.)

If the tax rate applying to capital gains at death were lower than the current rate, the criterion of equity would not be as well served. It is difficult to equate a one-time capital gain tax (at death) and a similar tax paid with

the annual income tax return. But an approximation can be made.

Revenue Generation. The amount of revenue generated depends entirely on the terms of the capital gains levy. Since the tax would be deducted from the gross estate, it would affect the amount of estate tax due.

Structure of Agriculture. If the capital gains tax rate is more favorable than the tax on ordinary income, then investments to achieve capital gains would still be attractive. However, the rate of increase in land values and land investment by nonfarmers might be less than now.

Lower tax rates on capital gains than on ordinary income are especially attractive to high-income investors, both farm and nonfarm.

PROPOSAL SIX: TAX ON GENERATION-SKIPPING

Equity. Although generation-skipping techniques are not widely used in farm estates at the present time, increased incentives may be expected as farm estates increase in value through growth and inflation. Generation-skipping techniques have provided one of the most lucrative means of avoiding taxes and accumulating and transferring wealth tax-free in nonfarm estates. Limits on generation-skipping would not only reduce the potential for concentration of wealth and power through extended family control of property, but might also result in income and wealth redistribution through the generation of more revenues that can be used for transfer payments.

The taxing of generation-skipping might also increase the tax incidence on unearned wealth, and thus could add an additional dimension of parity between the tax burden of wage earners and property owners. Of all of the proposals discussed, limits on generation-skipping may have the largest *potential* impact on unearned wealth distribution and equality of opportunity.

Revenue Generation. Because the use of generation-skipping techniques is not common in agriculture, the tax revenue generated from this sector by the proposed changes will be small.

Structure. Generation-skipping techniques along with lifetime tax-free transfer (within certain limits) can be used to acquire and maintain extended family control over substantial wealth. In agriculture, these extended family operations may be managed in such multi-owner business organizations as corporations or partnerships or placed in trust under professional management. Subjecting accumulated wealth to transfer taxation during each generation would reduce the potential for the accumulation of large sums of tax-free wealth and the concentrated structure of the industry that would result. Although greater impact might be seen on the structure of other more concentrated sectors of the economy than in agriculture, the proposed regulation might limit such concentration in farming.

PROPOSAL SEVEN: RELAXATION OF INSTALLMENT PAYMENT PROVISIONS

Reportedly, meeting a tax obligation on an estate can sometimes cause urgent and costly liquidation of a farm or other small business. To the extent that this is true, granting greater latitude in paying death taxes would have some impact on the structure of agriculture. It would act to sustain the existing structure and to keep farming in somewhat larger units than would otherwise prevail.

Insofar as present rules can put some heirs under a serious temporary financial strain, the proposal might contribute to equity.

SUMMARY

Appreciation in value of many farm estates, due in part to accumulation of physical assets but also reflecting increased prices of these assets, has made those estates much more subject to death tax levies than was true in an earlier era.

The individual farmer, like every citizen, favors easing of the amount of tax obligation. The case for such action is strengthened by the fact that the tax formulas have not been adjusted to keep pace with inflation. But the same may be said of all federal tax rates and deductions, as they have at best been adjusted only very slowly. (State tax rates have generally increased.)

When six separate proposals for changes in death taxes are matched against criteria of effects on efficiency, equity, revenue generation, and structure of agriculture, the results show a mixed pattern. Some proposals that are attractive to individual farmers test out well by social criteria, but others do not. Still others are essentially neutral.

Few if any of the proposals would have a clear net general effect on the efficiency of agriculture. Various forms of organization ("structure") of agriculture have about the same operating efficiency. Hence this conclusion concerning death taxes.

Tax revenue is generated in direct proportion to the size of exemption, the tax rate, and allowable deductions. There is no mystery here. The effect any tax change would have on revenue can be readily calculated.

Equity and structure of agriculture are the crucial criteria. In general, in the American democratic tradition equity is not served by increasing the level of exemption or decreasing rates in death taxes. However, the effect on equity is complicated by the three separate sources of appreciation in value of estates. In that regard, the proposal to tax capital gains on gifts and at death could

improve equity, assuming the levy were the same as in the rest of the economy. The proposal to tax generation-skipping would likewise fulfill the equity criterion — perhaps more clearly than any of the other five proposals.

If the portion of estates that represented build-up of actual physical assets could be separated out, equity would be less involved in a more liberal death tax policy applied to it than in a similar application to the unearned-income portion.

Equity is not a major consideration in proposals to unify estate and gift taxes or to change the present marital deduction.

In many respects the effect that changes in death taxes would have on the structure of agriculture runs parallel to their effect on equity. For example, a higher death tax exemption or lower rates would push toward larger farms, even perhaps to a hereditary-estate agriculture. Holding the exemption relatively low, taxing capital gains at death, taxing generation-skipping, and possibly even unifying estate and gift taxes — all would act in the direction of keeping farms somewhat smaller and in more dispersed owner-operator hands.

The proposal that is most certain to move agriculture toward a system of nonfarm-landholding with more farm tenancy would be an increased death tax exemption for farm estates only. Such selective preferential treatment would also be highly inequitable.

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APPENDIX X

CLEVELAND TRUST,
August 11, 1975.

Mr. HERBERT L. SPIRA,
Counsel, Select Committee on Small Business,
Old Senate Office Building, Washington, D.C.

DEAR MR. SPIRA: In response to your inquiry, I enclose copies of various papers from my file relating to the problem of death taxation of illiquid assets, primarily small business. As Dick Covey points out in his material to you, we view the problem as either calling for a preferential rate (by way of exemption or otherwise) or of easing the burden of a uniform rate by way of extensions or other means. The papers enclosed either deal with the liquidity aspects or are some of the better argued papers on the general problem of changing the present step-up basis rule with respect to assets passing at death.

The only text I am familiar with is Professor Bosland's book on estate tax valuations of closely held businesses. This work is primarily a discussion of the valuations results achieved in the courts, but does include material which comes to the conclusion that the estate tax valuation problem has significantly led to mergers and concentrations in that area.

The papers enclosed are the following:

(1) American Bar Association paper on the liquidity and extension problem submitted to the Ways and Means Committee on September 15, 1970.[1]

(2) American Bankers Association memorandum on liquidity submitted to the Treasury Department dated October 5, 1970.[2]

(3) Statement of the National Livestock Tax Committee submitted to the Ways and Means Committee on March 29, 1973.[1]

(4) 1963 Memorandum discussing the carry-over basis rule tentatively adopted by the Ways and Means Committee during that year.[1]

(5) Statement of William P. Sutter submitted to the Ways and Means Committee dated March 29, 1973.[1]

I trust these materials may be helpful to you.

Very truly yours,

J. H. BUTALA, JR.

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[1] Material retained in committee files.

[2] Memorandum printed as a subsequent exhibit.

October 5, 1970

MEMORANDUM FOR THE TREASURY
DEPARTMENT CONCERNING LIQUIDITY

I. Introduction

The Tax Reform Studies and Proposals of the Treasury Department under the prior Administration (the Studies) contain a section captioned "Liberalization of Payment Rules". The opening two paragraphs of the section accurately state

> "Estates which contain farms or closely held family businesses sometimes encounter difficulty in finding the cash needed to pay the Federal taxes which become due shortly after death. This problem can arise as a result of improper estate planning, rapid appreciation in the value of an asset, or reluctance to sell an asset for sentimental or business reasons. The inability to pay death taxes in a timely fashion is here referred to as the 'liquidity problem'.
>
> Careful business and estate planning can help to eliminate the liquidity problem. Moreover, the Internal Revenue Code already provides installment payment privileges for use in situations in which an estate contains a farm or other closely held business. However, experience has shown that little use of these installment payment privileges is presently being made, partly because certain other provisions of the Internal Revenue Code create barriers to the use of these privileges."

The "liquidity problem" will, in many cases, be more serious than it is under existing law if a tax on unrealized appreciation at death or a carryover basis rule is substituted

for the current basis rule applicable to property included in a decedent's gross estate.

II. Current Law

There are several provisions in current law that may, in varying degrees be helpful in lessening liquidity problems.

§6161(a)(2). This section permits the time for paying estate taxes to be extended for "a reasonable period not in excess of 10 years" if payment of any part of the tax would result in "undue hardship to the estate". Treas. Regs. §20.6161-1(a) states that no single extension can exceed one year. Treas. Regs. §20.6161-1(b), relating to the hardship requirement, says

> "The extension will not be granted upon a general statement of hardship. The term 'undue hardship' means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in undue hardship. However, a sale of property at a sacrifice price or on a severely depressed market would constitute an undue hardship. Furthermore, the necessity for selling an interest in a family business, which is included in the gross estate, to unrelated persons will be considered to be an undue hardship even though the interest could be sold at a price equal to its current fair market value".

§6165. If an extension of time is granted to pay any part of the estate tax the taxpayer may be required to furnish a bond (in an amount not to exceed double the amount as to

which an extension is granted) conditioned upon the payment of the extended amount.

§6166. This section permits the time for paying estate taxes to be extended automatically for a period not to exceed 10 years if the value of an interest in a closely held business included in the decedent's gross estate exceeds either 35% of the decedent's gross estate or 50% of the decedent's taxable estate. The portion of tax as to which an extension is available is the same percentage of the net tax payable as the value of the closely held business bears to the gross estate. The words "closely held business" are defined to mean

a. An interest as a proprietor in a trade or business carried on as a proprietorship.

b. An interest as a partner in a partnership carrying on a trade or business if (i) 20% or more of the total capital of the partnership is included in the gross estate or (ii) the partnership has ten or less partners.

c. Stock of a corporation carrying on a trade or business if (i) 20% or more in value of the voting stock is included in the gross estate or (ii) the corporation has ten or less shareholders.

The amount of the tax as to which payment is extended plus interest is to be paid in equal annual installments.

§6163. This section states that if the value of a reversionary or remainder interest in property is includible in a decedent's gross estate the payment of that part of the tax attributable to such interest may, if the executor elects, be postponed until six months after the termination of the preceding interest. Treas. Regs. §20.6163-1(c) provides that the tax attributable to the reversionary or remainder interest is an amount which bears the same ratio to the total tax as the value of the interest bears to the entire gross estate.

§6601(b). This section states that if the time for payment of estate tax is extended under either §6161(a)(2), §6163 or §6166, interest shall be paid at a 4% rate rather than at the usual 6% rate.

§303. This section provides that a distribution of property to a shareholder in redemption of stock which is included in a decedent's gross estate is entitled to capital gains treatment to the extent that the amount of the distribution does not exceed all death taxes imposed as a result of the decedent's death and all funeral and administration expenses of the decedent's estate provided that the stock included in the decedent's gross estate exceeds 35% of the gross estate or 50% of the taxable estate.

III. Proposals of Studies

The Studies proposed changes in some of the sections of the Code discussed in Part II above and in other sections.

§6161. This section would be broadened to apply to capital gains taxes on net unrealized appreciation taxed as a result of the decedent's death.

§6165. This section would be revised to permit the use of security arrangements, such as mortgages, pledges and escrow agreements, in lieu of bonds. The exact form of the security arrangement would be left to the District Director. When determining the amount of the collateral to secure the payment of taxes where an extension is granted under §6166, §6165 would provide that the decedent's interest in a closely held business shall constitute adequate collateral.

§6166. This section would be liberalized by (i) changing the percentage limitation to 25% of the decedent's taxable estate, (ii) increasing the shareholder limit to 15 and (iii) broadening the section to cover gains taxed at death if the gains attributable to the closely held business are more than 25% of all gains taxed at death. §6166 would be "tightened" by eliminating the "voting stock" qualification and by shifting from annual to quarterly installment payments. No

reason is given for eliminating the "voting stock" provision. The stated reason for shifting to quarterly installments is

> "This conforms with existing collection practice in connection with estimated taxes and certain other taxes which are paid in installments. This change will also provide earlier notice of possible delinquency on the part of the estate."

§6601(b). This section would be revised by, generally speaking, requiring a higher interest rate on taxes as to which extensions have been granted than the current 4% rate. Specifically the Studies state:

> "To achieve interest neutrality so far as decisions regarding payment of taxes are concerned, a provision is proposed, similar to section 483, giving the Secretary or his delegate discretionary authority to establish the rate of interest at any given time in light of market conditions. To facilitate this exercise of discretion, and to ease administrative difficulties, the following guidelines for the exercise of this power would be followed: (1) The rate of interest should be adjusted only on January 1 of any given year, and should remain constant throughout that year. (2) Adjustments to interest rates should be made in whole point units, rather than in fractions of a percent. (3) Adjustments should be made in light of market conditions, determined by adding 2 percentage points to the Federal Reserve System's recommended rediscount rate. (4) The rate of interest applicable on the date on which a tax becomes payable will remain the same for that tax liability until it is paid. For example, if a tax becomes payable on December 31 of a given year, when the rate of interest under section 6601 is 5 percent, that rate of interest will remain applicable even though the interest rate is raised a few days later by the Commissioner."

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§303. This section would be revised by (i) permitting redemptions to extend over a 10 year period, but not to allow the use of notes or the like to avoid the time limitation, and (ii) restricting its application to those persons liable for the payment of the federal estate tax or the tax on capital gains at death with respect to closely held businesses as defined in §6166 (thus automatically applying the qualifications set forth in that section) but not permitting a "qualified" redemption for state death taxes or funeral and administration expenses.

§2204. This section relieves the executor from personal liability when the full amount of the estate tax determined to be due has been paid. A discharge cannot be obtained when an extension of time to pay the tax has been obtained because the tax has not been paid. §2204 would be revised to permit the discharge of an executor from personal liability when (i) the executor has paid all taxes assessed prior to the date of the discharge and for which no extension has been requested and (ii) the executor enters into a §6165 security arrangement. Also, similar rules would be applied to other fiduciaries holding assets includible in the gross estate and if the fiduciary applies for a discharge from personal liability and the executor fulfills the two

conditions set forth in the preceding sentence the discharge would be available to such fiduciaries.

The Studies also suggest a revision of §535 to make it clear that post-death earnings could be accumulated by a closely held business in a §303 redemption without being subject to the penalty tax. This change was made by the Tax Reform Act of 1969.

IV. Comments on Proposals of Studies

We do not believe the proposals made in the Studies with respect to the "liquidity problem" are a satisfactory solution to this most difficult problem, particularly if it is increased by a tax on unrealized net appreciation at death. This is not to say that some of the proposals are not helpful. They are. We would like to discuss each of the sections involved in detail, and in so doing will indicate our disagreement with the proposals of the Studies.

§6601(b). The change suggested in the interest rate, from 4% to a rate 2% higher than the Federal Revenue System's recommended rediscount rate, will under current conditions and conditions that are now foreseeable for the future increase considerably the interest payable when extensions of time to pay the estate tax are obtained. Interest as well as the tax is a part of the "liquidity problem". Thus the effect of the

suggested change is to increase rather than to decrease this problem. We share the concern of the Studies with respect to granting a preference in the form of a 4% interest rate when extensions are granted under §6161(a)(2), §6163 or §6166. We would, however, prefer a return to the normal 6% rate in all cases, rather than to a rate based upon market conditions at the decedent's death. Our support for a change in the interest rate is subject to the qualification that the other liberalizing changes that will hereafter be suggested are made.

§6165. We favor the changes suggested by the Studies in permitting the use of security arrangements rather than bonds and permitting the decedent's interest in a closely held business to constitute adequate collateral. We do, however, believe that some additional explanation of how the arrangements would operate is required and that the use of these arrangements should, to the extent feasible, be "standardized" through regulations so as to avoid variances between District Directors with regard to their use.

§2204. We favor permitting an executor or other fiduciary to be relieved from personal liability upon the payment of the estate tax currently due and the execution of a §6165 security arrangement, subject to the qualification that the security arrangement should be executed by the fiduciary having control over the affected assets who may be a

trustee rather than the executor. The continued personal liability of fiduciaries has very severely restricted the use of §6166. We also favor extending the release from personal liability to the decedent's income and gift taxes.

§6166. We favor the reduction in the percentage requirement to 25% of the taxable estate but oppose the change in the definition of a "closely held business" to eliminate the 20% voting stock provision. The result of this elimination would be that a corporation having more than 15 shareholders (increased from 10) could not qualify under §6166, or in fact under a §303 redemption since the provisions of §6166 would apply to §303 redemptions.

The primary difficulty with the position taken in the Studies is that it fails to recognize that the liquidity problem arises from the lack of a market for the stock and that this may be present regardless of the number of shareholders which the corporation has. We believe that the provisions of §6166 should be available whenever the percentage limitations are met and (i) the stock is not traded on a national securities exchange or in the over-the-counter market or (ii), if so traded, the decedent's gross estate includes 20% or more of the voting stock of the corporation and suggest that the section be amended to so provide. Requirement (i) is substantially the same as that suggested

by the Treasury in determining whether a stock is a "liquid asset" in its original proposal for accelerating the payment of estate tax.

We oppose the proposal that installment payments be required quarterly rather than annually as under current law. This proposal would increase the liquidity problem and be more burdensome administratively. The reasons suggested in the Studies for the change are unconvincing.

Finally, no percentage limitation should be applicable in connection with the application of §6166 to unrealized appreciation in the closely held business taxed at death. If the percentage limitation is met for the estate tax, the extension should be available for tax on appreciation regardless of whether any specific percentage of the total appreciation is represented by the business.

§303. We favor the proposals relating to this section that would extend the redemption period to 10 years, broaden the section so as to cover any tax on unrealized appreciation in the redeemed stock. We also favor the insertion of a requirement that §303 may be utilized only to the extent the redeeming shareholder is liable for the payment of death taxes <u>or</u> funeral and administration expenses. The payment of state death taxes and funeral and administration expenses is a part of the liquidity problem. Thus the proposal of the Studies

that redemptions for these purposes be eliminated worsens rather than lessens that problem and we oppose such a change. The Studies give no reason for this elimination. Also we see no reason to "equate" §303 redemptions with §6166 extensions. The policy reasons behind the two provisions are quite different. If §303 redemptions are to be equated to §6166 extensions, then the modifications of §6166 suggested above should be applicable.

§6161(a)(2). The Studies propose no change in this section except to have it apply to unrealized appreciation taxed at death. We suggest that the word "undue" be eliminated in §6161(a)(2) so that an extension would be granted upon a showing of "hardship" as contrasted to "undue hardship". We believe it is most difficult to split hairs between what is "hardship" and what is "undue hardship". Further, if as mentioned above no special interest rate is available in connection with extensions there is no reason not to have a liberal extension of time provision.

We also suggest that the regulations to §6161(a)(2) be revised to state that an extension will be granted for that part of the tax attributable to an asset where receipt of the asset is delayed for a period after the decedent's death until the asset is collected. To illustrate, if a decedent's estate [illegible] a right to receive a payment of $50,000 in each of five

years after his death the estate tax attributable to the payment could be postponed until the payment was received. The policy considerations that led to the enactment of §6163 are equally applicable to this type of case.

THE TRUST DIVISION OF THE
AMERICAN BANKERS ASSOCIATION

October 5, 1970

THE FIRST NATIONAL BANK OF CHICAGO

WILLIAM K. STEVENS / VICE PRESIDENT
EXECUTIVE OFFICER / TRUST DEPARTMENT

October 2, 1970

Mr. Richard B. Covey
Carter, Ledyard & Milburn
Counsellors at Law
2 Wall Street
New York, New York 10005

Re: American Bankers Association, Trust Division, Taxation Committee

Dear Dick:

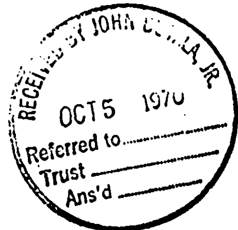
Enclosed is a copy of the statement filed with the Committee on Ways and Means by the Section of Taxation. It covers suggestions for liberalizing the current extensions of time for payment of estate taxes.

Sincerely yours,

Bill

WKS/vm

cc: Helmut Andresen
John H. Butala, Jr.
Paul F. Butler
Dic L. Dorney
Austin Fleming
C. B. Peterson, Jr.



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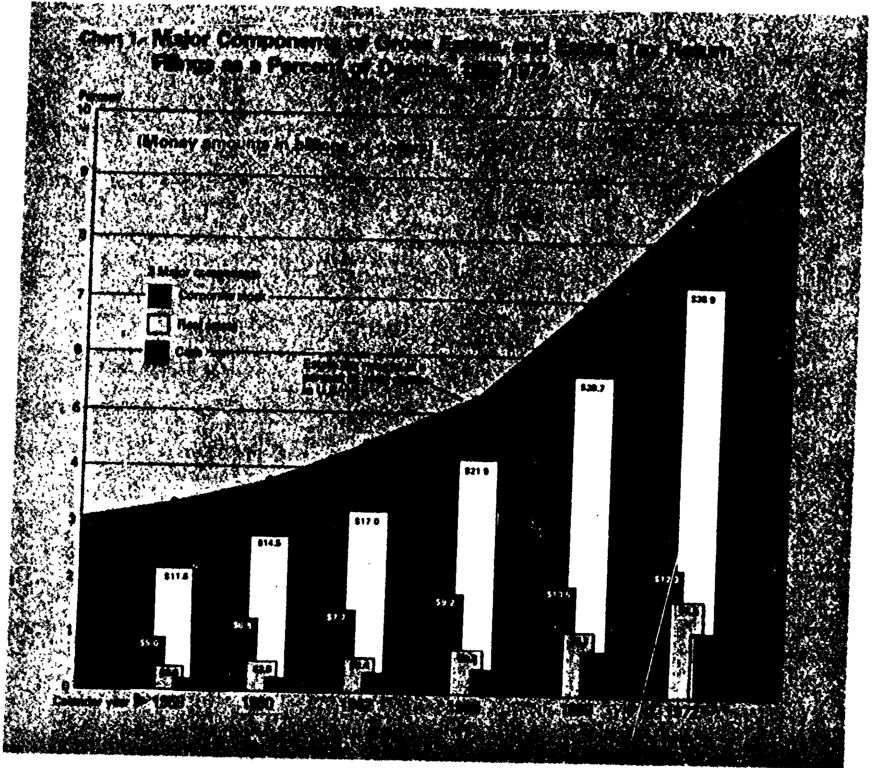
APPENDIX XI



APPENDIX XII

(The following letter was received in response to a letter from Mr. Killough, upon which the committee requested comment by the Department of Treasury. The original letter may be found in part 1 of these hearings, page 639.)

THE SECRETARY OF THE TREASURY
WASHINGTON

AUG 11 1975

Dear Mr. Chairman:

Thank you for your letter of July 8, 1975, to Secretary Simon, with which you enclosed a copy of a letter from Mr. James G. Killough of Atlanta, Georgia, commenting on the domestic international sales corporation provisions of the Internal Revenue Code, and making some suggestions for changes to make DISC more useful for small businesses.

We are aware, as Mr. Killough points out, that some DISCs are having problems investing their accumulated deferred income in qualified assets, and that in many cases the producer's loan alternative may not be viable, in part because of its complexity. As an alternative Mr. Killough suggests expanding the range of assets in which a DISC may invest, and providing for assistance to DISCs by the Small Business Administration.

In general, a DISC may invest only in assets which relate to the export business. This limitation was considered necessary to insure that the deferred earnings of a DISC could only be used in the export business. We still believe that generally this approach is the proper one, and we do not feel that any substantial change would be appropriate at this time. We do, however, recognize the special problems of smaller businesses which could justify special exceptions.

However, it must also be kept in mind that the provisions concerning DISC are already among the most complex in the tax law, and adding special rules dealing with small business would complicate them further. One problem that small businesses have been having with DISC is dealing with its complexity. Any additional complexity would make it even more difficult for the small businessman to use these provisions.

We agree with Mr. Killough that DISC is a useful provision and we are glad that many small businessmen have been encouraged to enter the export market because of DISC. As you may know DISC has been listed as one of the provisions of the Internal Revenue Code which will be reviewed in connection with

the consideration of tax reform by the House Ways and Means Committee this year. Secretary Simon in his testimony pointed out, as Mr. Killough does in his letter, that a repeal of DISC would hit those who have manufactured for export, at a time when unemployment is high and investment capital is badly needed.

Sincerely yours,

Stephen S. Gardner
Acting Secretary

The Honorable
Gaylord Nelson, Chairman
Select Committee on
Small Business
United States Senate
Washington, D.C. 20510

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