TAX REFORM ACT OF 1975

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

H.R. 10612

AN ACT TO REFORM THE TAX LAWS OF THE UNITED STATES

MARCH 17, 18, 19, 22, 23, 24, 25, 26, 29, 30, 31, APRIL 1, 2, 5, 6, 7, 8, 9, AND 13, 1976

PART 7 OF 8 PARTS

(Written Testimony)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

69-516 O WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $5.20

S361-42

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado

CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
BILL BROCK, Tennessee

MICHAEL STERN, *Staff Director*
DONALD V. MOOREHEAD, *Chief Minority Counsel*

CONTENTS

(Parts 1-8)

Discussion between members of the Senate Committee on Finance and the witnesses: Page

Russell B. Long, chairman ... 23, 30-32, 40, 41, 127, 131, 132, 191, 192, 202-204, 239-242, 245, 265, 266, 279, 282-284, 308, 310, 311, 381-388, 394, 398, 401, 403-406, 431, 432, 434, 435, 438, 441, 444, 445, 467, 468, 480-482, 483, 501-505, 508-510, 519, 522, 525-528, 541, 545-547, 571-573, 575-578, 597, 599, 609, 614, 620-622, 624, 629, 661, 703, 706, 707, 713, 714, 772-777, 779, 782, 794, 795, 798-800, 830, 831, 833, 834, 838, 854, 883, 884, 1336, 1385, 1387, 1389, 1390, 1395-1397, 1487, 1488, 1496, 1497, 1507, 1513, 1519, 1520, 1524, 1528, 1531, 1587, 1637, 1638, 1640, 1642-1644, 1652, 1653, 1655, 1656, 1662-1665, 1679-1681, 1690-1705, 1718, 1722, 1724, 1739, 1743-1745, 1889, 1890, 1895, 1897, 1900, 1919, 1923-1925, 2017, 2021-2023, 2041, 2042, 2059-2062, 2134-2137, 2146-2148, 2198, 2199, 2374, 2375, 2379-2381, 2390, 2396-2398, 2400, 2402, 2403, 2405-2407

Herman E. Talmadge ... 193-195, 318, 349, 350, 358, 380, 442-444, 1023, 1025, 1034, 1038, 1054, 1055, 1057, 1058, 1062, 1065, 1067, 1140, 1142, 1160, 1171, 1185-1189, 1239, 1243, 1244, 1257, 1258, 1675, 1679, 2381-2383

Vance Hartke ... 1928, 1929, 2137, 2138, 2145, 2146, 2182, 2183

Abraham Ribicoff ... 25-27, 898, 899, 901-903, 905, 910, 912-914, 933, 937, 938, 948, 949, 972, 974-976, 983, 984, 996, 1017, 1018, 1393-1395, 1490, 1491, 1847, 1850, 1869-1874

Harry F. Byrd, Jr ... 23-25, 204, 264, 265, 385, 386, 503, 510, 511, 567, 573-575, 674, 676, 686, 687, 712, 713, 837, 1036, 1055, 1263, 1293, 1337, 1347, 1359, 1390, 1391, 1396, 1634-1636, 1638-1640, 1747-1749, 1773, 1776, 1899, 1918, 1921, 1942, 1965, 1989, 1991, 2079, 2183, 2184, 2386, 2387

Gaylord Nelson ... 34-37, 1583, 1585, 1636, 1637, 1639, 1640

Walter F. Mondale ... 1784, 1786, 1789-1792, 1829, 1847, 1850, 1874, 1880, 1881, 1883-1886, 2387, 2388

Mike Gravel ... 39, 40

Lloyd Bentsen ... 42, 43, 626, 629, 676-678, 707, 708, 766, 769, 777-779, 832, 836, 837, 1587, 2388-2391

William D. Hathaway ... 626-628, 678, 683-686, 1387, 1388

Floyd K. Haskell ... 1392, 1393

Carl T. Curtis ... 29, 30, 195, 200, 201, 242-245, 312, 316-318, 397, 401, 402, 430, 441, 442, 468, 623, 624, 626, 674-676, 709-711, 781, 919-921, 935, 972-976, 1034, 1035, 1041, 1049, 1050, 1052, 1053, 1065, 1066, 1077, 1140, 1142, 1171, 1175, 1176, 1186, 1245, 1246, 1260, 1261, 1293, 1294, 1310, 1336, 1337, 1349, 1359-1361, 1494-1496, 1516-1518, 1531-1533, 1654, 1655, 1682-1685, 1693, 1699, 1701, 1702, 1723, 1724, 1775, 1776, 1786, 1787, 1899, 1922, 1927, 1928, 1942, 1944-1946, 1949-1951, 1959, 1961-1965, 2134, 2135, 2143-2145, 2147, 2182, 2197, 2198, 2201, 2206-2209, 2227-2230, 2234-2236, 2294, 2295

Discussion between members of the Senate Committee on Finance and the witnesses—Continued — Page

Paul J. Fannin — 27–29, 318, 346–348, 358, 359, 381, 468, 504, 508, 714, 766, 854, 880, 881, 1391, 1392, 1488, 1489, 1497, 1518, 1519, 1531, 1532, 1615–1618, 1632–1634, 1644, 1645, 1653, 1654, 1661, 1662, 2022, 2040, 2045, 2046, 2057, 2058, 2078, 2079, 2111–2113, 2117, 2121, 2126, 2127, 2135, 2145, 2294, 2295, 2299–2301, 2310, 2311, 2313, 2314, 2337–2339, 2349, 2350, 2356, 2362, 2363, 2371–2373

Clifford P. Hansen — 33, 34, 309, 310, 314–316, 348–50, 360, 481, 839, 840, 918, 919, 983, 996, 1035, 1055, 1067, 1142, 1143, 1246, 1247, 1262, 1263, 1292, 1294, 1295, 1338, 1586, 1611, 1612, 1631, 1632, 1681, 1701, 1722, 1787, 1788, 1791, 1792, 1880, 1881, 1885, 1899, 1922, 1923, 1925–1927, 1963, 2022, 2040, 2373, 2374, 2392, 2393, 2395, 2396, 2401, 2402

Robert Dole — 37, 38, 521, 522, 527, 528, 613, 614, 712, 938, 944–947, 1183, 1184, 1264, 1395, 1396, 1748, 2135, 2391, 2392

Bob Packwood — 405, 406, 519–521, 708, 709, 764–768, 772, 779, 780, 834–836, 903, 904, 915, 916, 918, 936, 972, 973, 983, 1056, 1057, 1077, 1141, 1242, 1243, 1389, 1486, 1487, 1615, 1632, 1697–1699, 1788, 1789, 1897, 1898, 1925, 1948, 1949, 1952, 2039, 2045, 2056, 2057, 2077, 2103, 2141, 2143, 2182, 2383, 2385, 2386, 2398–2400

William V. Roth, Jr — 1951, 1964, 1991, 2005, 2009, 2010

ADMINISTRATION WITNESSES

Simon, Hon. William E., Secretary of the Treasury, accompanied by Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy; William M. Goldstein, Deputy Assistant Secretary of the Treasury for Tax Policy; Victor Zonana, Deputy Tax Legislative Counsel, Department of the Treasury; and Harvey Galper, Associate Director, Office of Tax Analysis, Department of the Treasury — 10, 2367

PUBLIC WITNESSES

Ad Hoc Committee for an Effective Investment Tax Credit, George A. Strichman, chairman, accompanied by William K. Condrell, general counsel — 1739

Ad Hoc Committee on Family Foundations, James W. Riddell of Dawson, Riddell, Taylor, Davis & Holroyd and H. Lawrence Fox of Pepper, Hamilton & Scheetz — 2204

Aetna Life & Casualty Co., John H. Filer, chairman, accompanied by John J. Creedon, senior vice president, and general counsel of the Metropolitan Life Insurance Co., and Mortimer Caplin of the firm of Caplin & Drysdale — 1867

Alles, Stephen, president, Association of American Railroads, accompanied by John P. Fishwick, president and chief executive officer, Norfolk & Western Railway Co — 1918

Air Transport Association of America, Paul R. Ignatius, president, accompanied by William Seawell and Charles McErlean — 1491

American Association of Nurserymen, Inc., Robert F. Lederer, executive vice president — 432

American Association of Presidents of Independent Colleges and Universities, Phillip T. Temple, Preeau & Teitell, accompanied by Emerson Ward, M.D., chairman of the board of development, Mayo Clinic — 2234

American Bankers Association, William M. Horne, Jr., chairman, Taxation Committee, accompanied by: Thomas A. Melfe, chairman, Taxation Committee of the Trust Division — 945

American Bar Association, Sherwin P. Simmons, chairman, section on taxation, accompanied by Lipman Redman, vice chairman, government relations, and John S. Nolan, chairman, committee on implementing recommendations — 2298

American Council on Education, Durwood B. Varner, president, University of Nebraska, accompanied by Julian Levi, chairman, committee on taxation — 2188

PUBLIC WITNESSES—Continued

	Page
American Gas Association, Robert M. Dress, chairman and chief executive officer, Peoples Gas Co	1513
American Hereford Association, Henry Matthiessen, Jr., former president	397
American Institute of Certified Public Accountants, William C. Penick, chairman, Federal tax division	279
American Institute of Merchant Shipping, James R. Barker, Moore-McCormack Resources, Inc	1502
American Iron & Steel Institute, Frederick G. Jaicks, chairman, accompanied by Don Stinner, assistant comptroller of the Bethlehem Steel Co.	1327
American Machine Tool Distributors' Association, Robert W. Schoeffler, president, accompanied by James C. Kelley, executive vice president	1347
American Maritime Association, Ernest F. Christian and Alfred Maskin	1502
American Mining Congress Tax Committee, Dennis P. Bedell, chairman, accompanied by David T. Wright, partner, Coopers & Lybrand	993
American Paper Institute, Norma Pace, senior vice president, accompanied by Neil Wissing, director of taxes, Weyerhaeuser Co	1835
American Petroleum Institute, W. T. Slick, Jr., vice president, Exxon, U.S.A	795
American Public Power Association, Larry Hobart, assistant general manager	1609
American Rubber Manufacturers Association, Malcolm R. Lovell, Jr., president, accompanied by Edward Wright, vice president of economic affairs	1291
American Society of Travel Agents, Inc., Robert L. McMullen, president, accompanied by Glen A. Wilkinson, general counsel to ASTA	2100
American Telephone & Telegraph Co., Robert N. Flint, vice president and comptroller	1651
American Textile Manufacturers Institute, Inc., John T. Higgins, vice-president, Burlington Industries, accompanied by Jay W. Glasmann, counsel	1239
Associated General Contractors of America, Bill Hofacre, vice president, finance, Daniel International Corp	1773
Association of American Railroads, Stephen Ailes, president, accompanied by John P. Fishwick, president and chief executive officer Norfolk & Western Railway Co	1918
Bannon, Joan, Council on National Priorities and Resources	360
Barclay, Henry, Jr., Forest Industries Committee on Timber Valuation and Taxation, accompanied by Edward Knapp, A. Felton Andrews, and K. C. Van Natta	438
Barker, James R., of Moore-McCormack Resources, Inc., on behalf of American Institute of Merchant Shipping, accompanied by Ernest F. Christien and Alfred Maskin on behalf of the American Maritime Association	1502
Bartlett, Hon. Dewey F., a U.S. Senator from the State of Oklahoma, accompanied by Thomas Biery and Lee Rooker, professional staff assistants	2017
Batch, Ralph F., director, Illinois State Lottery	2357
Bedell, Dennis P., chairman, American Mining Congress Tax Committee, accompanied by David T. Wright, partner, Coopers & Lybrand	993
Benitez, Hon. Jaime, Resident Commissioner of Puerto Rico, accompanied by Salvador Casellas, secretary of the treasury of Puerto Rico, and Teodoro Moscoso, administrator, Economic Development Administration of Puerto Rico	1039
Bixler, Roland M., chairman, committee on taxation. National Association of Manufacturers, accompanied by Matthew P. Landers, chairman, international taxation subcommittee; and Edward A. Sprague, vice president and manager, fiscal and economic policy department	260
Blanchette, Robert W., chairman of the trustees, Penn Central Transportation Co., accompanied by Newman T. Halvorson, Jr., counsel	2347
Brandon, Robert M., director, Tax Reform Research Group	236
Brouse, J. Robert, president, Direct Selling Association, accompanied by Neil Offen, senior vice president and legal counsel	2123
Buckley, Hon. James L., a U.S. Senator from the State of New York	303

PUBLIC WITNESSES—Continued

Page

Bumpers, Hon. Dale, a U.S. Senator from the State of Arkansas 341
Bundy, Charles A., trustee, Southeastern Council on Foundations 2194
Burbach, Hon. Jules W., a State senator from the State of Nebraska and president, Midwest Task Force for Beef Exports, Inc., accompanied by Hon. Calvin F. Carsten, chairman, revenue committee; Douglas Titus, an attorney with Iowa Beef Processors, Inc.; Francis O. McDermott, a partner in the Chicago law firm of Hopkins, Sutter Mulroy, Davis & Cromartie 1050
Business Roundtable, Dr. Charls E. Walker, president, Charls E. Walker Associates, accompanied by David O. Williams, Jr., tax counsel, Bethlehem Steel Corp., and Albert E. Germain, tax counsel, Aluminum Co. of America 1693
Callahan, F. Murray, vice president, Heavy Duty Truck Manufacturers Association, accompanied by Garner Davis, vice president, Mack Truck, Inc. 1889
Calvin, Charles J., president, Truck Trailer Association 1889
Carsten, Hon. Calvin F., chairman, revenue committee, Nebraska Legislature 1050
Chamber of Commerce of the United States, Walker Winter, member of the board of directors, chairman, taxation committee 127
Chapoton, John E., on behalf of the Domestic Wildcatters Association, accompanied by Allan C. King, independent explorer, and Robert M. Beren, independent producer, Wichita, Kans., and cochairman, Small Producers for Energy Independence 769
Chrystie, Thomas L., senior vice president, Merrill Lynch & Co., Inc., accompanied by Walter Perlstein, tax counsel and John C. Richardson, attorney, Brown, Wood, Ivey, Mitchell & Petty 1845
Clark, Hon. Dick, a U.S. Senator from the State of Iowa 2293
Claytor, W. Graham, Jr., chief executive officer, Southern Railway System, F. E. Barnett, chairman, board of directors and chief executive officer, Union Pacific Railroad 1918
Coalition for the Public Good, Donald A. Tollefson, accompanied by William Penick 2227
Columbia Pictures Industries, Inc., Alan J. Hirschfield, president and chief executive officer 661
Committee of Publicly Owned Companies, C. V. Wood, Jr., chairman, accompanied by V. B. Pettigrew 1481
Committee on American Movie Production:
  Leo Jaffe, chairman 661
  Burton S. Marcus 661
Committee on Taxation of the Association of the Bar of the City of New York, Robert H. Preiskel, chairman 703
Connecticut Farm Bureau, Inc., Luther Stearns, president 1918
Council of State Chambers of Commerce:
  George S. Koch, chairman 378
  Robert Matson, chairman, committee on State taxation 1158
Council of State Housing Agencies, Kenneth G. Hance, Jr., president, accompanied by Bruce S. Lane, Esq., Lane & Edson, general counsel 565
Council on Foundations, Inc., Robert F. Goheen, chairman 2179
Council on National Priorities and Resources, Joan Bannon 360
Covey, Richardson B., of Carter, Ledyard & Milburn 1946
Cunningham, T. A., president, Independent Cattlemen's Association of Texas 429
Diehl, Walter, international president, Theatrical Stage Employees and Moving Picture Machine Operators of the United States and Canada 661
Dillingham, Paul L., vice president and director of taxes, the Coca-Cola Co. of Atlanta, Ga., and director and chairman of the Tax Policy Committee of the Tax Council 1717
D'Inzillo, Steve, New York business representative, Moving Picture Machine Operators Union of the International Alliance 661
Direct Selling Association, J. Robert Brouse, president, accompanied by Neil Offen, senior vice president and legal counsel 2123

PUBLIC WITNESSES—Continued

	Page
Dobrozsi, T. A., president, Employee Relocation Council, accompanied by Jay W. Glasmann, tax counsel, and Cris Collie, executive director	2087
Dolbeare, Cushing, executive secretary, National Rural Housing Coalition	505
Domestic Petroleum Council, T. Howard Rodgers, president and president of Santa Fe National Resources, Inc	761
Domestic Wildcatters Association, John E. Chapoton	769
Douglas, John J., executive vice president, General Telephone & Electronics Corp., on behalf of U.S. Independent Telephone Association	1583
Drevs, Robert M., chairman and chief executive officer, Peoples Gas Co., on behalf of the American Gas Association	1513
Dukess, A. Carleton, chairman, National Housing Rehabilitation Association	545
Edison Electric Institute, James J. O'Connor, executive vice president, Commonwealth Edison Co., accompanied by Reid Thompson, chairman of the board, and president, Potomac Electric Power Co., and Al Noltz, Commonwealth Edison of Chicago	1640
Emergency Committee for American Trade, Ralph Weller, chairman, Otis Elevator Co	897
Employee Relocation Council, T. A. Dobrozsi, president, accompanied by Jay W. Glasmann, tax counsel, Cris Collie, executive director	2087
Esch, Hon. Marvin L., a Representative in Congress from the State of Michigan	1895
Exxon Co., U.S.A., W. T. Slick, Jr., senior vice president	795, 3934
Faber, Peter L., chairman, tax section, New York State Bar Association	351
Farm Journal, Ms. Laura Lane, Philadelphia, Pa	1959
Federal National Mortgage Association, Oakley Hunter, chairman of the board and president	2074
Filer, John H., chairman, Aetna Life & Casualty Co., accompanied by John J. Creedon, senior vice president and general counsel of the Metropolitan Life Insurance Co., and Mortimer Caplin of the firm, Caplin & Drysdale	1867
First National Bank of Midland, Tex., Charles D. Fraser, executive vice president	831
First National Retirement Systems, Inc., Thomas L. Little, chairman of the board, accompanied by F. Jerome Shea, president, and Rufus S. Watts, technical vice president	2005
Flint, Robert N., vice president and comptroller, American Telephone & Telegraph Co	1651
FMC Corp., Robert McLellan, vice president for international and government relations	1063
Forest Industries Committee on Timber Valuation and Taxation, Henry Barclay, Jr	438
Fox, H. Lawrence of Pepper, Hamilton & Scheetz, accompanied by Ernest G. Wilson	2382
Fraser, Charles D., executive vice president, First National Bank of Midland, Tex	831
Friedberg, Sidney, executive vice president and general counsel, The National Housing Partnership and member, executive committee, Ad Hoc Coalition for Low and Moderate Income Housing	541
Furber, Ms. Jacqueline, Wolcott, N.Y	1959
Gainsbrugh, Dr. Martin, economic consultant, National Dividend Plan, accompanied by Hal Short, consultant to NDP	1357
Gamet, Donald M., vice chairman for tax practices, Arthur Anderson & Co., accompanied by William C. Penick, tax partner	1524
Garfield, David, chairman, Special Committee for U.S. Exports and vice chairman, Ingersoll-Rand Co., accompanied by Phil F. Sauereisen, president, Sauereisen Cement Co.; Peter Nelsen, president, Globus Corp.; and Robert G. Hyde, director, International Programs, General Dynamics	1063
Gatton, C. M., president, Bill Gatton Chevrolet-Cadillac	465
General Dynamics, Robert G. Hyde, director, international programs	1063
Globus Corp., Peter Nelsen, president	1063

PUBLIC WITNESSES—Continued

Page
Goheen, Robert F., chairman, Council on Foundations, Inc ... 2179
Goldwater, Hon. Barry M., a U.S. Senator from the State of Arizona, accompanied by Terry Emerson, counsel ... 2289
Gosnell, W. Lee, director of government relations, National Association of Wholesaler-Distributors ... 1989
Government Services, Savings & Loan, Inc., Arthur J. Phelan, chairman of the Board ... 474
Griffin, Hon. Robert P., a Senator from the State of Michigan ... 1895
Griskivich, Peter, director, Motor Vehicle Manufacturers Association ... 1889
Hance, Kenneth G., Jr., president, Council of State Housing Agencies, accompanied by Bruce S. Lane, Esq., Lane & Edson, general counsel ... 565
Harris, Dr. William J., Jr., vice president, research and test department, Association of American Railroads ... 1918
Hart, John C., president, National Association of Homebuilders, accompanied by Leonard L. Silverstein, tax counsel, and Carl A. S. Coan, Jr., legislative counsel ... 593
Haslam, C. L., counsel, on behalf of Duke University ... 2181
Heavy Duty Truck Manufacturers Association, F. Murray Callahan, vice president, accompanied by Garner Davis, vice president, Mack Truck, Inc. ... 1889
Hesse, Alfred W., Jr., chief executive officer, and acting president, Reading Co., accompanied by Ernest S. Christian of Patton, Boggs & Blow ... 2351
Higgins, John T., vice president, Burlington Industries, for American Textile Manufacturers Institute, Inc., accompanied by Jay W. Glasmann, counsel ... 1239
Hilton Hotels Corp., Warner H. McLean, tax director ... 2108
Hirschfield, Alan J., president and chief executive officer, Columbia Pictures Industries, Inc ... 661
Hobart, Larry, assistant general manager, American Public Power Association ... 1609
Hofacre, Bill, vice president, finance, Daniel International Corp., on behalf of the Associated General Contractors of America ... 1773
Holman, M. Carl, president, the National Urban Coalition ... 2199
Horne, William M., Jr., chairman, Taxation Committee, American Bankers Association, accompanied by: Thomas A. Melfe, chairman, Taxation Committee of the Trust Division, American Bankers Association ... 945
Hunter, Oakley, chairman of the board and president, Federal National Mortgage Association ... 2074
Hy-Gain Electronics Corp., Richard N. Thompson, secretary-treasurer and general counsel, accompanied by Zoltan M. Mihaly, special counsel ... 1172
Ignatius, Paul R., president, Air Transport Association of America, accompanied by William Seawell and Charles McErlean ... 1491
Independent Cattlemen's Association of Texas, T. A. Cunningham, president ... 429
Independent Petroleum Association of America, A. V. Jones, Jr., president ... 880
Inouye, Hon. Daniel K., a U.S. Senator from the State of Hawaii ... 2038
International Council of Shopping Centers, Wallace R. Woodbury, chairman, tax subcommittee ... 522
International Economic Policy Association, Timothy W. Stanley, president ... 2305
International Tax Institute, Inc., Paul D. Seghers, president ... 1167
Jaffee, Leo, chairman, Committee on American Movie Production ... 661
Jaicks, Frederick G., chairman, American Iron & Steel Institute, accompanied by Don Stinner, assistant comptroller of the Bethlehem Steel Co ... 1327
Johnson, LeRoy, corporate tax counsel, Northrup, King & Co., accompanied by Wayne Underwood, international marketing director of ASTA ... 1880
Jones, A. V., Jr., president, Independent Petroleum Association of America ... 880
Jones, John, on behalf of the National Football League ... 609
Karth, Hon. Joseph K., a Representative in Congress from the State of Minnesota ... 1028
Kelso Bangert & Co., Louis O. Kelso, managing director and chief economist, accompanied by Norman G. Kurland, Washington counsel ... 1885

PUBLIC WITNESSES—Continued

Page

Kelso, Louis O., managing director and chief economist, Kelso Bangert & Co., accompanied by Norman G. Kurland, Washington counsel 1885
Kennedy, Hon. Edward M., a U.S. Senator from the State of Massachusetts 180
Koch, George S., chairman, Council of State Chambers of Commerce, accompanied by Eugene Rinta, executive council 378
Kuhn, Bowie, commissioner of baseball 609
Laguarta, Julio S., chairman, legislative committee, National Association of Realtors; accompanied by Gil Thurm, staff legislative counsel, and Edwin L. Kahn, of Arent, Fox, Kintner, Plotkin & Kahn, special tax counsel 483
Lane, Ms. Laura, Farm Journal, Philadelphia, Pa 1959
Lawrence, Don, president, National Apartment Association, accompanied by John C. Williamson, general counsel 516
Lederer, Robert F., executive vice president, American Association of Nurserymen, Inc., accompanied by John Manwell 432
Leisenring, E. B., Jr., chairman, tax committee, National Coal Association, accompanied by Robert F. Stauffer, general counsel, and Larry Zalkin, treasurer, Westmoreland Coal Co. 1625
Libin, Jerome B., Sutherland, Asbill & Brennan 960
Little, Thomas L., chairman of the board, First National Retirement Systems, Inc., accompanied by F. Jerome Shea, president, and Rufus S. Watts, technical vice president 2005
Lovell, Malcolm R., Jr., president, Rubber Manufacturers Association, accompanied by Edward Wright, vice president of economic affairs of American Rubber Manufacturers Association 1291
Machinery and Allied Products Institute, Charles W. Stewart, president, accompanied by Frank Holman, staff counsel 1257
Maer, Claude M., Jr., National Livestock Tax Committee, accompanied by Flynn Stewart, member; Henry Matthiessen, Jr., former president, American Hereford Association; William McMillan, executive vice president, National Cattlemen's Association; and Bill Jones, executive vice president, National Livestock Feeders Association 397
Manufacturing Chemists Association, F. Perry Wilson, chairman of the board, Union Carbide Corp 981
Marcus, Burton S., Committee on American Movie Production 661
Matson, Robert, chairman, Committee on State Taxation, Council of State Chambers of Commerce, accompanied by William R. Brown, secretary and associate research director 1158
McDermott, Francis O., partner, Chicago law firm of Hopkins, Sutter, Mulroy, Davis & Cromartie 1050
McLean, Warner H., tax director, Hilton Hotels Corp 2108
McLellan, Robert, vice president for international government relations, FMC Corp., accompanied by Robert Moody, tax counsel, FMC Corp 1063
McMullen, Robert L., president, American Society of Travel Agents, Inc., accompanied by Glen A. Wilkinson, general counsel to ASTA 2100
Merrill Lynch & Co., Inc., Thomas L. Chrystie, senior vice president, accompanied by Walter Perlstein, tax counsel, and John C. Richardson, attorney, Brown, Wood, Ivey, Mitchell & Petty 1845
Metropolitan Life Insurance Co., Dr. Charles Moeller, Jr., senior vice president and economist 1660
Midwest Task Force for Beef Exports, Inc., Hon. Jules W. Burbach, president 1050
Moeller, Dr. Charles, Jr., senior vice president and economist, Metropolitan Life Insurance Co 1660
Motor Vehicle Manufacturers Association, Peter Griskivich, director 1889
Moving Picture Machine Operators Union of the International Alliance, Steve D'Inzillo, New York business representative 661
Nathan, Robert R., Robert R. Nathan Associates, Inc., on behalf of Small Producers for Energy Independence 851
National Apartment Association, Don Lawrence, president, accompanied by John C. Williamson, general counsel 516

PUBLIC WITNESSES—Continued

	Page
National Association of Home Builders, John C. Hart, president, accompanied by Leonard L. Silverstein, tax counsel, and Carl A. S. Coan, Jr., legislative counsel	593
National Association of Manufacturers, Roland M. Bixler, chairman, committee on taxation	260
National Association of Realtors, Julio S. Laguarta, chairman, legislative committee, accompanied by Gil Thurm, staff legislative counsel, and Edwin L. Kahn, of Arent, Fox, Kinter & Kahn, special tax counsel	483
National Association of Retired Federal Employees, Charles Merin and Judith Park, legislative assistants	2117
National Association of Theater Owners, Paul Roth, chairman of the board	631
National Association of Wholesaler-Distributors, W. Lee Gosnell, director of government relations	1989
National Cattlemen's Association, William McMillan, executive vice president	397
National Coal Association, E. B. Leisenring, Jr., chairman, tax committee, accompanied by Robert Stauffer, general counsel, and Larry Zalkin, treasurer, Westmoreland Coal Co	1625
National Conference of Motion Picture and Television Unions, Sam Robert, coordinator	661
National Dividend Plan, Dr. Martin Gainsbrugh, economic consultant, accompanied by Hal Short, consultant to the NDP	1357
National Foreign Trade Council, Inc., Robert M. Norris, president, accompanied by: Raymond A. Schroder, chairman, tax committee; Wesley N. Fach, vice president, tax-legal division	910
National Housing Partnerships, Sidney Freidberg, executive vice president and general counsel, and member executive committee, Ad Hoc Coalition for Low and Moderate Income Housing	541
National Housing Rehabilitation Association, A. Carleton Dukess, chairman	545
National Livestock Feeders Association, Bill Jones, executive vice president	397
National Livestock Tax Committee, Claude M. Maer, Jr	397
National Machine Tool Builders' Association, J. B. Perkins, president, Hill Acme Co., accompanied by James A. Gray, executive vice president, and James H. Mack, public affairs director	1306
National Realty Committee, A. Albert Walsh, president, accompanied by Alan J. B. Aronsohn NRC tax counsel	507
National Rural Housing Coalition, Cushing Dolbeare, executive secretary	505
National Savings & Loan League, Gilbert G. Roessner, past president	2053
National Urban Coalition, M. Carl Holman, president	2199
Natural Resources Group of the Central Bank of Denver, Allen Thomas, vice president	831
Needham, James J., chairman of the board, the New York Stock Exchange, accompanied by Donald L. Calvin, vice president, NYSE, and Dr. William C. Freund, vice president and chief economist, NYSE	1781
New York State Bar Association, Peter L. Faber, chairman, tax section	351
New York Stock Exchange, James J. Needham, chairman of the board, accompanied by Donald L. Calvin, vice president, NYSE, and Dr. William C. Freund, vice president and chief economist, NYSE	1781
Nolan, Kathleen, national president, Screen Actors Guild	661
Nolan, William J., Jr., chairman, Committee on Taxation, United States Council of the International Chamber of Commerce, Inc	933
Norman B. Ture, Inc., Norman B. Ture, president	1675
Norris, Robert M., president National Foreign Trade Council Inc., accompanied by: Raymond A. Schroder, chairman, Tax Committee; Wesley N. Fach vice president, tax-legal division	910
Pace, Norma, senior vice president, American Paper Institute, accompanied by Neil Wissin, director of taxes, Weyerhaeuser Co	1835

PUBLIC WITNESSES—Continued

	Page
Northrup, King & Co., LeRoy Johnson, corporate tax counsel, accompanied by Wayne Underwood, international marketing director, ASTA	1880
O'Connor, James J., executive vice president, Commonwealth Edison Co., on behalf of Edison Electric Institute, accompanied by Reid Thompson, chairman of the board and president, Potomac Electric Power Co., and Al Noltz, Commonwealth Edison of Chicago	1640
Panel consisting of: Bowie Kuhn, commissioner of baseball, accompanied by Walter J. Rockler and James P. Fitzpatrick; Robert O. Swados, vice president and director of Buffalo Sabres Hockey Club, on behalf of the National Hockey League; John Jones and Andrew Singer on behalf of National Football League; Ronald S. Schacht, National Basketball Association	609
Panel consisting of: Leo Jaffe, chairman, Committee on American Movie Production; Burton S. Marcus, Committee on American Movie Production; Walter Diehl, International President of the Theatrical Stage Employees and Moving Picture Machine Operators of the United States and Canada; Sam Robert, coordinator, New York Conference of Motion Picture and Television Unions and National Conference of Motion Picture and Television Unions and vice president of Local 52; Paul Roth, chairman of the board, National Association of Theater Owners; Steve D'Inzillo, New York business representative, Moving Picture Machine Operators Union of the International Alliance; Alan J. Hirschfield, president and chief executive officer, Columbia Pictures Industries, Inc.; and Kathleen Nolan, national president, Screen Actors Guild	661
Panel consisting of: Mrs. Lloyd Royal, Springfield, Nebr.; Ms. Audrey Sickinger, Cato, Wis.; Ms. Jacqueline Furber, Wolcott, N.Y.; Ms. Laura Lane, Farm Journal, Philadelphia, Pa.; and Ms. Jo Ann Vogel, Cato, Wis	1959
Panel consisting of: Peter Griskivich, director, Motor Vehicle Manufacturers Association; Berkley C. Sweet, president, Truck Body & Equipment Association, accompanied by James A. Hackney III, chairman, tax committee, Hackney & Son; F. Murray Callahan, vice president, Heavy Duty Truck Manufacturers Association, accompanied by Garner Davis, vice president, Mack Truck, Inc.; and Charles J. Calvin, president, Truck Trailer Manufacturers Association	1889
Panel consisting of: Stephen Ailes, president, Association of American Railroads, accompanied by John P. Fishwick, president and chief executive officer, Norfolk & Western Railway Co.; Dr. William J. Harris, Jr., vice president, research and test department, Association of American Railroads; W. Graham Claytor, Jr., chief executive officer, Southern Railway System, and F. E. Barnett, chairman, board of directors and chief executive officer, Union Pacific Railroad	1918
Panel consisting of: Dr. William Perrault, president, National Association of State Lotteries; Edward Powers, executive director, New Hampshire Sweepstakes Commission; John Winchester, executive director, Connecticut State Lottery, and vice president, National Association of State Lotteries; and Ralph F. Batch, director, Illinois State Lottery	2357
Paragon Resources, Inc., James C. Templeton, president	840
Parker, Foster, president, Brown & Root, accompanied by Prof. Michael E. Conroy, University of Texas at Austin	1181
Penick, William C., chairman, Federal tax division, American Institute of Certified Public Accountants	279
Penn Central Transportation Co., Robert W. Blanchette, chairman of the trustees, accompanied by Newman T. Halvorson, Jr., counsel	2347
Perkins, J. B., president, Hill Acme Co. accompanied by James A Gray, executive vice president, National Machine Tool Builders' Association, and James H. Mack, public affairs director, NMTBA	1806

PUBLIC WITNESSES—Continued

Page

Perrault, Dr. William, president, National Association of State Lotteries 2357

Phelan, Arthur J., Jr., chairman of the board, Government Services Savings & Loan, Inc 474

Powers, Edward, executive director, New Hampshire Sweepstakes Commission 2357

Preiskel, Robert H, chairman, Committee on Taxation of the Association of the Bar of the City of New York 703

Reading Co., Alfred W. Hesse, chief executive officer and acting president, accompanied by Ernest S. Christian of Patton, Boggs & Blow 2351

Riddell, James W., of Dawson, Riddell, Taylor, Davis & Holroyd, and H. Lawrence Fox of Pepper, Hamilton & Scheetz, on behalf of the Ad Hoc Committee on Family Foundations 2204

Robert, Sam, coordinator, New York Conference of Motion Picture and Television Unions and National Conference of Motion Picture and Television Unions and vice president of Local 52 661

Rodgers, T. Howard, president, Domestic Petroleum Council, and president of Santa Fe Natural Resources, Inc 761

Roessner, Gilbert G., president, City Federal Savings & Loan Association, Elizabeth, N.J., and past president of the National Savings & Loan League, accompanied by Henry Carrington, executive vice president of the league, and Leonard Silverstein, tax consultant to the league 2053

Roth, Paul, chairman of the board, National Association of Theater Owners 661

Royal, Mrs. Lloyd, Springfield, Nebr 1959

Sauereisen Cement Co., Phil F. Sauereisen, president 1063

Schacht, Ronald S., National Basketball League 609

Schoeffler, Robert W., president, American Machine Tool Distributors' Association, accompanied by James C. Kelley, executive vice president 1347

Scott, Tom, Jr., chairman, legislative committee, U.S. League of Savings Associations, accompanied by William Prather and John Sapienza 2042

Screen Actors Guild, Kathleen Nolan, national president 661

Security Industry Association, Virgil H. Sherrill, chairman, governing council, accompanied by Edward I. O'Brien, president, and James W. Walker, Jr., executive vice president 1825

Seghers, Paul D., president, International Tax Institute, Inc 1167

Sherrill, Virgil H., chairman, governing council, Securities Industry Association, accompanied by Edward I. O'Brien, president, and James W. Walker, Jr., executive vice president 1825

Sickinger, Ms. Audrey, Cato, Wis 1959

Simmons, Sherwin P., chairman, section of taxation, American Bar Association, accompanied by Lipman Redman, vice chairman, government relations, and John S. Nolan, chairman, committee on implementing recommendations 2295

Singer, Andrew, on behalf of the National Footbald League 609

Slick, W. T., Jr., senior vice president, Exxon Co., U.S.A., on behalf of American Petroleum Institute 795, 3934

Small Producers for Energy Independence, Robert R. Nathan, Robert R. Nathan Associates 851

Southeastern Council on Foundations, Charles A. Bundy, trustee 2194

Special Committee for U.S. Exports, David Garfield, chairman, and vice chairman, Ingersoll-Rand 1063

Stanley, Timothy W., president, International Economic Policy Association 2305

Stearns, Luther, president, Connecticut Farm Bureau Association, Inc 1918

Stewart, Charles W., president, Machinery and Allied Products Institute, accompanied by Frank Holman, staff counsel 1257

Stobaugh, Prof. Robert B., Harvard Business School 1187

Stone, Hon. Richard, a U.S. Senator from the State of Florida 312

Strichman, George A., chairman, Ad Hoc Committee for an Effective Investment Tax Credit, accompanied by William K. Condrell, general counsel 1789

Swados, Robert O., vice president and director, Buffalo Sabres Hockey Club, on behalf of the National Hockey league 609

PUBLIC WITNESSES—Continued

	Page
Sweet, Berkley C., president, Truck Body & Equipment Association, accompanied by James A. Hackney III, chairman, tax committee, Hackney & Son	1889
Tax Council, Paul L. Dillingham, director and chairman of the tax policy committee, and vice president and director of taxes, the Coca-Cola Co. of Atlanta, Ga	1717
Tax Reform Research Group, Robert M. Brandon, director	236
Temple, Phillip T., Preeau & Teitell, accompanied by Emerson Ward, M.D., chairman of the board of development, Mayo Clinic, on behalf of the American Association of Presidents of Independent Colleges and Universities	2234
Templeton, James C., president, Paragon Resources, Inc	840
Texaco, Inc., Wilford R. Young, vice chairman of the board of directors and general counsel	797, 3934
Theatrical Stage Employees and Moving Picture Machine Operators of the United States and Canada, Walter Diehl, international president	661
Thomas, Allen, vice president, Natural Resources Group of the Central Bank of Denver	831
Thompson, Richard N., secretary-treasurer, and general counsel, Hy-Gain Electronics Corp., accompanied by Zoltan M. Mihaly, special counsel	1172
Titus, Douglas, attorney, Iowa Beef Processors, Inc	1050
Tollefson, Donald A., Coalition for the Public Good, accompanied by William Penick	2227
Truck Body & Equipment Association, Berkley C. Sweet, president, accompanied by James A. Hackney III, chairman, tax committee, Hackney & Son	1889
Truck Trailer Manufacturers Association, Charles J. Calvin, president	1889
Ture, Norman B., president, Norman B. Ture, Inc	1675
United States Council of the International Chamber of Commerce, Inc., William J. Nolan, Jr., chairman, Committee on Taxation	933
U.S. Independent Telephone Association, John J. Douglas, executive vice president, General Telephone & Electronics Corp	1583
U.S. League of Savings Associations, Tom Scott, Jr., chairman, legislative committee, accompanied by William Prather and John Sapienza	2042
Varner, Durwood B., president, University of Nebraska, accompanied by Julian Levi, chairman, committee on taxation, American Council on Education	2138
Vogel, Ms. Jo Ann, Cató, Wis	1959
Walker, Dr. Charls E., president, Charls E. Walker Associates, on behalf of the Business Roundtable, accompanied by David O. Williams, Jr., tax counsel, Bethlehem Steel Corp., and Albert E. Germain, tax counsel, Aluminum Co. of America	1693
Walsh, Albert A., president, National Realty Committee, accompanied by Alan J. B. Aronsohn, NRC tax counsel	567
Weller, Ralph, chairman, Otis Elevator Co., on behalf of Emergency Committee for American Trade	897
Wilson, F. Perry, chairman of the board, Union Carbide Corp., on behalf of Manufacturing Chemists Association	981
Winchester, John, executive director, Connecticut State Lottery	2357
Winter, Walker, member of the board of directors, chairman, taxation committee, Chamber of Commerce of the United States, accompanied by Robert R. Statham, director, tax and finance section; and Walter A. Slowinski, member of the chamber's taxation and international committees	127
Wood, C. V., Jr., chairman, The Committee of Publicly Owned Companies, accompanied by V. B. Pettigrew	1481
Woodbury, Wallace R., chairman, tax subcommittee of the International Council of Shopping Centers	522
Young, Wilford R., vice chairman of the board of directors and general counsel, Texaco, Inc	797, 3934

ADDITIONAL INFORMATION

Opening Statements of Members of Committee on Finance

	Page
The Chairman	1
Senator Curtis	3
Senator Fannin	3
Senator Hansen	5
Senator Dole	9

Tables and Charts

Averaged annual rate of change in real growth for member nations of OECD, 1960-70	8
Investment as percent of real national output, 1960-73	8
Productivity growth, 1960-73	9
1975 gross national product and employment figures	47
Indicators and estimates of DISC performance	50
U.S. productivity growth, 1950-75	54
Illustrative computation of 50-percent corporate dividend deduction	73
Illustrative computation of 50-percent individual dividend gross-up and credit	74
Real gross national product	102
Consumer Price Index	103
Productivity growth, 1960-73	104
Actual and projected investment as a percent of GNP	105
Debt-equity ratios for selected industries	106
The President's tax cut proposals	107
Tax rate schedule for President's tax reduction proposals	108, 109
Tax liabilities under various tax laws	110
Comparison of individual income tax provisions	115
Revenue losses of individual income tax reduction compared to 1974 law	116
Total tax liability under various tax laws	117
Distribution of tax liabilities under President's proposal for 1976 compared with Revenue Adjustment Act extended by size of adjusted gross income	118
Income distribution of liability under President's proposal for 1977 compared with Revenue Adjustment Act unextended	121
Income distribution of liability under President's propsal for 1977 compared with President's proposal for 1976	122
Revenue losses of corporate income tax reduction compared to 1974 law	123
Annual costs and benefits of taxable municipal bond plan with 30-percent subsidy	124
Effects of tax proposals on fiscal year 1977 receipts	125
Comparison of cost recovery allowances	178
Productivity growth, 1960-73	180
Growth of tax expenditures (chart 1)	181
Growth of tax expenditures (chart 2)	182
Projected increases in selected tax expenditures	183
Tax expenditure estimates, by function	196
Kennedy tax reform proposals—Estimated fiscal year revenue effects of principal recommendations	212
Distribution of benefits of maximum tax—1972	214
Partnership return	247
Small business corporation return	248
Individual income tax return	248
Distribution of DISC's net income by size of parent corporation	257
Economic impact of a capital recovery allowance system (H.R. 7543)	277
Economic impact of a permanent 10-percent investment tax credit for all taxpayers	278
Initial impact and net Federal revenue estimates for proposed tax revisions	278
Importance of reasons for foreign investments	293
Relating to livestock	423-29
Relating to forestry	448-53

TABLES AND CHARTS—Continued

	Page
Impact of tax proposals on the yield from a successful residential real estate investment	495–497
Taxes and transfers as a percentage of income, 1965	510
Housing-related tax expenditures, 1977	512
Estimated impact of substituting a tax credit of not more than $200 for tax deduction of mortgage interest and property taxes	513
Approximate distribution of Federal housing subsidies by income class, 1973	514
Estimated amount of Federal housing subsidy, by income class, fiscal 1976	514
1974 housing-related tax expenditures, by adjusted gross income class	515
Effects of Tax Reform Act of 1975	538–590
Ways and Means Committee version—Effect of minimum tax on investor	561–562
Estimated man-years of work requirements and wages paid for construction of a single family house	598
Relating to pension fund assets	607–608
Length and form of ownership of major league baseball clubs, January 1, 1976	642
Combined statement of income and expenses for major league baseball teams for years 1969–73, inclusive	642
Comparison of baseball and football revenues	643
Baseball franchise purchases, 1965–75	643
U.S. apparel imports	1046
Beef production credit mechanism on price	1054
IBP export sales, 1961-75	1059
Merchandise trade balance, 1970–75	1080
Dependence on selected imported industrial raw materials, 1973	1081
U.S. trade growth in 1970's	1083
Tax incentives for exports	1121–1123, 1127
Nontax incentives for exports	1124–1126, 1128
Performance update, 1975	1147–1154
Survey of 30 major U.S. engineering—Construction companies foreign activities in 1974 and 1975	1183, 1187
Skill compositions of selected work forces, CIRCA 1970	1196
U.S. employment of 2,233 U.S.-based multinational enterprises in manufacturing compared with other firms in same industries, 1966 and 1977	1198
Number of full-time equivalent employees by industry, 1970 and 1973	1199
U.S. balance-of-payments inflows and outflows, U.S. foreign direct investments of manufacturing industries, 1970 and 1973	1200
U.S. balance-of-payments inflows and outflows, U.S. foreign direct investments of all U.S. industries, 1970–73	1200
Relationship between U.S. foreign direct investment inflows and other U.S. trade, 1970–73	1200
Foreign trade of United States associated with 293 U.S. multinational enterprises compared with other U.S. trade, 1966 and 1970	1201
Rank of U.S. firms among 10 firms with largest sales in 9 industries, worldwide including United States, 1971	1202, 1204
A comparison of the sales and number of foreign manufacturing affiliates of U.S. versus non-U.S. multinational enterprises, 1970	1205
Categories of companies with largest market shares in 90 product-country markets	1206
Rank in 1973 of U.S. firms among 10 firms with largest sales in 1971 in 9 industries, worldwide including United States	1207
Change in worldwide sales, including those in the United States, from 1971 to 1973 of 10 largest firms	1208
Growth in book value of foreign direct investments by private firms of selected countries, 1971 to 1973	1208
Foreign income tax rates and foreign dividend tax rates for U.S.-owned foreign affiliates whose taxes would be affected if a U.S. tax rate were placed on their unremitted foreign earnings: Selected countries and worldwide totals for affiliates in manufacturing, 1966	1211
Funds flow, computer model of U.S. multinational enterprise, first year of base case with current tax law	1219
Sample tax calculations, U.S.-owned foreign subsidiary, current tax laws	1220

TABLES AND CHARTS—Continued

Page

Funds flow, computer model of U.S. multinational enterprise, first year of base case with a U.S. tax on unremitted foreign earnings ---- 1221
Example that illustrates advantage of subsidiary's paying out all earnings in year 1 under assumption that it has no earnings in year 2 ---- 1222
Estimated effects of placing a U.S. tax on unremitted foreign earnings of US.-owned foreign subsidiary, base case, year 1 ---- 1223
Illustration of possible order-of-magnitude effects of placing a U.S. tax on unremitted foreign earnings of US. manufacturing operations abroad, base case ---- 1224, 1225
Summary of results, computer simulation model of a US. multinational enterprise ---- 1226
Name, nationality, and sales of 10 firms with largest sales in 1971 in 9 industries worldwide including United States ---- 1230, 1231
Sales and number of affiliates, foreign manufacturing operations, U.S. and non-U.S. multinational enterprises, 1970 ---- 1232
U.S. balance of payments—Major international transactions, annual averages ---- 1289
U.S. balance of payments—Government versus private sector, annual averages ---- 1290
U.S. balance of payments—Private sector transactions, annual averages ---- 1290
U.S. balance of payments—Transactions relating to U.S. direct private investment abroad—Major world areas, annual averages ---- 1290
U.S. balance of payments—Transactions relating to U.S. direct private investment abroad—Major industry sectors, annual averages ---- 1291
Historical performance—Five major OE tire suppliers consolidated cash flow ---- 1298
Annual new manufacturing investment in plants and equipment of U.S. MNC's in the tire manufacturing industry ---- 1304
Effect on balance of payments resulting from multinational corporation manufacturing operations in the American tire industry ---- 1305
Machine tools—Domestic new orders ---- 1309
Net profit after taxes—All manufacturing and machine tools, 1969–74 ---- 1321
Average net income of all manufacturing corporations and machine tool companies surveyed, 1965 to date ---- 1322
Average net income of machine tool companies, income data in percent of net sales, 1965 to date ---- 1322
Machine tools—Domestic new orders ---- 1323
Machine tool industry—All employees versus domestic machine tool net new orders in constant dollars ---- 1324
Gross fixed capital formation as a percent of GDP, 1960–74 annual average ---- 1325
Productivity—Real GNP per employed civilian ---- 1325
Cost recovery allowable for tax purposes on machinery and equipment ---- 1326
Age of machine tools in six industrial nations ---- 1326
Federal expenditures, Federal revenues and Federal deficit-surplus, assuming NDP phased in, 1977–81 ---- 1365
Net reduction in Federal expenditures and Federal debt under NDP, assuming phasein began in 1972 ---- 1365
Actual and potential gross national product ---- 1367
Total income tax revenue over and above that realized under the No Financing/Pension Plan Case ---- 1421
Financing economic growth by monetizing productive capital while building market power into consumers through employee stockownership plan (ESOP) financing ---- 1425
Estimates of revenue cost of making investment credits refundable (S. 3080) as compared with revenue cost of present law investment tax credit (ITC) ---- 1495
Unused airline investment credits, at December 31, 1975 ---- 1501
Present and proposed minimum taxable income forms ---- 1529, 1530
Real estate investment, residential housing and shopping center development (joint return) ---- 1537
Section 236. Housing project, rates of return on investment ---- 1537
Effect of LAL proposals on a section 236 project ---- 1538, 1539

TABLES AND CHARTS—Continued

	Page
Oil and gas development drilling venture, two-well program—$200,000 other income	1540
Expenditures for new plant and equipment, 1965–75	1595, 1596
Comparison of leverage	1597
Long term "A" utility interest rates	1597
Long term debt interest rates new issues versus embedded rate	1598
Comparison of pre-tax interest coverage	1598
Assets required to generate $1 of sales revenue	1599
Total new security issues, 1966–75	1600
Utility employment, 1975	1601
Correlation between changes in investment and employment, 1948–75	1602
Dividend payout ratios, 1965–75	1603
Tax laws favor high growth, low dividend investments over low growth, high dividend investments	1604
GTE dividend reinvestment plan	1605, 1606
Capital requirements	1626
Estimates of construction expenditures investor-owned electric utility industry, 1976–89	1651
Bell system construction and financing, 1966–75	1658
Trends of government purchases and expenditures related to gross national product	1671
Actual and adjusted tax rate for corporate profits	1672
Estimated capital requirements and private saving, 1976–85	1688, 1689
Effect of DISC on financing of excess export receivables	1703
Nontaxable returns, 1972, by adjusted gross income groups	1725
Income subject to tax by adjusted gross income groups, taxable returns, 1972	1725
Income tax by size of adjusted gross income	1726
Exclusions by adjusted gross income groups	1726
Durable goods	1752
Real GNP per employed civilian, 1960–72	1753
Productivity growth, 1960–73	1753
Investment as percent of real national output, 1960–73	1754
Capital intensity and worker earnings	1754
Gross nonresidential fixed investment per person added to civilian labor force	1755
Actual and projected investment as a percent of GNP	1756
Estimated capital requirements and private saving, 1975	1756, 1757
Representative cost recovery periods in the United States and in selected foreign countries on machinery and equipment	1758
Comparison of cost recovery allowances	1769
Aggregate cost recoveries	1771
Comparative costs debt versus equity financing	1798
Tax saving and contribution to capital, 1972–74	1817
Selected tax treaties in effect between the United States and foreign countries as of April 1975	1862
Funds raised, private domestic nonfinancial corporations	1865
Corporate business selected liquidity ratios	1865
Individuals' holdings of equity securities	1866
Federal excise tax rates on trucks, buses, trailers, parts and accessories	1904
Retail sales of trucks subject to 10 percent Federal excise tax	1905
Mack U.S. domestic market average vehicle sales price	1910
Rate table for taxable estate	1999
Unadjusted and adjusted effective tax rates for major depository intermediaries, by institution size, 1973	2073
Basis point subsidy of various mortgage interest tax credits for alternative portfolios	2073
Estimated impact of proposed mortgage interest tax credit on Federal National Mortgage Asociation	2084
Total support by source, all colleges and universities reporting	2156
Voluntary support of education	2157, 2158
Average operating budget for medical schools	2211
List of recommendations of section of taxation, American Bar Association	2303–2305
Sales of foreign affiliates of U.S. firms	2310, 2311

69-516 O - 76 - pt. 7 - 2

TABLES AND CHARTS—Continued

Page
Direct investment capital outflow, income and net balance, 1948-75 ... 2314
Relationship of sales of U.S. majority owned foreign affiliates to U.S. imports ... 2316
Foreign country tax treatment of their subsidiaries operating abroad ... 2327-2329
Statutory tax rates in foreign countries ... 2332
Tax revenues as a percent of GNP for selected countries, total revenue and by type of tax all levels of government: Federal, State, local—1973 ... 2382
Producers' durable equipment ... 2392, 2393
Information on high income nontaxable individuals ... 2402

COMMUNICATIONS

Academy of the New Church, Louis B. King, president ... 3791
Ad Hoc Agricultural Tax Committee, Don Woodward, president, National Association of Wheat Growers ... 3628
Ad Hoc Committee for an Effective Investment Tax Credit, George A. Strichman, chairman ... 1745
Advanced Concepts Insulators, Division of Corrosion Control, Inc., Larry J. Ortt, manager ... 3441
Aerospace Industries Association of America, Inc ... 2847
Affleck, James G., chairman and president, American Cyanamid Co ... 2829
Aladdin Petroleum Corp., William C. Lane ... 3933
Allen, Hon. James B., a U.S. Senator from the State of Alabama ... 3901
Aluminum Recycling Association, Richard M. Cooperman, executive director ... 3452
American Accounting Association, James E. Wheeler, chairman, Committee on Federal Income Taxation ... 3346
American Association of Retired Persons ... 3071
American Association of University Professors, Dr. Joseph Duffey, general secretary ... 3213, 3220
American Bar Association:
John P. Bracken, chairman, house of delegates ... 3016
Lawrence E. Walsh ... 3367
American Chamber of Commerce of Mexico ... 3024a
American Chamber of Commerce of Venezuela, Thomas L. Hughes, president ... 2839
American College of Probate Counsel, Frank S. Berall, chairman, Committee on Estate and Gift Tax Reform ... 3641
American Council for Capital Formation ... 2510
American Council of Voluntary Agencies for Foreign Service, Inc., James J. Norris, chairman ... 2633
American Cyanamid Co., James G. Affleck, chairman and president ... 2829
American Farm Bureau Federation, John C. Datt, director, Washington office ... 2675
American Horse Council, Inc ... 3168
American Hospital Association ... 2765
American Institute of Certified Public Accountants, Federal tax division ... 2459, 3714
American Iron Ore Association ... 2729
American Land Development Association, Gary A. Terry, executive vice president ... 2526, 3210
American Life Insurance Association ... 2744
William T. Gibb, chief counsel ... 3378
Paul M. Hawkins, chief counsel, Federal taxes and pensions ... 3889
American Meat Institute ... 3846
American Mutual Insurance Alliance, K. Martin Worthy, counsel ... 3317
American Petroleum Institute ... 3934
American Public Power Association, Larry Hobart ... 1616
American Seed Trade Association, Harvey W. Mauth, president ... 3849
American Society of Association Executives, James P. Low, chief administrative officer ... 3018, 3611, 3615, 3748, 3869
Americans United for Separation of Church and State, Edd Doerr, educational relations director ... 3549
Anderson, Doug, All Season Insulation, Inc ... 3406
Asbill, Mac, Jr., on behalf of World Airways, Inc ... 3905

COMMUNICATIONS—Continued

Page

Association of American Chambers of Commerce in Latin America, Gordon J. Cloney, II, executive secretary 2875
Association of American Publishers and the Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry 3031
Association of Art Museum Directors, Evan H. Turner, president 3804
Association of Brass & Bronze Ingot Manufacturers, Brass & Bronze Ingot Institute, Robert V. Maudlin, executive director, Joint Government Liaison Committee 3415
Association of Media Producers 2916
Atlanta Rapco Insulation Co., Inc., James M. Smith, president 3411
Augsbury, Frank A., Jr., and his immediate family, Chase Troxell 2786
Authors League of America 3029
Bailey, John A 2700
Baker & McKenzie, Michael Waris, Jr 3281
Baldwin, Ronald P., president, Geothermal Resources International, Inc 3459
Barber, George H., division vice president, public affairs, Beatrice Chamber of Commerce 2678
Bartell, Rev. Ernest, president, Stonehill College, Inc 3803
Bates, James E., president, JEB, Inc., Management Services 2644
Bates, William F., vice president, drilling and production, McCulloch Oil Corp 2750
Beatrice Chamber of Commerce, Inc., George H. Barber, division vice president, public affairs 2678
Behrman, Jack N., professor of international business, University of North Carolina 2814
Berall, Frank S., chairman, committee on estate and gift tax reform, American College of Probate Counsel 3641
Berry, James D., president, Republic of Texas Corp 3908
Birchby, Kenneth L., chairman, Committee on Taxation, National Association of Mutual Savings Banks 3112m
Bittker, Boris I., Yale University 3807
Bjelland, Richard J., president, Landura Corp 3146
Black, Donald E., president, Mono Thermo Insulation, Inc 3431
Bobo, Jack E., secretary, National Association of Life Underwriters 2452
Boulineau, Fred, Marriott Corp 3207, 3838
Bracken, John P., chairman, house of delegates, American Bar Association 3016
Brandl, Mrs. Harald, Manitowoc County, Wis 3677
Brandon, Robert, Public Citizen's Reform Research Group 3686
Brandon, Robert M., director, Tax Reform Research Group 242
Brewer, J. Newton, Jr., chairman, Maryland Racing Commission 3193
Briger & Associates, attorneys at law, Peter L. Briger 2781, 2843
British-American Chamber of Commerce, David Farquharson 3017
Bromberg, Michael D., director, Federation of American Hospitals 3605
Brydon, Thomas E., president, XCEL Corp 3863
Buch, Harry L., chairman, West Virginia Racing Commission 3195
Buffington, G. N., National Association of Real Estate Investment Trusts, Inc 3043
Building Owners & Managers Association, International 3142
Business Men's Assurance Co. of America 3331
California Independent Producers Association, James H. Woods, executive vice president 3164
California Public Utilities Commission, D. W. Holmes, president 3596
California Savings & Loan League 3098
Callaghan, Richard L., Western Union Telegraph Co 2932
Cannon, Hon. Howard W., a U.S. Senator from the State of Nevada 3189
Caspersen, Freda R., Gerald D. Morgan 2807
Chamberlain, Charles E., and William J. Lehrfeld, Webster, Kilcullen & Chamberlain, on behalf of Sand Springs Home, Sand Springs, Okla 2973
Chappell, Paul H., attorney at law 3368f
Chappinelli, Dana, Spray Insulations, Inc., Division of Paul J. Kerz Co 3415
Chase Manhattan Bank 2809
Chicago Association of Commerce and Industry 2728
Child & Family Services of Connecticut, Inc., Roger J. Sullivan 3804
Christian, Ernest S., Jr 2781
Chromalloy American Corp., Joseph Friedman 3497

COMMUNICATIONS—Continued

Page
Ohrystie, Thomas L., senior vice president, Merrill Lynch & Co., Inc...... 1847
Citizens Committee on Tax Reform, Stephen J. Rapp, chairman...... 394, 2673
Oloney, Gordon J., II, executive secretary, Association of American Chambers of Commerce in Latin America...... 2875
Coalition of Concerned Charities, Elvis J. Stahr, chairman, and president, National Audubon Society...... 3263
Cobb, Caswell H., chairman, tax committee, Petroleum Equipment Suppliers Association...... 2909
Commission on the Review of the National Policy Toward Gambling, Charles H. Morin, chairman...... 3196
Community Museum of Brooklyn, Charlene Claye Van Derzee, assistant director/curator, vice president, National Conference of Artists...... 3027
Cooperman, Richard M., executive director, Aluminum Recycling Association...... 3452
Corcoran Gallery of Art, Roy Slade...... 3218
Council for Financial Aid to Education...... 2935
Council of Jewish Federations and Welfare Funds...... 2980
Crown, Joseph H., Taxation With Representation...... 3090a
Cutler, Herschel, Institute of Scrap Iron & Steel, Inc...... 3402
Dana Corp...... 2873
Datt, John C., director, Washington office, American Farm Bureau Federation...... 2675
Dauterman, Frederick E., Jr., Columbus, Ohio...... 2665
Davis, Charles W., National Association of Independent Insurers...... 3326, 3889, 3893
Dehmlow, Louis H. T., president, Great Lakes Terminal and Transport Corp., president, National Association of Plastics Distributors; vice president, National Association of Chemical Distributors; trustee, National Association of Wholesalers-Distributors...... 2583
Dempsey, Joe G., executive director, Los Angeles Inter-Foundation Center...... 3875
Denny Klepper Oil Co., William C. Lane...... 3733
Dingman, Michael D., president, Wheelabrator-Frye, Inc...... 3442
Disabled American Veterans, Charles L. Huber, national director of legislation...... 3368a
Doerr, Edd, educational director, Americans United for Separation of Church and State...... 3549
Dolan, Michael T., Great Falls, Mont...... 3432
Dolan, William M., president, Geothermal Resources Council...... 3418
Dooley & Knutson, certified public accountants, Brian Dooley...... 2785
Dubuque Packing Co., Robert C. Wahlert, president...... 3855
Duffey, Dr. Joseph, general secretary, American Association of University Professors...... 3213, 3220
Dulsky, Robert J., president, Tax Corp. of America...... 3355
Echeverria, Peter, chairman, Nevada Gaming Commission...... 3194
Eggers, Paul W., president, Geothermal Kinetics, Inc...... 3407
Electronic Industries Association...... 2516, 2880
Embassy of Ireland, John G. Molloy, Ambassador...... 3013
Engelhard Minerals & Chemicals Co...... 3081
Ervin, F. McDonald, South Side Cooperative-Condominium Owners Association of Chicago...... 3881
Ettner, Larry, director of planning and market research, Landura Corp...... 3152
Faber, Peter L., chairman, tax section, New York State Bar Association...... 2612, 2886, 3045
Farmer, Charles M., associate professor, agricultural economics, University of Tennessee...... 3625
Farquharson, David, British-American Chamber of Commerce...... 3017
Farrell, Leonard, chairman, Joint Committee on Pensions...... 3377
Federation of American Hospitals, Michael D. Bromberg, director...... 3605
Financial Executives Institute...... 2550
Fine, S. Richard...... 3835
Floss, Walter J., legislator, Legislature of Erie County, N.Y...... 2677
FMC Corp., Robert H. Malott, chairman of the board and president...... 1144
Fogel, Seymour, vice president, Lawyers Cooperative Publishing Co...... 3028
Fong, Hon. Hiram L., a U.S. Senator from the State of Hawaii...... 3941

COMMUNICATIONS—Continued

Page
Fox, H. Lawrence, on behalf of the Sun Oil Co — 2872
Frantz, Virgil L — 2640
Freeport Minerals Co., Freeport Kaolin Division — 3081
Friedlander, Philip P., Jr., general manager, National Tire Dealers & Retreaders Association, Inc — 3471
Friedman, Joseph, Chromalloy American Corp — 3497
Fristschle, Gustave, director, government relations, National Fisheries Institute, Inc — 3843
Frost National Bank, San Antonio, Tex., Tom C. Frost, Jr., chairman of the board — 2779
Frost, O. L., Jr., Occidental Life of California — 3485
Gage, Martin A., professor of accounting, Widener College, Taxation With Representation — 3836
Gaming Industry Association of Nevada, Inc., Les Kofoed, executive director — 3192
Garber, Gilbert, executive vice president, Garber Travel Service, Inc., and president, International Congress and Convention Association — 3024d
Gardner, Addison L., III — 3823
Geothermal Kinetics, Inc., Paul W. Eggers, president — 3407
Geothermal Resources Council, William M. Dolan, president — 3418
Geothermal Resources International, Inc., Ronald P. Baldwin, president — 3459
Gibb, William T., vice president and Washington counsel, Health Insurance Association of America — 3378, 3889
Gordon, Larry — 3823
Gorman, Peter J., chairman, Maine State Lottery Commission — 2365, 3193
Gray & Associates, Inc., Maurice Gray — 3006
Great Lakes Terminal and Transport Corp., Louis H. T. Dehmlow, president — 2583
Greater Philadelphia Chamber of Commerce, John B. Huffaker, chairman, Federal tax committee — 2587
Greene, J. Ashton, New Orleans, La — 2544
Greever, Chuck, All Season Insulation, Inc — 3406
Group for Recycling in Pennsylvania, Lore S. Keffer, president — 3469
Hall, Earl, Lewiston, Idaho — 2679
Handler, Dr. Philip, president, National Academy of Sciences — 2827
Hannifin, Philip P., chairman, Nevada Gaming Control Board — 3194
Harkins, George F., general secretary, Lutheran Council — 2987
Harrison, Gus, commissioner, Michigan State Lottery Bureau — 2364
Harriss, C. Lowell, professor of economics, Columbia University, economic consultant, Tax Foundation, Inc — 2701
Hasler, Gerald, president, National Remodelers Association — 3409
Hatfield, Hon. Mark O., a U.S. Senator from the State of Oregon — 2415
Havens Relief Fund Society, John S. Nolan — 3791
Hawaiian Sugar Planters' Association — 3134
Hawkins, Paul M., chief counsel, Federal taxes and pensions, American Life Insurance Association — 3889
Health Insurance Association of America, William T. Gibb, vice president and Washington counsel — 3337, 3889
Healy, Patrick, secretary, National Milk Producers Federation — 2518
Hedrick, F. Cleveland, Jr — 3571
Henderson, Mr. and Mrs. Robert C — 3451
Hennrikus, Col. George F., Jr., legislative counsel, Retired Officers Association — 2636
Herbst Oil Co., William C. Lane — 3733
Herlong, Edward L., counsel, National Association of Recycling Industries, Inc — 3433
Hershson, Morris, president, National Barrel & Drum Association — 3509
Hickman, Frederic W., Assistant Secretary, Department of the Treasury — 2226
High Point of Hartsdale I Condominium, Michael G. Tannenbaum, president — 3558
Hillcrest Medical Center — 3794
Hobart, Larry, American Public Power Association — 1616
Hofe's Insulation, Joseph R. Hofe — 3464
Hollister, Kenneth, first vice president—research, Dean Witter & Co — 3199
Holl, Richard H., chairman of the board, National Clay Pipe Institute — 3421
Holloway, Ronald E., partner, Peat, Marwick, Mitchell & Co — 3037
Holmes, D. W., president, California Public Utilities Commission — 3596

COMMUNICATIONS—Continued

Page
Homerite Co., Inc., Paul C. Ryan, president 3464
Hopkins, Fortescue W 3371
Huber, Charles L., national director of legislation, Disabled American Veterans 3368a
Huffaker, John B., chairman, Federal tax committee, Greater Philadelphia Chamber of Commerce 2587
Hughes, Thomas L., president, American Chamber of Commerce of Venezuela 2839
Humana, Inc 3252
Humphrey, Hon. Hubert H., a U.S. Senator from the State of Minnesota, joint statement with Senator Henry M. Jackson and Senator Warren G. Magnuson 3561
Independent Business Association of Wisconsin, Bruno J. Mauer, president 2510
Independent Insurance Agents of America, Inc., Jeffrey M. Yates, assistant general manager 3867
Inouye, Hon. Daniel K., a U.S. Senator from the State of Hawaii 3115
Institute of Scrap Iron & Steel, Inc., Herschel Cutler 3402
International Association of Holiday Inns, James L. Schwartz, president 3015
International Business Machines Corp 2782
International Congress and Convention Association, Gilbert Garber, president, and executive vice president, Garber Travel Service, Inc 3024d
International Economic Policy Association, Timothy W. Stanley, president 2309
Interreligious Taskforce on U.S. Food Policy 3633
Interstate Natural Gas Association of America, Walter E. Rogers, president 2546
Investment Co. Institute 3491, 3575
Jackson, Hon. Henry M., a U.S. Senator from the State of Washington, joint statement with Senator Warren G. Magnuson and Senator Hubert H. Humphrey 3561
JEB, Inc., Management Services, James E. Bates, president 2644
J. J. Jones Construction Co., Tom McDine 2742
J. M. Huber Corp 3081
Johnston, Douglas L., Portland, Oreg 3093
John Swenson Granite Co., Inc., Kurt M. Swenson, executive vice president 3275
Joint Committee on Pensions, Leonard Farrell, chairman 3377
Kasch, John E., vice president, Standard Oil Co. (Indiana) 3828
Keffer, Lore S., president, Group for Recycling in Pennsylvania 3469
Kidder, Peabody & Co., Inc., John H. Noonan, vice president 3237
Kiger, Hugh C., executive vice president, Leaf Tobacco Exporters Association 3855
King, Louis B., president, Academy of the New Church 3791
Kocolene Oil Corp., William C. Lane 3733
Kofoed, Les, executive director, Gaming Industry Association of Nevada 3192
Kolody, Dennis S., Dennis S. Kolody & Associates 3345
Krasicky, Eugene, general counsel, United States Catholic Conference 2657
Kremer, Maurice A., State senator, Nebraska State Legislature 3516
Kreutzer, Arthur C., vice president and general counsel, National LP-Gas Association 3583
Laborde, John P., chairman of the board and president, Tidewater Marine Service, Inc 2824
Land Improvement Contractors of America, Michael E. Strother 3507
Landura Corp:
Richard J. Bjelland, president 3146
Larry Ettner, director of planning and market research 3152
Lawson, W. D., III, president, National Cotton Council of America 3678
Lane, William C., Jr., of Batzell, Nunn & Bode, on behalf of Aladdin Petroleum Corp., Herbst Oil Co., Denny Klepper Oil Co., Kocolene Oil Corp., Martin Oil Service, Navajo Refining Co., and Power Test Corp 3933
Lawyers Cooperative Publishing Co., Seymour Fogel, vice president 3028
Leaf Tobacco Exporters Association, Hugh C. Kiger, executive vice president 3855
Legislature of Erie County, N.Y., Walter J. Floss, legislator 2677

COMMUNICATIONS—Continued

	Page
Lerner, Eugene M., chairman, finance department, Graduate School of Management, Northwestern University	3523
Lindholm, Richard W., professor of finance, University of Oregon	3927
Lisses, Rachel	3112o
Lloyd Walker Real Estate, Lloyd E. Walker, president	3451
Los Angeles Inter-Foundation Center, Joe G. Dempsey, executive director	3875
Love, William E., member, Oregon Racing Commission	3191
Low, James P., chief administrative officer, American Society of Association Executives	3018, 3611, 3615, 3748, 3869
Lundine, Hon. Stanley N., a U.S. Representative from the State of New York	2448
Lutheran Council, George F. Harkins, general secretary	2987
Machinery Dealers National Association	2918
Magma Power Co	3454
Magnatex Corp., Charles H. Priddy, president	3172
Magnuson, Hon. Warren G., a U.S. Senator from the State of Washington, joint statement with Senator Henry M. Jackson and Senator Hubert H. Humphrey	3561
Maine State Lottery Commission, Peter J. Gorman, chairman	2365, 3193
Malott, Robert H., chairman of the board and president, FMC Corp	1144
Manufacturers Life Insurance Co., Norman H. Tarver	3111
Marriott Corp., Fred Boulineau	3207, 3838
Marsh, Homer E., president, National Associated Businessmen, Inc	2685
Martin & Sons, foam insulation contractors, Donald H. Martin	3404
Martin Oil Service, William C. Lane	3733
Maryland Racing Commission, J. Newton Brewer, Jr., chairman	3193
Mastic Corp., Charles M. Mattes, executive vice president and general manager	3440
Mattes, Charles M., executive vice president and general manager, Mastic Corp	3440
Maudlin, Robert V., executive director, joint government liaison committee, Association of Brass & Bronze Ingot Manufacturers, Brass & Bronze Ingot Institute	3415
Mauer, Bruno J., president, Independent Business Association of Wisconsin	2510
Mauth, Harvey W., president, American Seed Trade Association	3849
May Department Stores Co	3004
McClure, Hon. James A., a U.S. Senator from the State of Idaho	2433
McCulloch Oil Corp., William F. Bates, vice president, drilling and production	2750
McFarlane, William F., secretary, producer steering committee, National Cotton Council	2682
McGrath, Mark J., Washington, N.C	3420
McKenney, C. A. "Mack", director of legislative affairs, Non-Commissioned Officers Association of the United States of America	2752
McKevitt, James D. "Mike", Washington counsel, National Federation of Independent Business	2642
Merrill Lynch & Co., Inc., Thomas L. Chrystie, senior vice president	1847
Merry, Ardis, Great Falls, Mont	3433
Michigan State Lottery Bureau, Gus Harrison, commissioner	2364
Mid-Continent Supply Co	2608
Mohay, John, executive vice president, National Independent Meat Packers Association	3844
Monongahela Power Co., Richard S. Weygandt, vice president	3201
Mono Thermo Insulation, Inc., Donald E. Black, president	3431
Montoya, Hon. Joseph M., a U.S. Senator from the State of New Mexico	2419
Morgan, Gerald D., of Hamel, Park, McCabe & Saunders, on behalf of Freda R. Caspersen	2807
Morin, Charles H., chairman, Commission on the Review of the National Policy Toward Gambling	3196
Morrison, Joe I., Sun Ray Energy Corp	3415
Morrison-Knudsen Co., Inc	2790
Mosier, Maurice L., executive vice president, National Constructors Association	2791

COMMUNICATIONS—Continued

Page

Motor & Equipment Manufacturers Association 3307
M.R.S. Urethane Co., Inc., Herbert Romelfanger, president 3405
National Academy of Sciences, Dr. Philip Handler, president 2827
National Associated Businessmen, Inc., Homer E. Marsh, president 2685
National Association for Uniformed Services 3343
National Association of Chemical Distributors, Louis H. T. Dehmlow, vice president 2583
National Association of Conservation Districts, David G. Unger 3515
National Association of Housing Cooperatives:
Fred Thornthwaite, treasurer and general manager, Cooperative Services, Inc 3553
Roger Willcox, president 3882
National Association of Independent Insurers, Charles W. Davis 3326, 3889, 3893
National Association of Laity, Dr. Joseph T. Skehan, economist, president 3390
National Association of Letter Carriers (AFL-CIO), James H. Rademacher, president 2748
National Association of Life Companies 3483, 3887
National Association of Life Underwriters, Jack E. Bobo, secretary 2452
National Association of Mutual Savings Banks, Kenneth L. Birchby, chairman, Committee on Taxation 3112m
National Association of Plastics Distributors, Louis H. T. Dehmlow, president 2583
National Association of Real Estate Investment Trusts, Inc., G. N. Buffington 3043
National Association of Recycling Industries, Inc., Edward L. Herlong, counsel 3433
National Association of Wholesale-Distributors, Louis H. T. Demhlow, trustee 2583
National Barrel & Drum Association, Morris Hershson, president 3590
National Christmas Tree Association 3143
National Clay Pipe Institute, Richard H. Holl, chairman of the board 3421
National Conference of State Legislatures, Loran Schmit, chairman, Task Force on Food Supply and Agriculture, and chairman, committee on agriculture and environment, State Legislature of Nebraska 3682
National Constructors Association, Maurice L. Mosier, executive vice president 2791
National Consumer Center for Legal Services 3475
National Cotton Council, William F. McFarlane, secretary, producer steering committee 2682
National Cotton Council of America, W. D. Lawson III, president 3678, 3861
National Federation of Independent Business, James D. "Mike" McKevitt, Washington counsel 2642
National Fisheries Institute, Inc., Gustave Fristschie, director, government relations 3843
National Football League, Pete Rozelle, commissioner 644
National Grange, John W. Scott, master 2649
National Independent Meat Packers Association, John Mohay, executive vice president 3844
National Limestone Institute, Inc., Richard P. Rechter, chairman, and executive vice president, Ralph Rogers & Co., Inc 3680
National LP-Gas Association, Arthur C. Kreutzer, vice president and general counsel 3583
National Milk Producers Federation, Patrick Healy, secretary 2518
National Remodelers Association, Gerald Hasler, president 3409
National Retired Teachers Association 3071
National Rural Electric Cooperative Association, Robert D. Partridge, executive vice president 3624
National Society of Public Accountants, Albert R. Van Tieghem, president 3359
National Tire Dealers & Retreaders Association, Inc., Philip P. Friedlander, Jr., general manager 3471
National Venture Capital Association 2569
Natomas Co 2907
Navajo Refining Co., William C. Lane 3783
Nebraska State Legislature, Maurice A. Kremer, State senator 3516

COMMUNICATIONS—Continued

Page
Nevada Gaming Commission, Peter Echeverria, chairman 3194
Nevada Gaming Control Board, Philip P. Hannifin, chairman 3194
New Hampshire Sweepstakes Commission, Edward J. Powers, executive director 2363
New York State Bar Association, Peter L. Faber, chairman, tax section 2612, 2886, 3045
Nolan, John S., Havens Relief Fund Society 3791
Non-Commissioned Officers Association of the United States of America, C. A. "Mack" McKenney, director of legislative affairs 2752
Noonan, John H., vice president, Kidder, Peabody & Co., Inc 3237
Norris, James J., chairman, American Council of Voluntary Agencies for Foreign Service, Inc 2633
Occidental Life of California, O. L. Frost, Jr 3485
O'Connell, Maj. Peter J., executive director, Rhode Island Lottery Commission 2363
O'Kelly, Alan P., of Paine, Lowe, Coffin, Herman & O'Kelly, on behalf of Washington Water Power Co 3594
Oklahoma Health Planning Advisory Council, committee on indigent care 3798
Order of Cistercians of the Strict Observance 3295
Oregon Racing Commission, William E. Love, member 3191
Ortt, Larry J., manager, Advanced Concepts Insulators, Division of Corrosion Control, Inc 3441
Otte, Dr. Carel, vice president, Geothermal Division, Union Oil Co. of California 3465
Paine, Webber, Jackson & Curtis, Inc., A. Jones Yorke, president 3594
Partridge, Robert D., executive vice president, National Rural Electric Cooperative Association 3624
Pearson, Hon. James B., a U.S. Senator from the State of Kansas 2913, 3621
Peat, Marwick, Mitchell & Co., Ronald E. Holloway, partner 3037
Peeples, Edward H., Virginia Commonwealth University 2697
Percy, Hon. Charles H., a U.S. Senator from the State of Illinois 2411
Petroleum Equipment Supplies Association, Caswell H. Cobb, chairman, tax committee 2909
Pietz, William, Public Citizen's Tax Reform Research Group 3686
Pineapple Growers Association of Hawaii 3123
Pizzagalli Construction Co., James Pizzagalli, vice president and counsel 2740
Pottberg, Alric C. T., president, Pottberg Ranches 3698
Power Test Corp., William C. Lane 3733
Powers, Edward J., executive director, New Hampshire Sweepstakes Commission 2363
Priddy, Charles H., president, Magnatex Corp 3172
Private Truck Council of America, Inc., John C. White 3305
Public Citizen's Tax Reform Research Group, William Pietz and Robert Brandon 3686
Pyramid Ventures, Inc 2845
Rademacher, James H., president, National Association of Letter Carriers (AFL-CIO) 2748
Ramsey, John C., product manager, Thermo Foam Insulation Co 3447
Rapp, Stephen J., chairman, Citizens Committee on Tax Reform 394, 2673
Rapperswill Corp., Charles H. Stillman, president 3455
Rasmussen, Hon. Dennis L., Nebraska State senator 3637
Rechter, Richard P., chairman, National Limestone Institute, Inc., and executive vice president, Ralph Rogers & Co., Inc 3680
Reese, Thomas J., legislative director, Taxation With Representation 2456, 3395
Republic of Texas Corp., James D. Berry, president 3908
Reserve Officers Association of the United States, Maj. Gen. J. Milnor Roberts, executive director 3098
Retired Officers Association, Col. George F. Hennrikus, Jr., legislative counsel 2636
Rhode Island Lottery Commission, Maj. Peter J. O'Connell, executive director 2363
Rice Contracting Co., Winston Rice 3458
Roberts, Maj. Gen. J. Milnor, executive director, Reserve Officers Association of the United States 3098
Rochester Tax Council 2535

COMMUNICATIONS—Continued

	Page
Rogers, Walter E., president, Interstate Natural Gas Association of America	2546
Romelfanger, Herbert, president, M.R.S. Urethane Co., Inc	3405
Royal, Mrs. Lloyd, Springfield, Nebr	1964
Rozelle, Pete, commissioner, National Football League	644
Russ, Perry A., director of national affairs, Society of American Florists & Ornamental Horticulturists	3533
Ryan Paul C., president, Homerite Co., Inc	3464
Sand Springs Home, Sand Springs, Okla., Charles E. Chamberlain and William J. Lehrfeld	2973
Santini, Hon. James D., a Representative from the State of Nevada	3190
Schiff, Frank W	2904
Schmit, Loran, chairman, committee on agriculture and environment, State Legislature of Nebraska, and chairman, Task Force on Food Supply and Agriculture, National Conference of State Legislatures	3682
Schnepper, Jeff A	3639
Schwartz, James L., president, International Association of Holiday Inns	3015
Schye, Garry T., S. & R. Home Foamers	3407
Sconyers, Charles E., vice president for development, Nebraska Wesleyan University	3003
Scott, John W., master, National Grange	2649
Securities Industry Association, James W. Walker, Jr., executive vice president	1829
Sierra, Ralph J., Jr., Taxation With Representation	3775
Skehan, Dr. Joseph T., economist, president, National Association of Laity	3390
Slade, Roy, Corcoran Gallery of Art	3218
Smith, James M., president, Atlanta Rapco Insulation Co., Inc	3411
Society of American Florists & Ornamental Horticulturists, Perry A. Russ, director of national affairs	3533
South Side Cooperative-Condominium Owners Association of Chicago, F. McDonald Ervin	3881
Spray Insulations, Inc., Division of Paul J. Kerz Co., Dana Chappinelli	3415
S. & R. Home Foamers, Garry T. Schye	3407
Stahr, Elvis J., president, National Audubon Society, and chairman, Coalition of Concerned Charities	3263
Standard Oil Co. (Indiana), John E. Kasch, vice president	3828
Stanley, Timothy W., president, International Economic Policy Association	2300
Stillman, Charles H., president, Rapperswill Corp	3455
Stockholders of America, Inc., Margaret Cox Sullivan, president	3183
Strichman, George A., chairman, Ad Hoc Committee for an Effective Investment Tax Credit	1745
Strother, Michael E., for the Land Improvement Contractors of America	3507
Sullivan, Margaret Cox, president, Stockholders of America, Inc	3183
Sullivan, Roger J., Child & Family Services of Connecticut, Inc	3804
Sun Oil Co., H. Lawrence Fox	2872
Sun Ray Energy Corp., Joe I. Morrison	3415
Swenson, Kurt M., executive vice president, John Swenson Granite Co	3275
Sylvest, Charles D	3375
Tannenbaum, Michael G., president, High Point of Hartsdale I Condominium	3558
Tarver, Norman H., Manufacturers Life Insurance Co	3111
Taxation With Representation:	
Thomas J. Reese, legislative director	2456, 3395
Charles Waldauer, professor of economics, Widener College	2695
Edward H. Peeples, Virginia Commonwealth University	2697
John A. Bailey	2700
Martin A. Gage, professor of accounting, Widener College	3836
Ralph J. Sierra, Jr	3775
Joseph H. Crown	3090a
Tax Corp. of America, Robert J. Dulsky, president	3355
Tax Foundation, Norman B. Ture	2851
Tax Foundation, Inc., C. Lowell Harriss, economic consultant	2701
Tax Reform Research Group, Robert M. Brandon, director	242
Terry, Gary A., executive vice president, American Land Development Association	2526, 3210

COMMUNICATIONS—Continued

	Page
The Homefoamers, All Season Insulation, Inc., Doug Anderson and Chuck Greever, co-owners	3406
Thermo Foam Insulation Co., John C. Ramsey, product manager	3447
Thiele Kaolin Co	3081
Thornthwaite, Fred, general manager, Cooperative Services, Inc., treasurer, National Association of Housing Cooperatives	3553
Tidewater Marine Service, Inc., John P. Laborde, chairman of the board and president	2824
Tierney, Paul J., president, Transportation Association of America	2932a
Tower, Hon. John, a U.S. Senator from the State of Texas	2368
Trans Union Corp., J. W. Van Gorkom, president	2929
Transportation Association of America, Paul J. Tierney, president	2932a
Treese, Robert E	2701
Troxell, Chase, on behalf of Frank A. Augsbury, Jr., and his immediate family	2786
Ture, Norman B., president, Norman B. Ture, Inc., on behalf of the Tax Foundation	2851
Turner, Evan H., president, Association of Art Museum Directors	3804
Unger, David G., National Association of Conservation Districts	3515
Union Oil Co. of California, Dr. Carel Otte, vice president, Geothermal Division	3465
United Automobile, Aerospace and Agricultural Implement Workers of America, UAW, Leonard Woodcock, president	2601
United Merchants & Manufacturers, Inc., Stroock & Stroock & Lavan	2901
United States Catholic Conference, Eugene Krasicky, general counsel	2657
Vander Jagt, Hon. Guy, a U.S. Representative from the State of Michigan	3529
Van Derzee, Charlene Claye, assistant director/curator, Community Museum of Brooklyn, and vice president, National Conference of Artists	3027
Van Gorkom, J. W., president, Trans Union Corp	2929
Van Tieghem, Albert R., president, National Society of Public Accountants	3359
Veterans of Foreign Wars, Thomas C. "Pete" Walker, commander in chief	3923
Wahlert, Robert C., president, Dubuque Packing Co	3855
Waldauer, Charles, professor of economics, Widener College	2695
Walker, James W., Jr., executive vice president, Securities Industry Association	1820
Walker, Thomas C., "Pete", commander in chief, Veterans of Foreign Wars	3923
Walsh, Lawrence E., American Bar Association	3367
Wamble, Hugh, Kansas City, Mo	3383
Washington Water Power Co., Alan P. O'Kelly of Paine, Lowe, Coffin, Herman & O'Kelly	3594
Western Union Telegraph Co., Richard L. Callaghan	2932
West Virginia Racing Commission, Harry L. Buch, chairman	3195
Weygandt, Richard S., vice president, Monongahela Power Co	3201
Wheelabrator-Frye, Inc., Michael D. Dingman, president	3442
Wheeler, James E., chairman, committee on Federal Income Taxation, American Accounting Association	3346
White, John C., Private Truck Council of America, Inc	3305
Willcox, Roger, president, National Association of Housing Cooperatives	3882
Williams & Jensen, Donald C. Evans, Jr	3290
Woodcock, Leonard, president, United Automobile, Aerospace and Agricultural Implement Workers of America, UAW	2601
Woods, James H., executive vice president, California Independent Producers Association	3164
Woodward, Don, president, National Association of Wheat Growers, on behalf of the Ad Hoc Agricultural Tax Committee	3628
World Airways, Inc., Mac Asbill, Jr	3905
Worthy, K. Martin, counsel, American Mutual Insurance Alliance	3317
XCEL Corp., Thomas E. Brydon, president	3863
Yara Engineering Corp., American Industrial Clay and Georgia Kaolin Divisions	3081
Yates, Jeffrey M., assistant general manager, Independent Insurance Agents of America, Inc	3867
Yorke, A. Jones, president, Paine, Webber, Jackson & Curtis, Inc	3591
Young Builders, Inc., John Young, president	3404
Zumberge, James H., president, Southern Methodist University	2991

Subject Index to Written Statements (Parts 6–8)

Part 6

	Page
General	2409–2775
Taxation of foreign source income	2777–2910

Part 7

Investment tax credit	2911–2932
Charitable contributions	2933–3009
Deductions for conventions outside the United States	3011–3024
Deductions allowed for authors and artists	3025–3033
Qualified stock options	3035–3039
Real estate investment trusts	3041–3067
Extension of tax cuts	3069–3077
Minimum tax	3079–3090
Individual retirement accounts	3092–3112
Tax shelters	3113–3180
Capital gains tax	3181–3186
Withholding tax on certain gambling winnings	3187–3195
Taxation of power companies	3197–3203
Deduction of expenses attributable to business use of homes, rental of vacation homes, et cetera	3205–3233
Industrial development bonds	3235–3260
Charitable organizations influencing legislation	3261–3271
Carryforward and carryback of net operating losses	3273–3292
Unrelated business income tax	3293–3302
Manufacturers excise tax	3303–3313
Consolidated returns by life insurance companies	3315–3327
Life insurance company distributions	3329–3334
Tax simplification (deductions; sick pay exclusion; military disability retirees)	3335–3352
Administrative provisions	3353–3363
Corporate taxation	3369–3372
Tax treatment of employee benefits under group legal service plan	3365–3367
Pension matters	3373–3379
Tax deductions for tuition costs	3381–3392
Energy conservation	3393–3472

Part 8

Tax treatment of prepaid legal services	3473–3480
Life and health insurance	3481–3487
Capital loss carryovers of regulated investment companies	3489–3493
Tax treatment of dividends	3495–3504
Highway use tax on conservation vehicles	3505–3520
Reinvested stock dividends	3521–3525
Motor vehicle excise taxes	3527–3530
Limitation on artificial losses	3531–3546
Tax deduction for educational expenses	3547–3550
Tax treatment of certain cooperative housing associations	3551–3558
Taxpayer privacy	3559–3568
Employee stock ownership plans (ESOP's)	3569–3572
Tax exempt State and local bonds	3573–3580
Motor fuel excise taxes	3581–3588
Taxation of utilities	3589–3596B
Tax treatment of reusable steel drums	3597–3602
Industrial development bonds	3604–3607

	Page
Trade associations' income from trade shows	3609–3612
Advertising in publications of tax-exempt organizations	3613–3617
Estate and gift taxes	3619–3772
Possessions' corporations in Puerto Rico	3773–3788
Charitable contributions	3789–3820
Tax shelters	3821–3832
Deduction of expenses attributable to business use of homes, rental of vacation homes, etc	3833–3839
Domestic international sales corporations (DISC)	3841–3864
Advertising and publications of tax exempt organizations	3865–3871
Private foundations	3873–3877
Cooperatives and condominiums	3879–3883
Premiums on guaranteed renewable health and accident insurance policies	3885–3890
Employment taxes	3891–3898
Personal holding companies	3899–3902
Bank holding company amendments	3903–3919
Mortgage interest tax credit	3921–3923
Value-added tax	3925–3930
Percentage depletion	3931–3937
Retirement income credit	3939–3949

Investment Tax Credit

STATEMENT BY SENATOR JAMES B. PEARSON

Mr. Chairman, I wish to take this oportunity to state my views regarding the use of the investment tax credit to encourage rural development and balanced national growth. Specifically I propose that an additional 3-percent investment tax credit be made available to those job-creating industries locating in rural nonmetropolitan areas and in certain core city areas which are experiencing a severe loss of jobs and population.

Last year I introduced the Balanced Growth Tax Credit Act of 1975—S. 1594. I intend to offer a slightly modified version of S. 1594 as an amendment to H.R. 10612. I believe that the investment tax credit can be used to influence economic growth patterns. I am convinced that the effort to achieve a more balanced economic population growth is a legitimate and worthwhile national goal.

Over the past several years there have been many expressions of concern in the Congress and across the country about the imbalance in the distribution of our Nation's population; that too many of our people are concentrated in too few metropolitan agglomerations. Many of us have argued that this tilt in the population balance away from the countryside and the small town toward the large cities is economically inefficient, environmentally unsound, and socially undesirable. And we have argued that this imbalance will worsen unless steps are taken to counter it.

Congress has formally recognized the problem and declared a commitment to policies of rural-urban balance. Title X of the Agricultural Act of 1970 states:

> The Congress commits itself to a sound balance between rural and urban America. The Congress considers this balance so essential to the peace, prosperity and welfare of all our citizens that the highest priority must be given to the revitalization and development of rural areas.

And title VII of the Housing and Urban Development Act of 1970 declares:

> The Congress finds that the rapid growth of urban population and uneven expansion of urban development in the United States, together with a decline in farm population, slower growth in rural areas, and migration to the cities, has created an imbalance between the Nation's needs and resources and seriously threatens our physical environment and that the economic and social development of the Nation, the proper conservation of our natural resources and the achievement of satisfactory living standards depend upon the sound, orderly, and more balanced development of all areas of the Nation.

These are bold declarations. I believe the intent they embody is sound; that the achievement of a more rational, balanced growth is essential to the Nation's health and welfare.

Yet the gap between these broad declarations and the concrete programs to achieve them is enormous. We did adopt the Rural Development Act of 1972. This was a significant legislative achievement, although the implementation of this act has been far from satisfactory.

69-516 O - 76 - pt. 7 - 3

And in the Housing and Community Development Act of 1974 we adopted several measures, particularly in the area of housing which will further the cause of rural development. There have been other actions favorable to the cause of rural development, at least indirectly. But all in all the record of concrete action is painfully disappointing.

Mr. Chairman, given the nature of our Federal system and our aversion to centralized planning, it is not likely that we will ever implement a comprehensive, unified balanced growth policy as such.

It is not likely that we will, at least in the near future, emulate the rather comprehensive balanced growth policies that many of the European countries have already adopted. But certainly we can and must take additional steps to advance the cause of balanced growth. The legislation I propose today is one such step, a step which I believe is timely and essential.

Specifically, I propose that section 801 of H.R. 10612, be amended to provide an additional 3-percent investment tax credit for job-creating industries locating in designated "balanced growth areas". That is, qualified investments would receive a tax credit of 13 percent from day of enactment to January 1, 1981, and a 10-percent tax credit thereafter.

Mr. Chairman, the special investment tax credit provided for in this bill applies to the manufacturing, processing, assembling, and distribution of personal property only. It does not apply to retailing, extractive industries, and agriculture.

Mr. Chairman, this proposal defines two types of balanced growth areas. First, are the nonmetropolitan, or rural counties. These are counties which are not a part of a standard metropolitan statistical area, which for the most part means they do not contain a city of over 50,000 people. There is one exception. Nonmetropolitan areas within 20 miles of cities of over 250,000 would be excluded.

Second, certain portions of urban counties which are suffering a serious decline in population could be designated as eligible balanced growth areas. This provision is made in recognition of the fact that while the primary problem is an imbalance between metropolitan and nonmetropolitan America, there is also a growing imbalance within some of our metropolitan communities. The movement of jobs from the central cities to the suburbs has created a great economic imbalance which needs to be addressed.

In summary, most nonmetropolitan areas and some metropolitan areas are potentially eligible for designation as balanced growth areas and, therefore, job-creating industries locating in these areas would be eligible for the special balanced growth tax credit.

One very important provision of this legislation involves State governments in the decisionmaking process as to how the system of balanced growth tax credits is to be used.

Specifically, areas which meet the definitions provided for in this legislation will not actually become eligible until they are formally designated as balanced growth areas by the individual State governments.

In other words, the State would have the option of designating all, some, or none of the areas within its boundaries which meet the definitional standards of the legislation. I would anticipate that some States would designate all potential balanced growth areas to be eligible.

Other States which have already developed some land use and balanced growth planning mechanisms would be selective and would designate only certain areas to be eligible for balanced growth tax credit. And, it might be, that some States would decide not to participate in the program at all.

In any case, this gives to the States an important responsibility. It would, I believe, provide an important stimulus to the development of land use and economic growth planning within each State. And, certainly, it would encourage a greater dialog between the State governments and the local communities. In this connection, this legislation provides that States shall designate the eligible balanced growth areas consistent with the State's goals of balanced growth and land use and in accordance with the expressed desires of the affected local communities.

One further comment in regard to the possible designation of balanced growth areas in metropolitan communities. If a county in a standard metropolitan statistical area has shown a net decline in population over the past 5 years, portions or all of that county may be designated as a balanced growth area. However, the State in designating balanced growth areas within metropolitan areas may not designate metropolitan balanced growth areas which contain a total population greater than the total population contained in designated nonmetropolitan balanced growth areas.

Over the years that I have advanced this proposal, I have found broad-based public support for this concept. At one time or another the use of tax incentives to encourage more dispersed population and economic growth patterns has been endorsed by such varied organizations and groups as the Advisory Commission on Intergovernmental Relations, the National Governors Conference, the National Advisory Commission on Rural Poverty, the National Advisory Commission on Civil Disorders, and many other groups and individuals interested in rural development and balanced national growth. One of the most recent and persuasive endorsements comes from the Science Advisory Panel to the Committee on Public Works of the House of Representatives.

This broad-based support has been manifested in the fact that proposals similar to the one I introduce today have twice, in 1969 and 1971, passed the Senate.

Mr. Chairman, later this year the tax-writing committees in both Houses will undertake comprehensive hearings on general tax reform. This will provide the proper forum for a full and detailed consideration of the use of tax credits to stimulate the rural development and balanced national growth. A full hearing of the issues involved may result in suggestions to modify the specifics of the bill I introduce today. On the other hand, I am fully convinced that a full and fair hearing of this issue will generate widespread support for the general proposition that the goal of rural development is a desirable one and that tax incentives can be used effectively to advance that goal.

Mr. Chairman, this proposal builds on the established principle that investment tax credits can be used to stimulate the development of new jobs. It proposes to use this tool to encourage the development of new jobs in areas which will contribute to the goal of balanced na-

tional growth. And, of particular importance, it brings the States into the decisionmaking process. This proposal provides them a powerful new tool that they can use to shape the growth patterns within their boundaries. Thus, while contributing to the goal of balanced national growth, this legislation I believe, also, would help to strengthen our Federal system.

STATEMENT OF THE ASSOCIATION OF MEDIA PRODUCERS

The Association of Media Producers is a professional and trade association representing producers and distributors of educational media and companies offering services to the educational media industry. Educational media includes motion pictures, filmstrips, film loops, and video programs. The materials produced by our member companies are an integral part of all aspects of educational development. Educators have come to rely upon the learning resources produced by the educational media industry and continue to demand these materials.

The Association of Media Producers' interest in H.R. 10612 focuses on the investment tax credit in the case of movie and television film.

Under the present law certain taxpayers are entitled to receive an investment tax credit for tangible personal property, often referred to as section 38 property produced by the taxpayer. Several years ago a court decision established that films are tangible personal property and as such are entitled to the investment credit; the Revenue Act of 1971 subsequently confirmed the court's decision.

However, recent action by the House of Representatives has excluded certain kinds of film materials because they are primarily topical in nature and have a useful life of less than 3 years. In H.R. 10612, section 802(K)(b) states, " * * * the term qualified film means any motion picture film, or videotape created primarily for use as public entertainment. Such term does not include any film or tape the market for which is primarily topical or transitory in nature."

Educational media are not topical or transitory in nature. Quite the contrary. Educational media typically have a life which far exceeds 3 years. Unfortunately, the specific reference to qualified films as those designed primarily for public entertainment effectively excludes educational media from eligibility for the tax credit currently permitted them.

The investment in educational films, filmstrips, and videotapes is a high-risk decision. An educational film, for example, may take several years to develop from the planning stages—research and writing—to the actual filming and marketing. These materials are designed to serve either curriculum or supplementary educational needs. They are not presold, and, like entertainment motion pictures, they require vigorous advertising, promotion, and marketing programs to return the investor's risk capital.

Because of the manner in which educational media are used in the schools, and because of the rather limited market for these materials, rarely could an educational media producer afford to create a product with a useful life of less than 3 years. While schools usually purchase textbooks on the basis of one per pupil, for example, educational film

materials are more likely sold on the basis of one or two per school district. The very unique character of the marketplace and the distribution patterns for educational media forces a delay on investment returns of from 2 to 4 years. Generally, it will take at least 7 years for an educational film to return approximately 95 percent of its revenue potential, and a large proportion of educational films have a useful life of 10 to 20 years. To withdraw a film from the market in less than 3 years would result in substantial loss to the producers. In addition, schools could not afford to purchase these materials if their value were limited to 3 years of use. As it is, a significant portion of educational media is purchased by schools with Federal funds under the Elementary and Secondary Education Act.

In addition to the investment risk taken by educational media producers, it should be noted that most of these producers are very small companies with annual sales of less than $1 million. Because of their small size, it is harder for them to secure capital for their investment since credit is harder to obtain. The costs of producing educational media have risen rapidly over the past few years, and the continued escalation of these costs has created problems for both producers and school purchasers. Quite obviously, the unavailability of the investment credit could drastically affect most educational producers. Some would go out of business, and others would be forced to sharply cutback production and increase prices. In these instances, there would be a decline in employment, since the need for researchers, script writers, filmmakers, and the like would be ratably reduced. This effect on the schools should not be underestimated because instructional materials are an integral part of educational curriculum.

With respect to subject matter, and whether or not educational films can be considered topical or transitory in nature, the distinguishing feature of which media is topical or transitory depends upon the original purpose for which it was produced. In this regard, a news program, or a documentary about a current event produced originally for television, or an industrial training film all may be products which have extremely short lives. In the case of an industrial training film, this may or may not be true depending upon the original purpose for which it was intended. For example, a manufacturer has a film made on how to use a particular product, but that product is constantly modified. In this case, the film would have to be continually revised to reflect changes made in the primary product itself. A television news program or a documentary concerning current affairs falls into the same category; these films are more easily described as topical or transitory.

However, as stated previously, educational media does not lend itself to such a description; the expense of film production, the resulting expense of films purchased by schools, the limited resources of schools for such purchases, and the small size of the production companies are factors which obviate production of educational media with useful lives of less than 7 years.

The Internal Revenue Service, as a result of litigation and the 1971 law, does not dispute the fact that film qualifies as personal tangible property for purposes of the investment credit. Nor does it dispute the viability of educational films versus entertainment films for credit

eligibility. The issues of dispute center on what constitutes "useful" dominant foreign use of a film. These issues, which the Tax Reform Act will attempt to resolve, have been raised by IRS with both entertainment filmmakers and educational filmmakers. Not since the Court ruling and the 1971 Revenue Act has there been an effort to disqualify a film from eligibility for the credit on the basis of subject matter. It was during deliberations of the House Ways and Means Committee on H.R. 10612, that subject matter became an issue.

It may be that this issue was raised in an attempt to clarify the "useful life" problem. H.R. 10612 would permit taxpayers to claim two-thirds of a full credit for all of their films regardless of the useful life of any particular film. Although a film with a useful life of less than 3 years, if judged separately, would not be eligible for the credit—under present law—filmmakers who produce only films with a useful life of less than 3 years would be eligible for a two-thirds credit under the new rule, when previously they could not take a credit at all. In this regard, the committee's attempt to exclude TV news shows or tapes of sports events is understandable. However, educational media do not fall into this category.

For this reason, we believe that a lack of understanding about the characteristics of educational media led to labeling such media as transitory or topical in nature. Clearly, this does not correspond with surveys of large school districts which reveal that even with more funds than are available in smaller districts, 75 percent to 80 percent of the film materials used in the larger districts are over 5 years old.

At no time do we contend that entertainment films are topical or transitory in nature. However, there is no question about the fact that educational media should be included in the category of "qualified films" and should receive the same investment credit as accrues to the entertainment films.

With this in mind we propose that H.R. 10612 be amended by adding the following as an additional phrase of the first sentence under section 48(k) (1) (B) as added by section 802(a) of the bill: "or for distribution to any organization described in Section 170(b) ((1) (A) (i), (ii), (iii), or (v)."

It may be that the inclusion of this language would require additional conforming amendments. The Finance Committee may wish to refer to code section 461(a) (6), which would be added by section 101 of the bill, and code section 464, which would be added by section 207 of the bill.

The Association of Media Producers strongly urges the Senate Finance Committee to correct the inequity contained in H.R. 10612 and to include educational film materials as items eligible for the investment tax credit.

Statement by Machinery Dealers National Association

I. Introduction

This statement is submitted by the Machinery Dealers National Association (MDNA), which is a national trade association composed of

350 small business companies who have joined together to promote the growth of the used machine tool industry and the modernization of the businesses who are dependent on used machinery. MDNA is speaking on behalf of the 115,000 metalworking firms in the United States, each of which employ fewer than 100 persons. These small businesses represent 87 percent of the firms in the metalworking industry and operate approximately 40 percent of the machine tools in use.

MDNA strongly supports proposals to expand the application of the investment tax credit. We believe, however, that tax equity for modernization of small business demands that the application of the investment tax credit also be expanded with respect to used machine tools as well as new capital equipment. Specifically, MDNA requests that the present $100,000 limitation on the value of used property eligible for the credit be eliminated to cover the increased prices of capital equipment.

Apart from the expanded application of the investment tax credit to used section 38 property, MDNA supports the following proposals:

(a) the permanent availability of an investment tax credit of equal size for new and used capital equipment to encourage capital formation in the United States;

(b) additional first-year depreciation allowances for small businesses under section 179 of the code;

(c) an increase in the corporate surtax exemption to $100,000; and

(d) an expansion of the asset depreciation range from 20 percent to 40 percent.

II. WHY EXPAND THE INVESTMENT TAX CREDIT FOR USED CAPITAL EQUIPMENT?

The purpose of the investment tax credit is to stimulate capital investment. By investing in used machinery and equipment four beneficial results are obtained:

(a) the competitive position of small businesses who are dependent upon used machinery for plant modernization is improved;

(b) such a credit stimulates employment in the most labor-intensive portion of the capital equipment industry;

(c) the short-run inflationary impact of the credit is avoided; and

(d) the position of the U.S. balance of trade is improved.

The competitive position of small businesses

It is recognized that the impact of the current recession has been particularly devastating for small businesses due to their inability to ride out the pressures of recession as well as their larger competitors. The buyers of used machines, which tend to be medium and small enterprises, have been particularly hard hit by the current combination of recession, inflation, and high interest rates in the U.S. economy. The primary purchasers of used machines include small motor manufacturers of automotive accessories. These companies rely heavily on the credit to permit them to compete with large corporations possessing mass producing, mass marketing, and broad financial capabilities. Large corporations buy new machine tools that are either highly automated multi-operation machines or numerically-controlled equip-

ment. Increasing the investment credit for new equipment, then, helps primarily the largest enterprises who need the credit the least; increasing the investment credit for used equipment helps primarily small business enterprises competing in fields dominated by a handful of giant corporations. When one thinks of the computer industry, for example, the name IBM immediately comes to mind, yet there are 65 firms with assets under $1 million also making various types of computers. The metal can field has 93 firms in the small assets brackets fighting to remain competitive with three dominant corporations. There are 111 of the same small asset group competing against 5 giants in the farm implement industry. The above examples are merely illustrative of the difficulties confronting small businesses in heavily concentrated markets in the U.S. economy.

Full modernization of a plant, or development of a production line, requires the purchase of multiple pieces of machinery. The small businessman simply cannot afford to purchase new capital equipment costing from $100,000 to $1 million. By liberalizing the investment credit for used machinery, the Government would be taking a long step toward eliminating the corporate caste system it has heretofore fostered, and would provide meaningful support for the small and medium sized manufacturer who wishes to grow and compete in a free and open market.

An expanded investment credit for used machinery would be job creating for the economy

A tax credit should stimulate employment for the economy as well as stimulate investment. This is a particularly important objective at the present time, with unemployment in the Nation's economy at the 7.5-percent mark. The investment credit for used machinery has a uniquely job-creating impact on the economy, because the purchasers of used machinery are obtaining machinery that is less complex than the new multioperation machines or numerically controlled equipment purchased by large corporations. Large plants, for example, have 86 percent of the automatic assembly machines and 90 percent of the special way-type and transfer machines in the United States—(see appendix A.[1] The objective of the latter sophisticated, automated equipment is to reduce the size of the work force required to complete a task; the used machines that are purchased, on the other hand, require men or women to operate them, not control stations. As the investment credit encourages the medium or small company to purchase machines, it also works to increase employment in a direct relationship to their expansion program.

The investment credit and inflation

The investment credit is, in the long run, antiinflationary, because it operates to produce more supplies for consumer demand. In the short run, however, the credit has an inflationary impact with respect to new capital equipment due to increases in the prices of scarce supplies required to produce the equipment and a substantial lag in the impact of the credit in causing more supplies to be produced.

---

[1] American Machinist, Oct. 29, 1973, at p. 156.

While endorsing the efficacy of the credit as a potent tool for stimulating capital investment, Klein and Taubman have pointed out that many decisions to invest in production equipment require up to two years to implement, and in the case of plant facilities, the lags are much longer, usually extending from 12 to 36 months.[2] The investment credit for used property, on the other hand, avoids the inflationary impact of the credit. First, since used machines by definition are already built, there is no immediate inflationary impact from the bidding up of materials to build the needed equipment. Secondly, since used machines are simpler to install, and typically immediately ready for installation, there is virtually no lag in producing additional supplies for the economy.

Thus, while the investment credit is essential for new equipment, it is also critical for used property and greatly assists the Nation's economy.

The credit and the U.S. balance of trade

Due to the energy crisis, the U.S. balance of trade is facing a prolonged period of being in deficit. The outflow last year alone for petroleum was $25 billion. In this context, it is essential to reduce the negative aspect of the capital equipment trade account. This can be done if the credit for used machinery is expanded, since used U.S. machine tools do not compete with new domestic machine tools, but compete in the areas of quality, price, size, and power with foreign machine tools. The growth of the foreign machine tool influx is demonstrated by the increase in imports from $25 million in 1961—pre-investment credit—to $216 million in 1974, or from 2 percent of the domestic market in 1961 to 10.6 percent in 1974. Stated another way, sales of foreign machine tools have increased by a factor of 10 since the initiation of the investment tax credit, while sales of used U.S. equipment have increased only by a factor of 3. The adverse effect on the U.S. balance of trade is obvious.

The used domestic machine market is placed at a decided competitive disadvantage with comparable foreign machinery which qualifies for the full tax credit on unlimited capital purchases. MDNA does not ask for preferential treatment but rather asks only for equal treatment in the marketplace.

III. THE LIMITATION ON USED PROPERTY SHOULD BE ELIMINATED

The investment tax credit began in 1962 as an effort to stimulate modernization of plant and facilities. In recognition of the need for all business, including small business, to modernize, the House Ways and Means Committee in 1962 qualified certain used property for the investment tax credit with the following explanation:[3]

> The bill, by limiting the credit principally to property which is new in use, will limit the investment stimulant primarily to provision for new productive

[2] Lawrence R. Klein and Paul Taubman, "Estimating Effects Within a Complete Econometric Model," in "Tax Incentives and Capital Spending," ed., Gary Fromm (The Brookings Institution: Washington, D.C., 1971), at pp. 239, 240.
[3] H. Rept. No. 1944, 88th Cong., 2d sess. (1964).

facilities. However, because of the great dependence of small business on used property, a limited credit is also made available.

The investment credit allowed to used property in 1962 was limited to $50,000 annually with no provision for a carry-back or carry-forward. This limitation was inadequate and arbitrary at the time, a fact that was recognized by the House Select Committee on Small Business in 1964 when it reported and recommended that:[4]

On the other hand, the House Small Business Committee, in its final report of the 87th Congress, pointed out that the limitations of $50,000 for purchase of used property in any one year and to property with a useful life of at least 4 years, excludes many businessmen from the operation of the 7-percent tax credit. It was recommended that changes in these limitations be considered by the appropriate legislative committee so as to permit the investment credit to be used to a greater extent by small business.

The inadequacy of the $50,000 limitation was recognized by the Senate Finance Committee in 1975, when it recommended the complete elimination of the limitation on used property eligible for the investment credit. Under the House bill, the limitation would have been increased from $50,000 to $75,000. The two Chambers compromised by agreeing to a $100,000 limitation on the amount of used property eligible for the investment tax credit.

The inadequacy of the $100,000 limitation agreed upon in 1975 is even more evident today due to increased inflationary pressures and improvement in technology in the used capital equipment industry. In an effort to quantify the increased costs of used machine tools between the years 1962 and 1975, MDNA has made an extensive survey of the prices of used capital equipment as advertised in the Industrial Machinery News. This survey was based upon a sampling of 40 representative items including cylindrical grinders, turret lathes, centerless grinders, toolroom and production milling machines, shapers, engine lathes, radial drills, vertical turret lathes, automatic screw machines, gear hobbers, presses, and sawing machines. In each case, MDNA compared the 1962 market price of a used machine tool manufactured between the years 1940 and 1945 with the 1975 used market price of the same model machine—or its successive model—produced by the same manufacturer between the years 1951 and 1957. Our survey—see appendix B, attached—indicates that prices of used machine tools in January 1975, were 231 percent higher than those of the equivalent machinery as advertised in 1962. Accordingly, the limitation on the investment credit for used equipment should be eliminated to take account of the impact of increased prices in the used equipment market. The revenue impact of the elimination of the limitation on used property eligible for the credit would be minimal; based on estimates supplied by the Treasury Department and accepted by the Senate Finance Committee in 1975, the removal of the limitation would produce a revenue loss of substantially less than the $90 million projected in 1975 by the Congress. The $100,000 limitation agreed upon in 1975 by the Congress is a step in the right direction, but is inadequate to meet the capital equipment needs of small businesses in the United States.

---

[4] *Id.*

IV. CONSIDERATION SHOULD BE GIVEN TO A FIVE-YEAR CARRY FORWARD FOR ELIGIBLE USED PROPERTY IF THE LIMITATION ON SUCH PROPERTY IS NOT REMOVED

If the limitation on eligible used property is not removed, then consideration should be given to the enactment of a 5-year carry forward for such property. New property has an investment credit carry back to each of the 3 taxable years preceding the unused credit year, and an investment credit to each of the 7 taxable years following the unused credit year for unused credits. Used property has no correlative carryback or carryover provisions. Equity also demands carryforward provisions for eligible used property if the $100,000 limitation on used property qualifying for the credit is not eliminated. Such a carryover period should be of at least a 5-year duration. Our proposal would not result in the revenue losses that would be associated with the application of carryback provisions. Thus, let us assume that $150,000 of used equipment is purchased in a given taxable year. Under MDNA's proposals:

(a) $100,000 of the used property would qualify for the credit in the year of purchase (assuming the current limitation level is kept); and

(b) there would be a carryforward of $50,000 toward the $100,000 limitation for the next year.

V. SUMMARY

MDNA strongly supports the proposals made to increase the application of the investment tax credit. We urge, however, that additional consideration be given to techniques to increase the effectiveness of the credit for purchases of used equipment. Such purchases assist small businesses, create jobs, eliminate the short-term inflationary impact of the credit, and assist the U.S. balance of trade. Specifically, MDNA urges the elimination of the limitation for eligible used property, and enactment of an investment tax credit of equal size for new and used capital equipment on a permanent basis.

MDNA is fully prepared and willing to assist the Treasury Department, or the staff of this committee, in any way to resolve this serious problem facing small business in the United States.

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 1,000 employees to see if they differed substantially from the plants with 100 to 1,000 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 percent 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 percent in plants with 100 or more employees. It drops to 30 percent in the plants with 1,000 and more employees.

At the other end of the life span, 23 percent 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 percent in plants with more than 100 employees and to 37 percent in plants with more than 1,000.

Plants with more than 1,000 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 percent in the smallest plants, 29 percent in the next size, 30 percent in the plants with more than 100 workers, and also 30 percent in those with more than 1,000 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 percent in the smallest size group, 28 percent in the next larger size, 30 percent in the next size, and 33 percent 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 percent in the smallest plants, drops to only 9 percent in the plants with 50–99 employees, then jumps to 12 percent in the plants with 100 or

more workers and to 16 percent in the plants with 1,000 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 percent for plants with more than 100 employees drops to 45 percent for the plants with more than 1,000 employees. Conversely, the 15 percent of units more than 20 years old in the 100 worker and up plants jumps up to 20 percent in the plants with more than 1,000 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 percent of the employees. They also have 32 percent of the metalcutting machine tools; 25 percent of the metalforming machines, 22 percent of the joining equipment, and 20 percent 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 percent of the workers in metalworking. These plants have 11 percent of the metalcutting and joining equipment, 12 percent of the metalforming equipment, and 9 percent 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 percent of the workers in metalworking. These plants have 57 percent of the metalcutting machines, 63 percent of the metalforming machines, 67 percent of the joining equipment, and 71 percent of the other equipment.

These generalizations do not apply in every case. The large plants have 86 percent of the automatic assembly machines, and 66 percent of these machines are less than 10 years old against only 61 percent young in the smaller plants.

The large plants have 90 percent 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 percent are less than 10 years against 55 percent 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 percent being under 10 years old, and these plants have 73 percent 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 percent in the small plants but only 29 percent in the large ones.

7. Summary of 11th Inventory by plant size

(based on number of employees)

Type of equipment	Under 50 emp.			50-99 emp.			100 or more emp.			Total			% of equip. in plants with 100 and over
	Total units	Under 10 yr.	Over 20 yr.	Total units	Under 10 yr.	Over 20 yr.	Total units	Under 10 yr.	Over 20 yr.	Total units	Under 10 yr.	Over 20 yr.	
Total metalcutting machines	787,640	37%	23%	258,230	37%	23%	1,346,333	31%	32%	2,382,203	34%	28%	57
Turning machines	166,638	32	26	55,869	32	30	270,940	29	33	493,447	30	31	55
Boring machines	12,894	33	31	4,849	33	28	36,823	29	33	54,168	30	32	68
Drilling machines	143,430	35	21	62,113	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	78	5	9,276	75	6	14,728	77	5	63
Special way-type & transfer machines	803	67	4	615	44	19	13,436	85	11	14,854	84	11	90
Automatic assembly machines	1,302	67	2	1,153	65	5	14,835	68	49	17,290	68	5	86
Tapping machines	13,722	40	18	4,645	44	14	17,973	31	28	36,340	36	22	49
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
Planing machines	2,786	4	72	843	3	72	3,983	6	66	7,612	5	69	52
Shaping machines	10,501	10	56	2,707	6	64	15,337	8	60	28,545	8	59	54
Contour sawing & filing machines	8,837	33	20	2,338	30	24	12,409	27	27	23,584	30	24	53
Cutoff & 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	290,129	33	30	489,600	36	26	59
Honing machines	7,779	48	11	2,067	47	18	10,877	46	18	20,723	47	15	52
Lapping machines	3,570	56	8	1,211	57	14	8,539	45	20	13,320	49	16	64
Polishing & buffing machines	36,773	32	34	10,618	40	19	62,825	30	27	110,216	32	29	57
Gear-cutting & 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 metalcutting machines	896	33	9	356	47	19	14,407	9	80	15,659	11	74	92
Total metalforming machines	173,378	31	28	84,445	29	28	445,486	30	30	703,297	31	29	63
Bending & forming machines-power	32,454	34	22	13,456	34	24	52,401	33	24	98,311	34	24	53
Hydraulic & pneumatic presses	14,717	41	19	7,416	44	18	54,666	41	21	76,799	41	20	71
Mechanical presses-power	68,034	25	33	34,108	22	33	188,837	25	36	290,979	25	35	65
Punching & shearing machines-power	28,724	36	24	11,148	31	27	49,159	31	33	89,028	33	29	55
Forging machines	4,702	24	42	3,821	22	48	19,224	24	42	27,747	24	43	69
Wire and metal-ribbon formers	7,391	30	22	4,077	31	41	14,847	26	37	26,315	28	33	56
Riveting machines	9,860	38	16	5,084	33	18	40,807	40	18	55,351	39	17	73
Other metalforming machines	7,694	39	19	5,347	40	18	25,727	31	24	38,767	34	22	66
Total machine tools	931,018	34	23	342,685	35	24	1,791,799	31	32	3,085,500	33	28	58
Total joining equipment	110,263	54	11	57,238	50	9	330,503	52	12	498,002	52	11	66
Electric arcwelding equipment	80,267	56	9	42,482	54	7	240,281	55	10	363,020	58	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	8	3,114	50	7	5,861	56	7	53
Flame cutting machines	4,851	50	12	2,066	48	10	7,942	46	13	14,859	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	48	10	5,593	44	10	70
Total other equipment	74,439	55	10	36,087	56	10	269,873	49	15	380,399	51	14	71
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 & 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 & drying ovens	10,688	46	11	6,497	53	7	41,392	48	13	58,577	48	12	71
Cleaning & finishing equipment	32,768	57	9	16,206	58	8	97,039	52	12	146,013	54	11	66
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

Plant-size analysis

8. How metalworking equipment ages

	% under 10 years old						
	1945	1949	1953	1958	1963	1968	1973
Metalcutting machine tools							
Turning machines*	59%	53%	42%	36%	33%	32%	30%
Boring machines*	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	—	—	—	—	41	42	36
Threading machines (exc. pipe and bolt)	60	66	39	38	28	29	26
Multifunction machines	—	—	—	—	—	77	77
Special way-type machines	—	—	—	66	62	59	56
Automatic assembly machines	—	—	—	—	—	72	65
Broaching machines	65	69	50	41	31	26	24
Planing machines	22	25	19	15	11	6	5
Shaping machines	38	37	31	23	17	11	8
Contour sawing and filing machines	—	—	64	51	41	32	30
Cutoff and sawing machines	66	67	56	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	38	27	28	24
Electrical machining units	—	—	—	—	85	83	77
Metalforming machine tools							
Bending and forming machines	54	60	49	46	41	36	33
Hydraulic presses	49	67	54	48	49	42	41
Pneumatic presses	—	82	67	55	61	54	55
Mechanical presses	39	39	37	34	29	28	25
Punching and shearing machines	—	41	39	37	34	34	32
Forging machines	52	28	27	20	20	25	24
Wire and metal-ribbon formers	—	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	—	67	58	56	63	67	63
Diecasting machines	—	83	54	70	56	49	51
Inspection and measuring equipment	—	—	—	—	—	56	54
Heating equipment	66	71	50	48	47	45	37
Cleaning equipment	—	64	55	52	53	55	54
Plating equipment	74	72	61	56	61	67	59

*Vertical turret lathes and vertical boring mills are included in "Turning machines" starting in 1968. They had been in "Boring machines."

Where blank spaces occur, no comparable data exists.

Source: American Machinist 11th Inventory

For drilling machines, it is 35 percent in the small plants and only 25 percent in the large.

For milling machines, it is 43 percent for the young machines in the small plants and only 33 percent in the large.

Grinding machines are 41 percent less than 10 in the small plants, only 33 percent less than 10 in the large plants.

Among the newest types of machines, the large plants have only 57 percent of the electrical machining units. Of these, 73 percent are less than 10 years old. In the smaller plants, the percentage of machines less than 10 years old rises to 81 percent in the plants with less than 50 workers and to 84 percent 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.

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 percent of the multifunction machines, and 75 percent of them are less than 10 years old. However, plants with 50 to 99 employees have 10 percent of the multifunction machines, and 76 percent of them are under 10 years old. Finally, the plants with less than 50 workers—plants that have only 9 percent of the employees—have 27 percent of the multifunction machines, and 83 percent 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 percent for the plants with more than 100 workers, 6 percent for those with 50 to 99 employees, and 22 percent 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 percent of the total workers, whereas it was 8 percent 5 years ago. These plants now have 32 percent of the metalcutting machines instead of the 30 percent they had then. They now have only 25 percent of the metalforming machines. They had 28 percent in 1968.

APPENDIX B

Used capital equipment	1951 1975/ 1957	1940 1962/ 1945
Landis 6 x 30 PL OD gr	$4,950	$1,000
W & S No. 3 turret	6,250	3,250
Cinn 10 x 18 OD PL	12,500	3,500
Cinn No. 2 centerless	11,950	3,950
K & T No. 4H PL mill	24,500	9,750
Cinn 24-in shaper	4,950	2,250
K & T 3K univ mill	13,500	6,450
K & T 3K vert mill	14,750	6,950
B & S No. 2 vert mill	4,250	2,950
W & S No. 5 turret	9,950	2,500
J & L No. 4 turret	10,950	4,950
W & S No. 3 turret	6,950	3,250
W & S No. 1A turret	37,500	2,950
Gisholt No. 2L turret	17,500	2,850
Cinn No. 3 vert mill	22,500	6,450
Cinn No. 5 vert mill	34,500	9,450
K & T No. 4K PL mill	24,500	9,750
Cinn No. 4-48 simplex mill	14,500	3,950
Gisholt No. 5 turret	4,950	4,950
Monarch 1L ft x 30-in lathe	5,950	2,750
Cinn 2-24 simplex mill	11,500	3,500
B & S No. 5 O.D. gr	7,950	2,750
Kent-Owens No. 2-20 mill	4,950	1,650
Cinn No. 1-18 plain prod mill	5,950	975
Cinn No. 2 centerless gr	12,500	3,950
Cinn-Bickford 5 ft 13 in radial drill	19,500	6,500
Bullard 36 in VTL	29,500	5,250
B & S No. 26 automatic	15,500	5,950
B-C No. A gear hob	13,750	1,950
Cinn 10 in x 18 in PL OD gr	7,950	1,650
DoAll 16 in band saw	3,950	950
Cinn No. 2 centerless	12,500	3,475
B & S No. 2G automatic	15,500	4,950
B & S No. 00G automatic	5,950	2,450
B & S No. 0G automatic	7,950	2,950
B-C No. 3 gear hobber	5,950	2,950
Cinn No. 2 centerless	10,950	4,950
B & S No. 00G automatic	11,950	5,025
Bullard 36 in VTL	32,500	4,950
Bliss No. 21 OBF	3,950	850
Total	527,550	159,475

Statement of J. W. Van Gorkom, President, Trans Union Corp., Lincolnshire, Ill.

CAPITAL INFORMATION AND INVESTMENT TAX CREDIT

Two major tax incentives have been created to encourage businessmen to invest in capital equipment: (1) Accelerated depreciation. (2) Investment tax credit.

In our company, and in many others, the way in which these incentives function actually creates a disincentive and has discouraged us from building or acquiring capital equipment. Now Congress has increased the investment tax credit and, instead of helping us, this increase will discourage us even more, so far as additional investment is concerned. I wish to explain why this has happened and to support the Treasury Department's proposal made in 1974 for correcting this anomaly.

Trans Union Corp. has been in existence since 1891. It owns over $500 million of various assets which it leases to a broad spectrum of users. For example, it owns some 37,000 railway cars which it leases to petroleum, chemical, fertilizer, and food companies. It owns irrigation systems that are leased to farmers, medical equipment leased to hospitals, ships leased to offshore drilling suppliers, and many other types of equipment. In a recent period of 18 months ending in June 1975, Trans Union invested almost $200 million in the construction and acquisition of these various types of capital equipment.

The guidelines for accelerated depreciation were adopted in 1962, and, in liberalized form, given express statutory sanction by Congress in 1971. These depreciation incentives permitted a faster writeoff of capital assets for tax purposes and thereby permitted a postponement in the payment of income taxes. This increased the cash flow from the assets and reduced the cost of owning them.

The essential point is this: This saving in the cost of ownership was promptly passed on to our lessees by a reduction in rental rates. The leasing industry is highly sensitive to cash flows and very highly competitive. Changes in cash flows due to changes in tax laws quickly find their way into the rental rates.

When the investment tax credit was created, the same thing occurred. The rental rate structure of the industry quickly adjusted to reflect the economic benefits of the ITC. We did not retain those benefits; we passed them on in the form of lower rental rates.

The ITC, however, can only be used to the extent that it offsets one-half of a company's income tax. This means that to obtain the full economic benefit of the ITC, a company's net taxable income generally must be somewhat greater than four times the ITC itself. We are unable to meet that requirement and, therefore, we cannot use all of the ITC that we generate. Nevertheless, the rents we charge are based on the assumption that we can use the entire credit, and when we can't, our return on the assets involved is reduced to a point that discourages further investment therein.

There can be several reasons why a taxpayer's taxable income is too low to use all of the ITC. In our industry, and in particular in our company, it results largely from our very rapid growth and our heavy investment in capital equipment in recent years.

The rents we receive for our leased equipment are never sufficient to show a taxable profit in the early years of an asset's life because of the accelerated depreciation and the heavy interest costs in those early years. As to any particular piece of leased equipment, a taxable loss is produced for several years after its construction or acquisition. In ordinary times, however, our older equipment provides enough taxable income to permit us to use the ITC. Recently, however, we had added enormously to our leased equipment and this has given us an unusually large investment in new equipment as compared to older equipment. This unbalanced condition of our investment will make it impossible for us to use the ITC that we have produced.

This situation is also exacerbated by our shipping operation. Encouraged by Congress to buy ships in the United States we had three

large vessels built here and took delivery in 1974 and 1975. They produced additional ITC but their depreciation and interest charges will greatly exceed their net operating revenues, for tax purposes, thereby producing more negative taxable income in the next several years.

If the ITC generated in 1 year cannot be used immediately, it can be carried forward for 7 years. This does not help us sufficiently because, if our growth continues, even at a reduced pace, it is now clear that we will be unable to use all of the credit even in the extended period. Furthermore, when receipt of the credit is delayed, its benefit is reduced, and a delay of 7 years would mean a loss of half of the economic benefit.

We are also permitted to pass the entire credit on to the lessee under certain circumstances, and we do this whenever we can. Unfortunately, many of our lessees are also unable to use the ITC. They insist that we retain it and provide them with a lower rental rate.

It might at first seem unreasonable for us to complain of our inability to use the ITC if we are presently paying little or no taxes because of our heavy depreciation and interest charges. However, it must be remembered that the economic benefit of both the higher depreciation and the ITC have already been passed on to our lessees. The rental rates we charge are based on the assumption that we can use both the accelerated depreciation and the ITC. If we only obtain one of them, then our costs are out of line with our revenues and we incur a disincentive to build and lease the equipment we supply to American business. We cannot change the industry's rental rates and we simply do not obtain sufficient income if the ITC is denied us. Because of the tax law we are put at a competitive disadvantage with lessors who are in a position to use the ITC to the fullest.

The point is especially important now that the ITC has been increased. It means that rental rates may drop even further because of an assumed drop in ownership costs and this will create a greater disincentive to us and to many in our industry. These companies cannot use the ITC they have already generated under the old lower rate, and the increase will merely bring pressure on the rental rates without any offsetting benefit. This will definitely discourage further investment and thereby do just the opposite of what Congress intended by the increase.

SOLUTION

In 1974 the Treasury Department, apparently recognizing the discrimination against taxpayers with little or no taxable income and in favor of highly profitable enterprises, proposed a simple solution to this problem. The Treasury recommended that if a taxpayer was unable to use his ITC for 3 years after it was generated, then he would receive a cash refund from the Treasury for the unused portion. This would certainly be a great improvement over the present limitations. The taxpayer would lose over 20 percent of the benefit by having to wait 3 years for his credit, but it would assure him that he would ultimately receive it. We could live with this proposal, but, obviously, an even greater incentive would be provided if the credit were paid shortly after the year in which it was earned.

WESTERN UNION TELEGRAPH CO.,
Washington, D.C., April 1, 1976.

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

DEAR MR. CHAIRMAN: I shall appreciate having the attached statement incorporated into the record of the current hearings on tax reform and extension and revision in present tax reduction provisions (including H.R. 10612) relating to the subject of Tax Treatment of Public Utilities and Capital Formation.

The Tax Reduction Act of 1975 temporarily eliminated the discrimination against public utilities by providing a uniform 10% investment tax credit for all industries, including public utilities, during the period January 22, 1975, through December 31, 1976.

We urge the enactment of further legislation eliminating the dual rate investment tax credit system and establishing for the future a permanent single uniform investment tax credit applicable to all industries, both public utilities (including telegraph companies) and nonpublic utilities alike.

Very truly yours,

RICHARD L. CALLAGHAN.

Attachment.

STATEMENT OF THE WESTERN UNION TELEGRAPH CO.

INVESTMENT TAX CREDIT

When the investment tax credit was originally enacted, public utilities were placed together in a special class that was granted only a 3 percent rather than the general 7 percent investment tax credit. Upon the restoration of the investment tax credit in 1971, the credit was increased to 4 percent for this special class.

Thus, prior to the Tax Reduction Act of 1975, the investment tax credit was 4 percent for public utilities and 7 percent for all other industries.

The 1975 Act increased the investment tax credit to 10 percent for all industries, including public utilities. This uniform 10 percent credit will remain in effect for only a limited period of time however; in the absence of new legislation, the former 7 percent and 4 percent credits will again become effective with respect to property acquired or placed in service after December 31, 1976.

A return to the dual rate system of investment tax credit whereunder the 4 percent credit provided for public utilities is 43 percent less than the 7 percent credit provided for all other industries would be unfair and inequitable to the public utilities. The discriminatory feature of the dual rate system was recognized by the House Committee on Ways and Means and by the Senate Finance Committee

during their consideration of the Tax Reduction Act of 1975, the reports of both Committees stating that:

"Under existing law, a 4-percent investment credit is provided for most public utilities, as compared to the 7-percent investment credit which applies generally. This lower investment credit for public utilities *discriminates* against investment in utilities and *impedes* such investment at a time when the public utilities need large amounts of capital to build up their capacity to meet the growth in demand for their services."

The 1975 Act temporarily cured this discrimination by providing a single uniform 10 percent investment tax credit for all industries, including public utilities, during the period January 22, 1975, through December 31, 1976.

The cure should now be made permanent by the enactment of further legislation eliminating the dual rate investment tax credit system and establishing for the future a permanent single uniform investment tax credit applicable to all industries, both public utilities (including telegraph companies) and nonpublic utilities alike. There is no rational basis for granting, for example, a higher investment tax credit to a manufacturing company than to a telegraph company.

TRANSPORTATION ASSOCIATION OF AMERICA

SUITE 1107 • 1100 17TH STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 296-2470

PAUL J. TIERNEY
PRESIDENT

March 10, 1976

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

Dear Mr. Chairman:

I understand that your Committee will begin consideration on March 17 of H.R. 10612, the tax reform proposal passed by the House.

Certain provisions of this legislation pertaining to the investment tax credit are of very considerable interest to the Transportation Association of America (TAA) and its members. In their behalf, I would like to offer some pertinent observations on this question.

TAA is a national non-profit organization whose membership includes not only carriers of all modes of transportation (air, motor, rail, water, pipeline and freight forwarder), but also users of the services of those carriers and investors in the transportation industry. The purpose of TAA is to act as a forum wherein the diverse views of these several interests may be reconciled on issues of major transportation importance for the good of the industry as a whole. A list of the TAA Board of Directors is enclosed for your information.

In its present form, H.R. 10612 would extend for a period of four years the temporary increase, to 10%, in the investment tax credit. TAA strongly supports this proposal as the minimum relief that should be granted in this area, but also wishes to urge that consideration be given to further relief. Specifically, we note that, in consideration last year of H.R. 6860, energy-related legislation, it was proposed to increase the basic investment tax credit applicable to energy-intensive areas of economic activity to 12%, with an additional 1% credit available for those companies which offer employee stock option plans. We believe there was a good deal of merit in this proposal, and urge that it be carefully studied for possible inclusion in the tax package being developed by your Committee.

As you are no doubt aware, the transportation industry is currently facing a serious problem in capital formation. During the past 25 years there has been a steady decline in capital investment in the transportation industry relative to investment in other economic sectors; expenditures

for new plant and equipment in transportation during 1974 (the last year for which we have full data) amounted to under 6% of the total U.S. investment level, which is about half of transportation's 1950 share of investment dollars. Over this same span of years the railroads have seen their share of U.S. capital investment decline even more steeply, from 5.8% in 1950 to 2.3% in 1974.

Present indications are that current capital investment in transportation must be very nearly doubled if the industry's needs are to be met with for the balance of this decade. I am enclosing for your information a tabulation of estimated annual capital requirements of the transportation industry over the period 1975-1979, together with figures demonstrating the actual outlays in the 1970-1974 period. Even ignoring inflation, it appears that transportation carriers must average nearly $10 billion in constant 1973 dollars for the balance of this decade in order to fully meet their capital needs; their actual 1970-1974 investment averaged only about $5.4 billion annually in the same constant 1973 dollars. Not a single mode of transportation was able, during 1970-1974, to generate investment equal to its 1975-1979 level of need.

Given these facts, it is very clear that the ability of the transportation industry to meet its capital requirements - and thus assure its ability to continue to respond adequately and efficiently to the nation's ever-increasing demand for transportation service - is in significant part dependent on the tax status of its investment program. We believe the seriousness of the problems being encountered by the transportation industry in this area fully warrants an increase in the investment tax credit to 12%, as was contemplated in H.R. 6860.

There is one other area upon which we wish to touch. This concerns the status of the tax credits which have been earned by industry, but which, by virtue of other financial problems encountered by particular companies, have remained unused and are now about to expire.

It is our understanding that more than half of all such expiring credits were earned within the transportation sector of the economy. This again vividly points up both the capital-intensivity of transportation as an industry and the serious economic problems the industry is encountering. It is for this reason that this Association has adopted a policy that such earned, but unused and expiring, investment credits should be treated as refundable overpayments of tax.

It is ironic that current tax laws should serve to discourage capital investment by precisely those companies which need the most - that is, companies encountering serious financial difficulties. In order to provide

Honorable Russell B. Long
March 10, 1976
Page Three

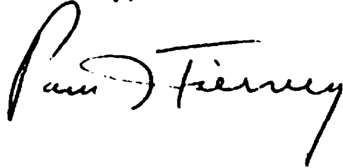
adequate, efficient and economical transportation service to a nation which depends upon that service, transportation carriers must constantly revitalize their operations with fresh infusions of capital investment. Certain major carriers, especially in the rail and air sectors, are currently either bankrupt or verging upon bankruptcy. If these carriers are to continue to meet the public demand for transportation service, and to resuscitate their own ailing financial structures, they must be in a position to generate substantial capital investment. Yet current tax policy serves to discourage their doing so, by denying them the relief that is accorded their more prosperous brethen.

Not only as a matter of simple equity, but also in recognition of the extraordinarily urgent needs of these insolvent and marginal carriers, we believe they are entitled to the same relief that is accorded other companies in our economy. In our view, it is both unreasonable and counterproductive to deny any transportation carriers use of investment tax credit provisions of the law simply because that carrier does not earn sufficient profits to enable it to make full use of earned investment credits. The critical public interest role of the transportation industry demands, in our opinion, that every possible incentive be accorded transportation carriers to meet their investment needs, and we believe current tax law should be amended to extend that incentive as broadly as possible.

For these reasons, we urge that you and your Committee give full consideration to incorporation of the described amendments in any tax legislation that is reported to the Senate for action.

Thank you very much for your interest and attention. We would like to request that this letter be made a part of the permanent record of hearings on this legislation.

Sincerely,



PT/dk

Enclosures (2)

ESTIMATED ANNUAL CAPITAL REQUIREMENTS
OF PUBLIC INTERCITY CARRIERS

1975-1979

(Millions of Constant 1973 Dollars)

	Replacement	Expansion	Total	Annual Outlays 1970-1974
Railroads	2,742	1,067	3,809	2,062
Airlines	1,021	1,106	2,127	1,439
Motor Carriers	1,565	579	2,144	1,079
Oil Pipelines	133	1,205	1,338	467
Water Carriers	207	203	410	315
Intercity Bus Lines	80	10	90	80
TOTALS	5,748	4,170	9,918	5,442

TRANSPORTATION ASSOCIATION of AMERICA

BOARD OF DIRECTORS

OCTOBER, 1975

Henry A. Correa, *Chairman*
President
ACF Industries, Incorporated
New York, New York

Paul J. Tierney, *President*
Transportation Association of America
Washington, D.C.

Stephen Ailes
President
Association of American Railroads
Washington, D.C.

Harold L. Albrecht
Vice President
Reynolds Metals Company
Richmond, Virginia

A. G. Anderson
Transportation Association of America
New York, New York

Grant Arnold
General Traffic Manager
Ethyl Corporation
Baton Rouge, Louisiana

George P. Baker
James J. Hill Professor of Transportation Emeritus
Harvard Business School
Boston, Massachusetts

Frank E. Barnett
Chairman Board of Directors
Chief Executive Officer
Union Pacific Railroad Company
New York, New York

W. J. Berta
Chairman
The Valley Line Company
St. Louis, Missouri

Henry Bartholomay III
Senior Vice President
Alexander & Alexander, Inc.
Chicago, Illinois

William A. Bresnahan
President
American Trucking Associations, Inc.
Washington, D.C.

Theodore W. Brooks
Senior Vice President
The Chase Manhattan Bank
New York, New York

Curtis D. Buford
President
Trailer Train Company
Chicago, Illinois

J. L. Burke
Attorney at Law
Tulsa, Oklahoma

William E. Callahan
Executive Vice President
International Harvester Company
Chicago, Illinois

Richard Canham
Assistant Manager, Transportation Department
Standard Oil Company of California, Western Operations, Inc.
San Francisco, California

Walter F. Carey
Chairman of the Board
Janesville Auto Transport
T.L.M.E.-DC & Dealers Transit
Lansing, Illinois

Edward E. Carlson
Chairman
United Airlines
Chicago, Illinois

H. T. Chilton
President and Chief Executive Officer
Colonial Pipeline Company
Atlanta, Georgia

John M. Christie
Chairman of the Board
The Riggs National Bank of Washington, D.C.
Washington, D.C.

Lee Cisneros
Director of Corporate Transportation
The Firestone Tire & Rubber Company
Akron, Ohio

Joseph A. Cooper
Senior Vice President–Marketing
Delta Air Lines, Inc.
Atlanta, Georgia

John A. Creedy
President
Water Transport Association
New York, New York

Robert H. Cutler
Chairman of the Board
Illinois-California Express
El Paso, Texas

Thomas E. Darnton
Vice President–Procurement and Production Control
General Motors Corporation
Detroit, Michigan

Donald S. Day
Manager, Traffic Operation
General Electric Company
Bridgeport, Connecticut

John E. Drick
Chairman of the Executive Committee
The First National Bank of Chicago
Chicago, Illinois

N. C. Dunn
Traffic Manager, Supply Department
Exxon Company, U.S.A.
Houston, Texas

J. Donald Durand
General Counsel
Association of Oil Pipe Lines
Washington, D.C.

William M. Fairhurst
Senior Vice President–Administration and Planning
Dana Corporation
Toledo, Ohio

Peter Fanchi, Jr.
President
Federal Barge Lines, Inc.
St. Louis, Missouri

John P. Fishwick
President and Chief Executive Officer
Norfolk & Western Railway Company
Roanoke, Virginia

Carl J. Fleps
Vice President–Government Relations
The Greyhound Corporation
Washington, D.C.

Sam H. Flint
Vice President–Corporate Operations
The Quaker Oats Company
Chicago, Illinois

Charles W. L. Foreman
Vice President
United Parcel Service
Greenwich, Connecticut

Welby M. Frantz
Vice Chairman of the Board
Eastern Express, Inc.
Terre Haute, Indiana

Gayton E. Germane
Professor of Logistics
Graduate School of Business
Stanford University
Stanford, California

David E. Gile
Senior Vice President
Marine Midland Bank
New York, New York

G. Zan Golden
Senior Vice President
North American Van Lines, Inc.
Fort Wayne, Indiana

R. C. Grayson
Chairman and President
St. Louis-San Francisco Railway Company
St. Louis, Missouri

Donald G. Griffin
Vice President–Traffic and Transportation
PPG Industries, Inc.
Pittsburgh, Pennsylvania

Frank L. Grimm
Chairman of the Board and Chief Executive Officer
O'Boyle Tank Lines
Rockville, Maryland

Harold F. Hammond
Senior Advisor
Transportation Association of America
Washington, D.C.

E. P. Hardin
President
Mobil Pipe Line Company
Dallas, Texas

John F. Harris, Jr.
Vice President, Petroleum Supply Division
Phillips Petroleum Company
Bartlesville, Oklahoma

Richard Haupt
Director, Transportation and Traffic Office
Supply Staff
Ford Motor Company
Dearborn, Michigan

Frank L. Heard, Jr.
General Counsel
Exxon Pipeline Company
Houston, Texas

Robert M. Hendrickson
Executive Vice President and Chief Investment Officer
The Equitable Life Assurance Society of the United States
New York, New York

J. W. Hershey
Chairman of the Board
American Commercial Lines, Inc.
Houston, Texas

Richard D. Hill
Chairman of the Board
The First National Bank of Boston
Boston, Massachusetts

Eugene Holland, Jr.
Executive Vice President
Continental Illinois National Bank & Trust Company of Chicago
Chicago, Illinois

John F. Horner
Vice President–Refining, Transportation and Engineering
Amoco Oil Company
Chicago, Illinois

John C. Howard
Vice President–Transportation
Bethlehem Steel Corporation
Bethlehem, Pennsylvania

Paul R. Ignatius
President
Air Transport Association of America
Washington, D.C.

George P. Jenkins
Chairman of the Board and Chairman of the Finance Committee
Metropolitan Life Insurance Company
New York, New York

William B. Johnson
Chairman and Chief Executive Officer
IC Industries
Chicago, Illinois

John M. Kinnaird
Vice President-Government Relations
American Trucking Associations, Inc.
Washington, D.C.

A. Carl Kotchian
Vice Chairman
Lockheed Aircraft Corporation
Burbank, California

William J. Kuhfuss
President
American Farm Bureau Federation
Park Ridge, Illinois

Jervis Langdon, Jr.
President and Chief Executive Officer
Penn Central Transportation Company
Philadelphia, Pennsylvania

Richard A. Lempert
Vice President and General Counsel
American Airlines, Inc.
New York, New York

Edwin A. Locke, Jr.
President
American Paper Institute
New York, New York

Clark MacGregor
Vice President
United Technologies Corporation
Washington, D.C.

Frank H. Madden
Vice President
Morgan Guaranty Trust Company
New York, New York

James C. Malone
Vice President
Union Carbide Corporation
New York, New York

G. W. Maxwell
President and Chief Executive Officer
Erie Lackawanna Railway Company
Cleveland, Ohio

James J. McNulty
Chairman of the Board
Emery Air Freight Corporation
Wilton, Connecticut

F. A. Mechling
President
Union Mechling Corporation
Pittsburgh, Pennsylvania

Louis W. Menk
Chairman of the Board
Burlington Northern Inc.
St. Paul, Minnesota

Thomas A. Micali
President
Trailmobile, A Division of Pullman, Incorporated
Chicago, Illinois

G. Russell Moir
Chairman of the Board and President
Transway International Corporation
New York, New York

Giles Morrow
General Counsel
Freight Forwarders Institute
New York, New York

James F. Morse
President
Federal Pacific Ltd.
Seattle, Washington

Edwin F. Mundy
Vice President-Traffic
Nabisco, Inc.
East Hanover, New Jersey

John A. Murphy
Chief Executive Officer
Gateway Transportation Co., Inc.
La Crosse, Wisconsin

W. L. Nahrgang
President and Chief Executive Officer
Johnson Motor Lines, Inc.
Charlotte, North Carolina

Frank A. Nemec
President
Lykes-Youngstown Corporation
New Orleans, Louisiana

D. H. Overmyer
Chairman of the Board
D. H. Overmyer Company, Inc.
New York, New York

Adrian B. Palmer
Chairman
Rollins Burdick Hunter Company
Chicago, Illinois

Michael Papadopoulos
General Manager, Transportation and Distribution
Shell Oil Company
Houston, Texas

V. L. Petersen
Vice President
The Goodyear Tire & Rubber Company
Akron, Ohio

John E. Phelan
General Traffic Manager
Anheuser-Busch, Inc.
St. Louis, Missouri

Robert W. Prescott
President
The Flying Tiger Line, Inc.
Los Angeles, California

Larry S. Provo
President
Chicago & Northwestern Transportation Company
Chicago, Illinois

William J. Quinn
Chairman of the Board
Chicago, Milwaukee, St. Paul & Pacific Railroad Company
Chicago, Illinois

C. B. Ramsdell
Vice President-Group Executive
Transportation Systems Group
Westinghouse Air Brake Company
Pittsburgh, Pennsylvania

John S. Reed
Chairman and Chief Executive Officer
The Atchison, Topeka & Santa Fe Railway Company
Chicago, Illinois

James E. Reinke
Vice President-Government Affairs
Eastern Air Lines, Inc.
Washington, D.C.

James J. Reynolds
President
American Institute of Merchant Shipping
Washington, D.C.

W. Thomas Rice
Chairman of the Board
Seaboard Coast Line Railroad Company
Jacksonville, Florida

Mark D. Robeson
Executive Vice President
Yellow Freight System, Inc.
Shawnee Mission, Kansas

J. R. Scanlin
Vice Chairman of the Board
GATX Corporation
Chicago, Illinois

Irving Seaman, Jr.
Chairman, Executive Committee
National Boulevard Bank of Chicago
Chicago, Illinois

Henry E. Seyfarth
Seyfarth, Shaw, Fairweather & Geraldson
Chicago, Illinois

Wilbur S. Smith
Wilbur Smith and Associates
Columbia, South Carolina

W. K. Smith
Vice President
General Mills, Inc.
Minneapolis, Minnesota

Lee R. Sollenbarger
Chairman of the Board
Transcon Lines
Los Angeles, California

William I. Spencer
President
First National City Bank
New York, New York

Edwin F. Stadelman
General Traffic Manager
J. C. Penney Company, Inc.
New York, New York

W. Stanhaus
Chairman of the Board
Spector Industries, Inc.
Chicago, Illinois

Robert L. Stone
Chairman and President
The Hertz Corporation
New York, New York

Stoney M. Stubbs
Chairman of the Board
Frozen Food Express, Inc.
Dallas, Texas

Robert E. Thomas
Chairman and President
MAPCO Inc.
Tulsa, Oklahoma

Stuart G. Tipton
Senior Vice President-Federal Affairs
Pan American World Airways, Inc.
Washington, D.C.

Kenneth L. Vore
Vice President-Traffic and Transportation
United States Steel Corporation
Pittsburgh, Pennsylvania

Charles J. Waidelich
President
Cities Service Company
Tulsa, Oklahoma

Michael J. Walsh, Jr.
Vice President-Transportation and Distribution
St. Regis Paper Company
New York, New York

William F. Ward
Vice President and Representative
Bank of America
Teheran, Iran

Hays T. Watkins
Chairman of the Board and President
The Chessie System
Cleveland, Ohio

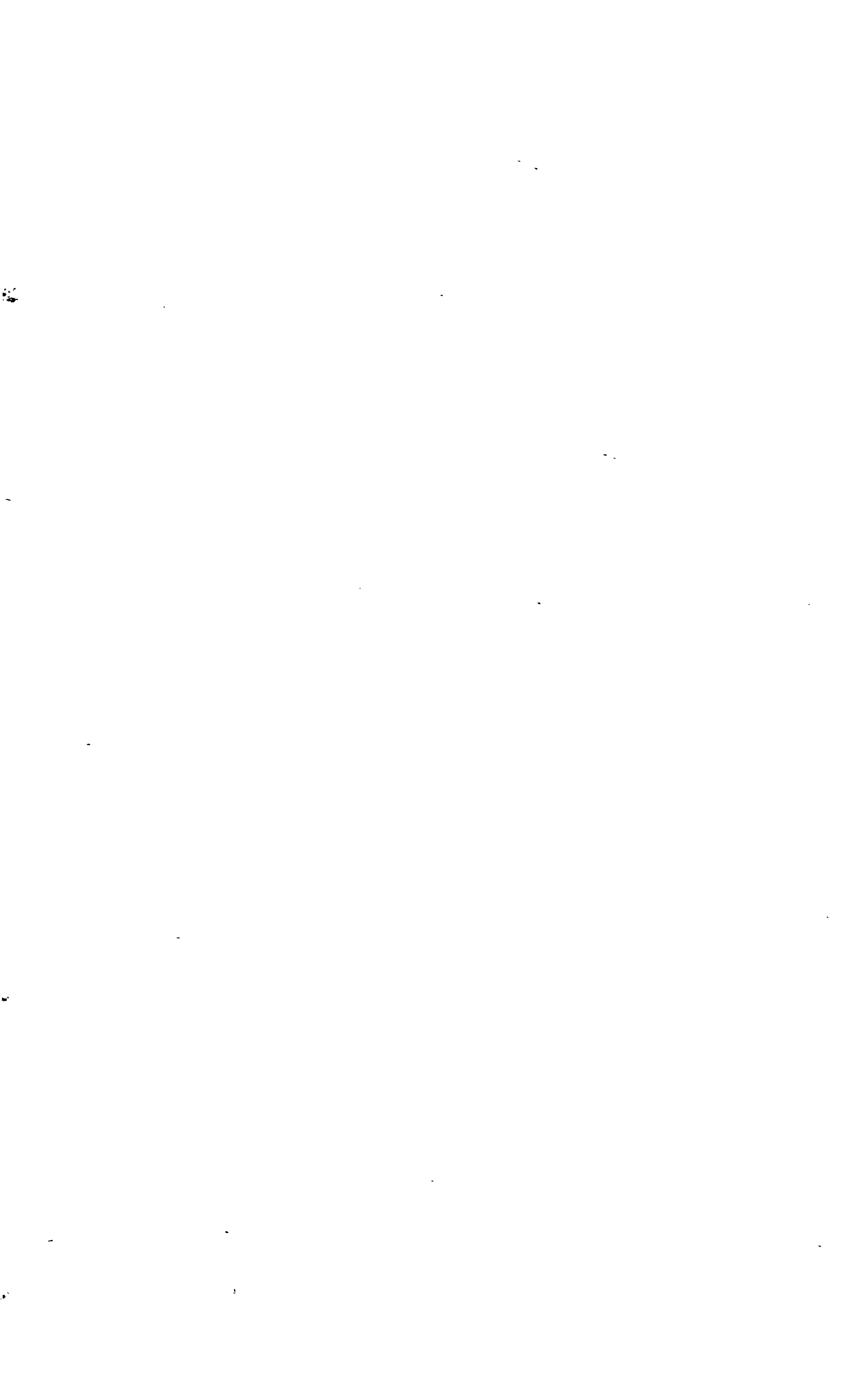
Charles A. Webb
President
National Association of Motor Bus Owners
Washington, D.C.

William G. White
Chairman of the Board
Consolidated Freightways, Inc.
San Francisco, California

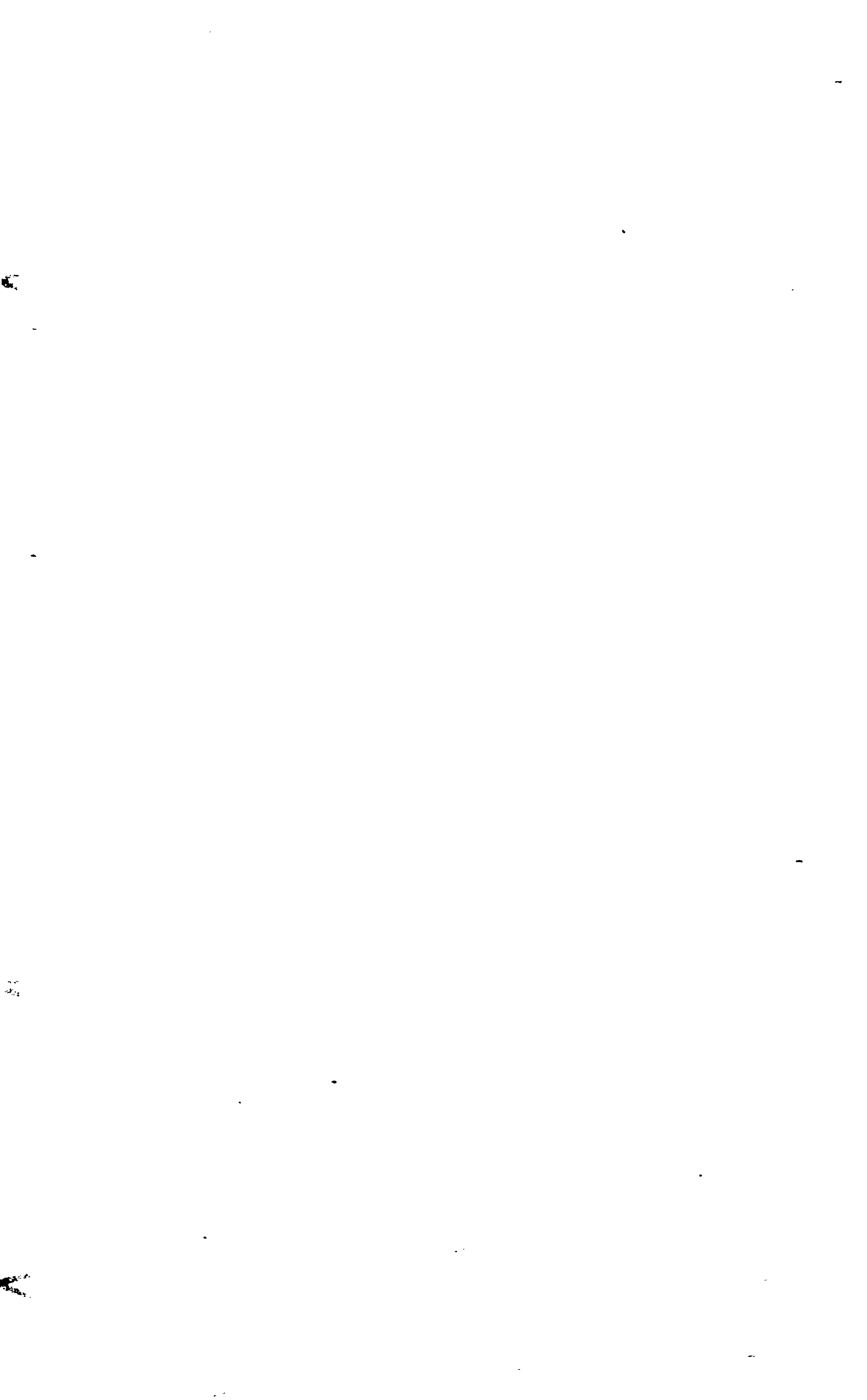
George K. Whitney
Consultant
Massachusetts Financial Services, Inc.
Boston, Massachusetts

William C. Whittemore
Senior Vice President and Treasurer
John Hancock Mutual Life Insurance Company
Boston, Massachusetts

J. Robert Wilson
Vice Chairman
Roadway Express, Inc.
Akron, Ohio



Charitable Contributions



STATEMENT OF THE COUNCIL FOR FINANCIAL AID TO EDUCATION

TAX REVISION

The Council for Financial Aid to Education is concerned about the likelihood that private, voluntary financial support of American institutions of higher education will be reduced substantially as a result of legislation that would weaken the tax incentives of individuals and corporations to make gifts, grants, and bequests to the colleges of their choice.

The voluntary support of higher education is a critical factor in the financial structure of both public and private institutions; the urgent need, therefore, is for more voluntary support, not less. Yet the incentives for voluntary giving to higher education are in danger of being seriously weakened by various legislative proposals that would directly or indirectly impinge on the way in which the contributions deduction operates.

The concern of the council is set forth fully in its publication "Voluntarism, Tax Reform, and Higher Education," 1975 edition, a copy of which is attached hereto and incorporated into this statement.

The contributions deduction should not be compared with other personal deductions. Charitable giving results from voluntary and discretionary decisions on the part of the taxpayer which are not motivated by personal financial gain. Other tax deductions normally provide the taxpayer with some tax relief for involuntary expenditures or provide him with a partial offset to some expenses for which he receives a benefit. Charitable contributions constitute a voluntary transfer of income from the taxpayer to nonprofit organizations, organizations which perform vital and essential services to our society. The voluntary support of higher education is an income transfer of precisely this kind, since our colleges and universities are providing educational, research, and other public service functions of immeasurable value to the Nation. In sum, the contributions deduction is not a tax shelter, not a tax avoidance gimmick, not a loophole; rather it is an incentive to taxpayers to increase the share of their incomes which they allocate to activities that are very much in the national interest.

Taxpayers do react to such incentives and are sensitive to the charitable deduction and to economic circumstances when they make their decisions about philanthropic giving. This is especially true of voluntary giving to educational institutions. An authoritative source of information in this area is the "Survey of Voluntary Support of Education" conducted by the Council for Financial Aid to Education for the past 20 years. This annual survey is now cosponsored by the Council for Advancement and Support of Education and the National Association of Independent Schools. Advance data from the most recent survey, covering the academic year 1974–75, is submitted to this

committee at this time as evidence of the amounts, sources, and purposes of the voluntary support of educational institutions, and as evidence of the sensitivity of certain groups of donors to incentives for providing such support.

As indicated on table 8, the two categories of individual donors, alumni and nonalumni, reduced their educational support about 6 percent in 1973–74 and by an equal amount in 1974–75. Since the two categories of individual donors taken together account for about half of the total amount of voluntary support, the 12 percent decrease since 1972–73 is a matter of consequence. The survey also reveals that nearly all of this decline was accounted for by reduced giving for capital purposes, including endowments. Since capital support is provided primarily by large contributions in the form of appreciated property, it is believed that the decrease was due to the prolonged and deep decline in the securities markets during 1973–74 and 1974–75.

Such sensitivity to the economic climate by major contributors to the institutions of higher education is illustrative of the way in which individuals react to changes in their incentives to give. There is no doubt that they would react in a similar way to any weakening of the tax incentives for educational and charitable giving.

The Committee for Economic Development issued in October 1973, a policy statement titled, "The Management and Financing of Colleges." One of their recommendations is:

> We urge that the existing tax incentives for voluntary support of higher education be maintained and, to the extent not incompatible with other objectives, expanded in order to strengthen the base of financial support of all colleges and universities.

The council endorses fully this statement. More specifically, it respectfully urges this committee, in considering various proposals for a minimum tax, to exclude the charitable contributions deduction from such legislation, so that the existing tax incentives for voluntary philanthropy are preserved.

TABLE 1.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; TOTAL SUPPORT, ALL INSTITUTIONS REPORTING

[Dollar amounts in thousands]

	1973-74[1]		1974-75		Percent change
	Number	Amount	Number	Amount	
Major private universities	69	$703,106	69	$648,477	−7.8
Private men's colleges	12	23,906	13	17,860	−25.3
Private women's colleges	77	67,761	80	64,460	−4.9
Private coeducational colleges	465	458,916	453	426,579	−7.1
Professional and special schools	52	88,202	54	69,327	−21.4
Total, private 4-yr	675	1,341,891	669	1,226,703	−8.6
Public institutions (4-yr)	206	386,161	207	430,831	+11.6
Total, 4-yr	881	1,728,052	876	1,657,534	−4.1
Junior colleges	107	18,799	110	17,009	−9.5
Grand total	988	1,746,851	986	1,674,543	−4.1
Average per institution		1,768		1,698	−4.0

[1] Figures shown differ slightly from those published in the 1973-74 survey report; 5 institutions have been reclassified and the amount of support reported by them in 1973-74 has been allocated to the class in which they reported in 1974-75.

TABLE 2.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; TOTAL SUPPORT, 827 INSTITUTIONS IN 2 SURVEYS

[Dollar amounts in thousands]

	Number	1973-74	1974-75	Percent change
Major private universities	68	$700,037	$645,069	−7.9
Private men's colleges	11	22,106	17,390	−21.3
Private women's colleges	71	62,836	62,200	−1.0
Private coeducational colleges	396	406,506	399,620	−1.7
Professional and special schools	45	79,130	65,144	−17.7
Total, private 4-yr	591	1,270,615	1,189,423	−6.4
Public institutions (4-yr)	160	334,856	366,357	+9.4
Total, 4-yr	751	1,605,471	1,555,780	−3.1
Junior colleges	76	14,986	13,708	−8.5
Grand total	827	1,620,457	1,569,488	−3.1
Total support of this group as percent of all institutions reporting		92.8	93.7	

TABLE 3.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; TOTAL SUPPORT, BY SOURCE, ALL INSTITUTIONS REPORTING

[Dollar amounts in thousands]

	1973-74		1974-75		Percent change
	Amount	Percent	Amount	Percent	
Foundations	$416,924	23.9	$384,500	23.0	−7.8
Nonalumni individuals	433,489	24.8	399,814	23.9	−7.8
Alumni	396,866	22.7	377,376	22.5	−4.9
Business corporations	276,192	15.8	275,905	16.5	−.1
Religious denominations	90,511	5.2	87,694	5.2	−3.1
Other	132,870	7.6	149,254	8.9	+12.3
Total	1,746,851	100.0	1,674,543	100.0	−4.1
Memo: All individuals	830,355	47.5	777,190	46.4	−6.4
Bequests	267,123	32.2	213,842	27.5	−20.0
Deferred gifts	56,904	6.9	61,220	7.9	+7.6
Other gifts by living donors	506,328	60.9	502,128	64.6	−.8

TABLE 4.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; TOTAL SUPPORT, BY SOURCE, 827 INSTITUTIONS IN SURVEYS

[Dollar amounts in thousands]

	1973-74		1974-75		Percent change
	Amount	Percent	Amount	Percent	
Foundations	$392,715	24.2	$362,756	23.1	−7.6
Nonalumni individuals	402,086	24.8	375,996	24.0	−6.5
Alumni	380,872	23.5	362,189	23.1	−4.9
Business corporations	250,932	15.5	256,881	16.4	+2.4
Religious denominations	75,504	4.7	79,374	5.1	+5.1
Other	118,348	7.3	132,293	8.3	+11.8
Total	1,620,457	100.0	1,569,488	100.0	−3.1
Total support of this group as percent of all institutions reporting		92.8		93.7	
Memo: All individuals	782,958		738,185		−5.7

TABLE 5.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; SUPPORT RECEIVED FROM INDIVIDUALS IN THE FORM OF BEQUESTS, ALL INSTITUTIONS REPORTING

[Dollar amounts in thousands]

	1973-74	1974-75	Percent change
Major private universities	$141,677	$11,779	−21.1
Private men's colleges	2,826	2,968	+5.0
Private women's colleges	13,958	10,358	−25.6
Private coeducational colleges	61,219	49,885	−18.5
Professional and special schools	13,064	4,620	−64.6
Total, private 4-yr	232,744	179,637	−22.8
Public institutions (4-yr)	33,026	32,123	−2.7
Total, 4-yr	265,770	211,760	−20.3
Junior colleges	1,353	2,082	+53.9
Grand total	267,123	213,842	−20.0
Bequests as a percentage of total voluntary support received by all institutions	15.3	12.8	

TABLE 6.—SURVEY OF VOLUNTARY SUPPORT, 1974-75; TOTAL SUPPORT, BY PURPOSE, ALL INSTITUTIONS REPORTING

[Dollar amounts in thousands]

	1973-74		1974-75		Percent change
	Amount	Percent	Amount	Percent	
Unrestricted	$579,995	33.2	$540,218	32.3	−6.9
Physical plant	302,336	17.3	258,669	15.4	−14.4
Research	227,957	13.0	251,252	15.0	+10.2
Student aid	227,832	13.0	222,675	13.3	−2.3
Faculty compensation	107,480	6.2	104,833	6.3	−2.5
Other	301,251	17.2	296,896	17.7	−1.5
Total	1,746,851	100.0	1,674,543	100.0	−4.1
Current	969,031	55.5	1,019,741	60.9	+5.2
Capital	777,820	44.5	654,802	39.1	−15.8

TABLE 7.—SURVEY OF VOLUNTARY SUPPORT, 1974-75—ESTIMATED TOTAL SUPPORT RELATIVE TO ENROLLMENT AND PURCHASING POWER

	All higher education						Percent change, 1969-70 to 1974-75
	1969-70	1970-71	1971-72	1972-73	1973-74	1974-75	
Total estimated support (millions)	$1,780	$1,860	$2,020	$2,240	$2,240	$2,160	+21.3
Enrollment (thousands)	8,005	8,581	8,949	9,215	9,602	10,224	+27.7
Support per student	$222	$217	$226	$243	$233	$211	−5.0
Price index (1967=100)	113.1	118.8	123.3	129.2	140.4	154.5	+36.6
Support per student in 1967 dollars	$196	$183	$183	$188	$166	$137	−30.1
Total expenditures (billions)	$24.7	$27.1	$29.2	$31.4	$35.0	$40.2	+62.8
Total expenditures per student	$3,090	$3,160	$3,260	$3,400	$3,645	$3,930	+27.2
Total expenditures per student in 1967 dollars	$2,730	$2,660	$2,640	$2,630	$2,600	$2,540	−7.0
Estimated support as percentage of expenditures	7.2	6.8	6.9	7.1	6.3	5.4	

TABLE 8.—SURVEY OF VOLUNTARY SUPPORT, 1974-75—ESTIMATED TOTAL SUPPORT BY SOURCE

[In millions]

	1972-73	1973-74	1974-75	Percent change, 1974-75 versus—	
				1973-74	1972-73
Foundations	$524	$535	$497	−7.1	−5.2
Nonalumni individuals	600	556	516	−7.2	−14.0
Alumni	536	509	486	−4.5	−9.3
Business corporations	320	354	357	+.8	+11.6
Religious denominations	99	116	112	−3.4	+13.1
Other	161	170	192	+12.9	+19.3
Total voluntary support	2,240	2,240	2,160	−3.6	−3.6
Memo:					
All individuals	1,136	1,065	1,002	−5.9	−11.8

VOLUNTARISM, TAX REFORM, AND HIGHER EDUCATION

1975 Edition

Published by the
COUNCIL FOR FINANCIAL AID TO EDUCATION

The Council for Financial Aid to Education (CFAE) is a non-profit service organization established in 1952 through the efforts of five prominent businessmen: Frank W. Abrams, Irving S. Olds, Walter P. Paepcke, Henning W. Prentis, Jr., and Alfred P. Sloan, Jr. It was originally supported by four major foundations: the Carnegie Corporation of New York; the Ford Foundation; the Rockefeller Foundation; and the Alfred P. Sloan Foundation. It is now financed by over 350 leading corporations. CFAE's purpose is to encourage the widest possible voluntary support of institutions of higher learning, especially by business. It promotes, but neither solicits nor disburses, funds for higher education. Its unique program consists of studies in educational philanthropy, both business and college oriented; a corporation and academic consultation service; publications directly useful to corporate contributions officers; a national public service advertising campaign utilizing the now familiar theme of "Give to the College of Your Choice. Now."; informational publications to broaden the base of college support; national key city and key industry leadership meetings for business executives; and periodic symposiums for corporate and college administrators.

VOLUNTARISM, TAX REFORM, AND HIGHER EDUCATION

TABLE OF CONTENTS

Synopsis 5

I. The Challenge to Voluntarism Summarized 7
- Tax Reform and Charitable Gifts 7
- The Basis for the Challenge 8
- Voluntarism and Higher Education 9

II. How Proposed Tax Reform Threatens Voluntarism, Particularly with Respect to Higher Education 11
- Tax Complexity and Equity 11
- Tax Simplification and Reform 12
- The Views of Tax Critics 12
- Congressional Interest in Tax Reform 13
- Proposals for Tax Reform Affecting Gifts to Higher Education 14
- Gifts of Appreciated Property 15
- Charitable Bequests 18
- The Minimum Taxable Income Proposal 19
- Other Proposals 22

III. The Importance of Voluntarism to Higher Education 24
- The Importance of Voluntary Support 24
- The Early History of Voluntary Support 25
- The Period After 1910 26
- Voluntary Support Since 1965-66 28

IV. The Future of Voluntarism in Higher Education 31
- Potential Consequences of Tax Reform 31
- Substitution of Government Support Unlikely and Undesirable 32

One of a series of publications designed to increase voluntary support of higher education produced by the Council for Financial Aid to Education (CFAE).

A complete list of CFAE publications may be obtained from the CFAE, 680 Fifth Avenue, New York, N.Y. 10019.

Charity is not a loophole . . .
"A loophole is an ambiguity or omission in a statute that permits evasion of the intent of the statute."
— Webster

Synopsis

The voluntary contribution of time, effort, and money is one of the hallmarks of American society. This concept, which stands in opposition to an exclusive reliance on government for the achievement of social goals, has been vital in the establishment and preservation of many treasured American institutions.

In particular, voluntary initiative and voluntary support have been of fundamental importance in the establishment and development of the system of higher education in the United States. Much of the superior quality of higher education is due to its diversity and its freedom from outside control. Voluntary financial support is one of the vital factors responsible for the independence of educational institutions, public and private alike.

However, voluntarism is now being challenged through the consideration of several proposals for changing the present tax treatment of private philanthropy. Those who advocate such changes do so in part on grounds of political philosophy and in part on grounds of equity. Some argue that the contributions deduction encourages taxpayers to spend money that rightfully belongs to the public treasury, and others hold that the "benefits" of the deduction favor the wealthy vis-a-vis all other taxpayers.

The first of these views is contrary to the fundamental beliefs which gave rise to the system of voluntary action for the public good; the second argument reflects a misinterpretation of the operation of the tax incentives for educational and charitable contributions and a lack of understanding of who it is that benefits from such voluntary giving.

Among the proposals for altering the tax treatment of charitable gifts are:

1. a reduction in the contribution deduction for gifts of appreciated property,
2. a limitation on the estate tax charitable deduction,
3. a minimum income tax that effectively reduces the maximum contributions deduction (and in some cases eliminates it entirely) for certain high-income taxpayers.

Although these proposals are advanced in the name of greater tax equity, their principal effect would be not to enhance tax equity but to reduce the flow of voluntary philanthropy.

The importance of tax incentives in the growth of voluntary support of higher education is indicated by the historical record. Private gifts and grants to colleges and universities increased from $23 million in 1909-10 to more than $2.2 billion in 1973-74. The initial upsurge in educational philanthropy prior to 1929-30 coincided with the adoption of the income tax and the charitable contributions deduction, and the extraordinary growth since 1939-40 has taken place against a background of relatively high tax rates.

Since 1965-66 the rate of growth of voluntary support has been only about half the prior postwar level. The upward push on institutional costs from inflation and growing enrollment has been greater in the last eight years than previously; this in combination with a slowing of income growth has produced a widespread financial crisis among colleges and universities. The proposals for tax reform, therefore,

BEST COPY AVAILABLE

would be seriously damaging to higher education since the need now is for more private support, not less.

Voluntarism should be encouraged, not discouraged. Philanthropy has served as an effective instrument of public policy in channelling private funds to education and other desirable areas, and it has helped to preserve the pluralistic society that is so greatly valued in the United States. Any decrease in the tax incentives for charitable giving will lead to reduced private support of the institutions of higher education, thus endangering their solvency and their capacity to serve society. The substitution of additional government appropriations for philanthropic support is both unlikely and undesirable. Reliance on public funding for a disproportionate share of academic income would weaken the values inherent in diversity, jeopardize the freedom and independence of the institutions of higher education, and attenuate the quality and effectiveness of educational programs.

The achievements of higher education in contributing to the progress and welfare of American society have been made possible in large part by the voluntary initiatives of countless individuals who have given their money to support the colleges of their choice. It is imperative that voluntary support should continue to be encouraged by public policy, and that the provisions of the Internal Revenue Code which provide tax incentives for such support should be maintained and strengthened.

I. The Challenge to Voluntarism Summarized

One of the characteristics of American society that has so clearly distinguished it from other societies is its reliance on individual initiative and voluntary action in the achievement of national goals. Unlike the autocratic societies of the past and the collective societies of the present, in which a central authority makes all the decisions that relate to ends and means, American society has held fast to the notion that it is the aggregate of its citizens, functioning individually and cooperatively, that determine objectives and the appropriate ways for reaching them. This characteristic, the propensity for voluntary responsibility and voluntary action, has never quite been matched by any other society in modern times.

Voluntary responsibility and voluntary action inevitably include the practice of free-will giving to charitable endeavors in response to perceived need. *Voluntarism* in this sense has become a basic part of American heritage and the American system of free enterprise, and like that heritage and that system it is uniquely American. In no other country has voluntarism taken root and flourished as it has in the United States; in no other country has private philanthropy for the public good become such a vital part of the national culture and such a deeply-ingrained custom as it has in the United States.

As with other elements of culture and other customs, there is a tendency to take voluntarism for granted and to forget the fact that it has been at the foundation of many of the country's most important and valued institutions. Voluntarism has been responsible for the creation and maintenance of churches, schools, colleges, hospitals, libraries, museums, and the performing arts; voluntarism has given rise to the private health and welfare systems and many other functions and services that are now such an integral part of American civilization and culture.

Tax Reform and Charitable Gifts

Despite its obvious contributions to this country's growth and greatness, this unique system of voluntarism is now being challenged through several proposals for "tax reform" which would fundamentally alter the tax treatment of charitable gifts and contributions. These proposals would, in effect, penalize those who voluntarily support education and other philanthropic activities. As Dr. Jonas Salk, of polio vaccine fame, stated recently in testimony before the House Ways and Means Committee,

> *"... I come before you ... as a scientist who has been enabled through the American system of private philanthropy to carry out his work in a manner that would not have been possible had this system not existed. A rather paradoxical situation is developing in which the system that has been responsible for the success of this country in the war against disease is in the process of being weakened and destroyed."* ... *"The paradox to which I refer is the contemplation of legislation to reduce incentive* [for private giving] *at a time when Federal funding ... is being diminished."*

Voluntarism, as a part of the American free enterprise system, now involves in one way or another the wealth, the interest, and the personal service of over 70

million people. Although it developed long before the Federal income, gift, and estate taxes came into being, it has for more than a half a century been stimulated and encouraged by those provisions of the tax laws which explicitly recognize that the donor makes a personal sacrifice and contributes to the general welfare when he provides financial support to the philanthropy of his choice. In enacting these provisions, the Congress took into account the incentive effects on voluntary giving and endorsed the view that the citizen has an obligation to support charitable, religious, and educational causes. As they are now written, the tax laws do not bestow any financial benefits on the donors of voluntary funds, rather they eliminate some of the penalties which would otherwise bear on philanthropically-minded taxpayers.

As Norman A. Sugarman, a private attorney and former official of the Internal Revenue Service, said in his testimony to the House Ways and Means Committee on behalf of the Council of Jewish Federations and Welfare Funds, "Charity is not a loophole Charitable contributions are voluntary and discretionary, and should not be lumped with other deductions with which they have no relationship in regard to character or policy." "The need exists," he continued, "for greater participation, at all levels, in the support of voluntary philanthropy. The tax laws should encourage all people to meet this need rather than discourage their support of voluntary philanthropy."

The Basis for the Challenge

The attack on voluntarism comes from a number of sources, the most important of which are those who object to the tax treatment of philanthropy on grounds of political philosophy. They view the tax savings involved in the contributions deduction as an expenditure of what would otherwise be public revenue, without the appropriate legislative debate and administrative control. Under the existing law, it is said, the taxpayers may spend funds that rightly belong to the public treasury, and this enables individuals and corporations to direct the use of "public" funds according to their own inclinations, preferences, or whims, and often in ways that are inconsistent with national priorities. As such, this argument reflects the belief that all functions and services that are in some sense "public" should be carried out by government, a view that runs counter to the fundamental philosophy which gave rise to and fostered the concept of voluntarism.

There are others who have attacked voluntarism indirectly, and often unintentionally, in the mistaken belief that a taxpayer derives some financial benefit from the provisions which encourage philanthropic giving, and that the size of the benefit is greater for wealthy persons than it is for those in the middle and lower income brackets. This view reflects the notion that while it is equitable to tax increasing incomes at increasing rates, it is somehow inequitable to allow a commensurate tax reduction for that part of income given to charity.

Some are simply unaware or unconvinced of the vast and irreversible changes to American culture and living patterns that would occur if the traditions of voluntarism were to be weakened or eliminated. Others, in their zeal for additional Federal and state funding for vital programs, have lost sight of the crucially important role of private giving in the maintenance of a free society. Whatever the views of those who actively seek to change the tax treatment of philanthropic giving, or of

those who would passively allow such changes to occur, the net result of these tax proposals, if enacted, would be catastrophic for American social organization and life. The voluntary society as it is known today might well disappear. In its place would arise an expansion in the power and responsibility of government, an increasing centralization of authority, and a further enlargement of bureaucratic control over many elements of social activity.

It is clear that changes in the tax laws affecting the incentives for voluntary giving would have an impact far beyond the flow of philanthropic funds between individuals and corporations on the one hand and the legion of voluntary agencies, organizations, and institutions on the other. Although total giving in 1972 is estimated to have exceeded $22 billion, of which $2.02 billion went to higher education, these figures represent only the contributions of money and property. Great numbers of people, 70 million or more, give of their energy and time, as well as their money, on behalf of human needs. Volunteer service is often inspired by and tied to the financial support provided by individual and corporate donors. The dollar value of these volunteer services is incalculable. It follows, therefore, that the discouragement of charitable contributions could have a chilling effect upon all aspects of voluntarism.

The Congress has, for more than 50 years, provided a succession of new provisions in the tax laws aimed at giving further encouragement to private philanthropy for the public good. The Administration has endorsed the view that these provisions should not now be replaced by deterrents to voluntary giving. In a statement presented to the House Ways and Means Committee on April 30, 1973, George P. Schultz, Secretary of the Treasury, said:

> *"We urge that you do nothing which will jeopardize the vitality of our voluntary charities, which depend heavily on gifts and bequests. These organizations are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969, and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage these institutions. We believe the public accepts them as fair."*

Voluntarism and Higher Education

Although voluntarism impinges upon nearly every field of human endeavor, it has been, and is, particularly applicable and especially important to higher education. Voluntary action was chiefly responsible for the establishment of almost all American colleges and universities until the Civil War. In the last hundred years voluntary action and voluntary support preserved, maintained, and strengthened both private and public institutions of higher education. And voluntary financial support currently provides a vital part of the critical resources that are needed by all colleges and universities in the United States. This source of funds has been a major factor in the development of American higher education and in elevating it to a position of excellence.

The Committee for Economic Development, in a recent policy statement,[1]

[1] *The Management and Financing of Colleges*, New York, N.Y., October 1973.

noted that "... the flow of private support is essential to the diversity, strength, and vitality of the nation's colleges and universities. It provides a means of achieving the high degree of independence and freedom indispensable to the attainment and preservation of superior quality in education. We therefore conclude that the encouragement of private support is very much in the national interest." The statement concluded with the following recommendation: "We urge that the existing tax incentives for voluntary support of higher education be maintained and, to the extent not incompatible with other objectives, expanded in order to strengthen the base of financial support of all colleges and universities."

In view of the historical relationship between voluntarism and higher education, and because of the importance of voluntary support to colleges and universities and their students, the current proposals for revising the provisions of the tax laws that affect the contributions deduction are potentially of far-reaching consequence to higher education and to American society.

II. How Proposed Tax Reform Threatens Voluntarism, Particularly with Respect to Higher Education

It is clear that the long-standing public policy of encouraging private philanthropy through tax incentives is now being seriously questioned, and that some of the provisions of the tax laws which give expression to this policy are in danger of being modified or eliminated. Many proposals have been put forth for changing the provisions of the present law regarding the tax treatment of charitable gifts, and some of these proposals have been embodied in proposed legislation. These developments merit close scrutiny.

Tax Complexity and Equity

The history of the Internal Revenue Code is one of increasing complexity. The Act of 1954, as amended to include 1974 legislation, is a ponderous document. Its provisions deal with income taxes, employment taxes, estate and gift taxes, excise taxes, and many questions of administration and procedure. Scattered throughout the Code are innumerable definitions and cross-references, the principal purpose of which is to make the law as precise as possible in the context of the complexities of modern economic life. As written, the Code is now so long and complicated that it is doubtful whether any one human being could comprehend it fully.

The increase in the complexity of the Code reflects the social, political, and economic changes that have taken place since the Sixteenth Amendment was adopted in 1913. The income tax itself was initially adopted as a means of securing an adequate revenue for the Federal government, and it reflected a widely-held belief that "income" was an appropriate measure of the taxpayer's ability to pay. The approach to income taxation, however, recognized that the tax should not be applied to gross income, but to some concept of taxable income which allows for certain exclusions and deductions. As time passed, the definition of income itself became increasingly complex, and the exclusions and deductions were re-defined and enlarged in order to provide fully for the special circumstances affecting various groups of taxpayers. Many other provisions were added to implement particular public policies that had nothing whatever to do with taxation as a means of obtaining revenue.

A disproportionate part of the complexity of the Code is contained in the legislation that was enacted after 1939, the reason being that tax rates, which had been relatively low, were sharply increased during the early forties. The continuation of relatively high rates in the post-war years generated urgent concerns with the question of tax equity. Taxpayers' incentives to minimize their taxes also gave rise to numerous tax avoidance arrangements, many of which became the subjects of tax revision because of the undesirable features involved and the amounts of income that were escaping taxation.

Tax Simplification and Reform

The increase in the complexity of the Code and the proliferation of special provisions ultimately generated interest in tax simplification and tax reform. In the late sixties, for example, it became known that a number of high-income persons had so arranged their affairs that they paid little or no tax; in some cases this resulted from the fact that the income was derived from tax-exempt sources, in other cases the taxpayers had qualified for the unlimited charitable deduction and had made sufficient contributions that no taxable income remained, and in yet other cases other special provisions of the tax law were involved. In addition, many specialists in tax law and tax policy recommended simplifying and restructuring many of the complex provisions of the Code.

Public interest in an overhaul of the tax structure, and the concerns of legislators with respect to the questions of tax abuse, tax complexity, and tax equity, ultimately led to a major effort at tax reform in 1969. Even though the Tax Reform Act of 1969 did make a number of significant changes in some of the key provisions of the Code, it did not materially revise the structure of the law. Indeed, it made the law even more complex through the addition of special provisions relating to private foundations and the creation of new forms of preferential income subject to differential tax treatment. Interest in the question of tax reform did not diminish as a result of this Act; on the contrary, tax critics advocated even more strongly the need for a thorough overhaul of the entire tax system.

The Views of the Tax Critics

In its broadest form, the attack on the charitable contributions deduction and other provisions of the Code is part of a general objection to the use of tax incentives to implement various elements of public policy. The argument is that all the special exemptions, deductions, and tax credits, including the provisions relating to charitable giving, are really nothing more than government subsidies of certain activities which are determined outside the normal appropriations process. Some $91 billion in such "tax expenditures" were identified in fiscal year 1974, including nearly $5 billion due to the deductibility of charitable contributions.

In weighing tax expenditures versus direct budget appropriations, the tax critics contend, among other things, that tax incentives permit windfalls by paying taxpayers for doing what they would do anyway, and that tax incentives are inequitable in that they are worth more to the high-income taxpayer than the low-income taxpayer. These objections have become most appealing, and the charitable contributions deduction has been attacked principally on these grounds.

Most of the tax critics regard the special income exclusions, the preferential forms of income, and the personal deductions as "loopholes" through which some persons manage to avoid paying their "fair share" of taxes. In this context, the charitable contributions deduction, and particularly the provisions regarding gifts of appreciated property, is typically attacked as a "loophole" on the grounds that the deduction bestows an economic benefit on high-income taxpayers that exceeds the benefit available to low-income taxpayers. They would advocate, as an alternative, either a system of Federal matching grants in which the amount of the matching

payment would be independent of the taxpayer's tax rate, or a system of tax credits in which the amount of the credit would be equal for all taxpayers.

The arguments advanced by the tax reformers rest on a premise that does not accord with the traditional political philosophy of American society. They view any exclusion from income taxation, and particularly the personal deduction for charitable gifts, as though it were a largesse bestowed on the taxpayer by the government for doing something that is largely a matter of personal choice. They argue that this "special favor" is unwarranted as a matter of propriety and equity. They view philanthropic gifts as a form of discretionary spending, like other personal consumption outlays, to be made out of income remaining after taxes. On this interpretation, no taxpayer should have the privilege of making a charitable gift, tax-free.

That this view is contrary to the traditional American concept, which holds that a person should not be taxed on that part of his income given for philanthropic purposes, is amply demonstrated by the continuity of past legislation reaffirming and expanding the tax incentive for charitable giving.

Congressional Interest in Tax Reform

Congressional interest in further tax reform has been evidenced repeatedly since 1971. It was a major issue in the 1972 elections, and the platforms of both major political parties contained strong statements favoring tax equity and tax simplification. Many candidates took positive positions on the tax reform issue as a matter of high priority, and several have since urged numerous specific revisions of the Code. Some of the proposals affecting the charitable contributions deduction are identical to those considered and rejected during the debates on the Tax Reform Act of 1969.

The House Ways and Means Committee held public hearings on the subject of tax reform during the spring of 1973. While those hearings covered all areas of the Internal Revenue Code, the Committee expressed particular interest in 20 major subjects, including estate and gift tax revision (" . . . changes in the unlimited charitable deduction . . . ") and the income tax treatment of foundations and charitable contributions.

After the hearings, the Committee turned its attention to other subjects, and it took no action on tax reform until late spring, 1974. Along with other questions, many of the specific proposals which would affect the tax incentives for charitable giving were given serious consideration during the "mark-up" sessions held during the summer and fall. Although the final bill did not contain any changes in the tax law that would have had an adverse effect on the contributions deduction, it was not reported out to the floor of the House and the 93rd Congress adjourned without enacting any major tax legislation.

Tax reform was again a political issue during the 1974 Congressional elections, and many candidates made it the major element in their appeals to the voters. The outcome of the election has materially altered the prospects for tax legislation in 1975-76. A significant number of new, young, reformed-minded legislators were voted into office, and as a consequence of their influence the operational structure of the House, including the committee system, was substantially altered. In particular, the Committee on Ways and Means was expanded to 37 members, and it

was reorganized for the first time into small sub-committees to deal with the major areas of Committee responsibility. The entire Ways and Means Committee, however, constitutes the Sub-committee on Taxation, and it has announced a firm intention of reporting out a tax reform bill in 1975. In addition, the 75 "freshman" Democrats in the House have established a study group on tax reform, and this is widely taken as a sign of the determination of the Congress to accomplish fundamental reforms of the tax structure before the end of the 94th Congress in 1976.

As of early June, 1975, there was some uncertainty about the Ways and Means Committee's timetable for tax reform. Plans were pending for some three weeks of additional hearings, but the opening session continued to be postponed under the pressure of other business. While it is likely that a comprehensive package of tax reform will not emerge until 1976, it is very possible that some small tax reform bills will be completed and sent to the floor of the House in the fall of 1975 and that one or more of such bills will have some impact on the tax incentives for charitable giving.

The prospects for legislative action affecting the charitable contributions deduction hinge to some extent on the report and recommendations of the Commission on Private Philanthropy and Public Needs (the Filer Commission) which are expected to be published in the fall of 1975. This group, composed of private citizens, was formed in late summer of 1973 with the cooperation of the Secretary of the Treasury and the Chairman of the House Ways and Means Committee. Among its purposes, the Filer Commission is examining the role of private philanthropy in American life and the structure and operation of the tax incentives for charitable giving. In its brief existence, it has commissioned a large number of study papers, surveys, statistical analyses, and other projects, many of which bear on the various proposals for tax reform affecting the charitable contributions deduction.

Proposals for Tax Reform Affecting Gifts to Higher Education

In the past three or four years, a large number of specific proposals for tax reform have been drawn up and many of them have been embodied in proposed legislation. Among the proposals which would directly alter the structure of present tax incentives for private philanthropy are:

1. repeal of the charitable contributions deduction,
2. substitution of a tax credit for the charitable contributions deduction or for all personal deductions,
3. reduction of the allowable deduction for charitable gifts of long-term appreciated property by one-half the amount of appreciation,
4. inclusion of the unrealized appreciation in gifts of property as an item of preference income for the minimum tax,
5. restriction of the contributions deduction to amounts in excess of some percentage of adjusted gross income, or "floor",
6. limitation on the estate tax charitable deduction to 50% of the adjusted gross estate, and
7. taxation of unrealized appreciation of property at death without exception for property bequeathed to charity.

In addition, there are several proposals which would have indirect effects on

the operation of the contributions deduction. One such proposal would put a limit on the total of items designated as "tax preferences". To the extent that any part of charitable contributions, such as gifts of appreciated property, might be designated as preference income, the limitation would have the effect of reducing the tax incentive for charitable giving in those cases where taxpayers have large amounts of other tax preference income. Somewhat akin to this is the Treasury's Minimum Taxable Income proposal (see below).

An illustration of the way in which some of these measures have been woven into proposed legislation is contained in a bill introduced by Rep. James C. Corman (D-Calif.) early in 1975.[2] In addition to many sweeping and complex changes affecting other parts of the tax law, there are several provisions in this bill that would greatly weaken the tax incentives for charitable giving. It repeals all personal exemptions and deductions, including the deduction for charitable contributions, from adjusted gross income and substitutes for them a tax credit equal to 24% of the total of personal exemptions and deductions. It repeals the preferential tax treatment of long-term capital gains, thereby making all capital gains taxable as ordinary income. Although it provides for an adjustment to the tax basis of appreciated property to give recognition to the fact that some of the appreciation is due merely to inflation, it limits the deduction for gifts of appreciated property to the amount of the adjusted basis rather than the fair market value at the time of gift. It adds five new items to the list of items of tax preference income and it reduces the allowable deductions from the total of tax preferences in the calculation of the minimum tax. It imposes a gift tax on the interest transferred to charity in certain cases where a donor makes a transfer of property to a charity and a third party at the same time. And it limits the estate tax charitable deduction to 50% of the adjusted gross estate.

In the light of this bill and other indications of continuing Congressional interest, much importance attaches to those proposals that are likely to be given serious consideration by the tax-writing committees. Included are those proposals that would alter the income tax treatment of gifts of appreciated property and the estate tax treatment of charitable bequests, and those proposals designed to ensure that all individuals should pay some minimum tax regardless of exclusions and deductions (Minimum Taxable Income proposals). All these subjects merit close examination, in part because they have been singled out by tax critics as provisions for which reform is most urgent and necessary, and in part because they affect such a large part of the flow of voluntary support to the institutions of higher education.

Gifts of Appreciated Property

Under the present law, a taxpayer may make a charitable gift in the form of property other than cash. If the property is a capital asset (other than inventory) that the taxpayer has held for more than six months, then he may claim the fair market value of the gift for his contributions deduction, even if the property has a fair market value in excess of its cost (or other tax "basis"). This is a typical situation in instances where charitable gifts of a substantial size are involved. And such gifts, although small in number, represent a very significant share of the total amount of

[2] HR 1040, the "Tax Equity Act of 1975."

individual giving, particularly in support of higher education, as will be shown below.

According to the critics, the tax treatment of gifts of appreciated property to charity constitutes a particularly egregious inequity in the tax law. The alleged inequity arises from the belief that the taxpayers who have appreciated property, and who are thus in a position to take advantage of this option, are those in the top income brackets. These individuals, it is said, not only get the "benefit" of a reduction in taxes on their ordinary incomes, which is taxed at the highest end of the rate structure, they also avoid paying taxes on the capital gains which would have been due if they had sold their properties instead of given them to charity. Further, it is claimed that in practice such gifts typically involve property for which the tax basis (or cost) is very low, perhaps even zero, and that in such cases it is possible "to make money by giving it away."

The question is a matter of fundamental importance to the entire voluntary sector and especially to higher education. There are really two separate issues involved, (1) whether the argument of the tax critics is technically valid, and if so under what conditions, and (2) whether the provisions of the present law serve the public interest to such an extent as to outweigh the revenue "loss" to the Treasury and other similar considerations.

It is probably true that most charitable gifts in the form of appreciated property are made by taxpayers in the upper brackets. It does not follow, however, that the law discriminates against the lower income taxpayers or that it is in any other way inequitable. Although charitable gifts do reduce the taxes paid by donors, there is no financial gain to the individual taxpayers as a result; rather, there is typically a reduction in the donors' wealth that is larger than their tax "savings." This excess, as well as the tax savings proper, accrues to the benefit of charitable donees. In short, the diversion of tax revenues from the Treasury goes not to the taxpayers but to philanthropy, and hence to the public good.

The purpose of this provision of the Code is simply to encourage voluntary giving in the public interest, and this particular tax incentive is responsible for a very large portion of gifts by individuals to higher education and other charitable recipients. Since the benefits of voluntary giving accrue to the charitable and educational institutions rather than to the taxpayers who make the gifts, there can be no economic discrimination or inequity in favor of the wealthy in this arrangement.[3]

The assertion that it is possible to make money by giving it away depends upon a specific assumption about the taxpayers' alternatives. The tax critics take the position that wealthy persons typically must sell long-term capital gain property in order to raise the cash they need to pay the taxes due on their ordinary income. Using a hypothetical case in which such property has a zero basis, and in which the taxpayer's tax rates are at a maximum, it is then shown that by giving the property to charity the total Federal tax "savings" can exceed the fair market value of the property itself by about 5%.

[3] Since voluntarism is an alternative to reliance on government, charitable gifts may be thought of as a voluntary tax which, like the progressive income tax itself, results in a redistribution of income from the rich to the poor. Most charitable giving directly or indirectly benefits the low and middle income segments of society more than the wealthy. Therefore, by stimulating the wealthy to give more, this provision in the tax law results in a beneficial discrimination in favor of the low-income taxpayers and those whose incomes are so low they pay no taxes at all.

69-516 O - 76 - pt. 7 - 6

While such cases may conceivably exist, the extreme technical requirements would make them very rare. Furthermore, it is highly questionable whether individual taxpayers must make a choice only between the sale or the gift of their property. High income taxpayers typically do not use appreciated assets to pay the taxes due on ordinary income, so they are not forced to sell long-term capital gain property for this particular reason. The alternative and more relevant choice, then, is for them either to give the property away or to retain it. In the overwhelming majority of cases, it will cost the taxpayer more to make the gift and save something in taxes than not to make the gift and save nothing in taxes. That is, the individual will be worse off, in the sense that his net wealth will be less, after he makes a charitable gift than he would be if he were to keep his property. This is true even beyond the reduction in net wealth, for by making a gift in the form of securities, real estate, or other income-producing property the taxpayer also gives up the future income that he would enjoy if he kept the property in his possession.

The principal proposal for tax reform in this area is to reduce the amount of the charitable deduction by one-half of the unrealized appreciation on the property. The taxpayer would still have some incentive to make contributions in the form of appreciated property, but instead of taking 100% of the fair market value of the property as a deduction, he would take the fair market value of the property less 50% of the unrealized appreciation as his deduction. One of the provisions in the Tax Reform Act of 1969 made this change with respect to the deduction for gifts of appreciated property to private foundations.[4] While the extension of this rule to gifts of appreciated property to public charities would remove the remote possibility that a taxpayer might "make money by giving it away" (assuming that his only alternative is to sell the property), it would also greatly reduce the incentives for making such gifts. A reduction in the incentives for voluntary giving would reduce the flow of individual contributions to educational and charitable recipients, and the loss of contributions income to the voluntary sector would exceed by an astronomical margin any conceivable gain that might accrue from the change as a matter of "equity."

In terms of the public interest, the provisions of the present law have in fact resulted in a flow of charitable and educational gifts in the form of appreciated property that is substantial in amount and important in impact. The testimony on this particular point at the public hearings on tax reform in April, 1973, brought out repeatedly that, for the agencies and organizations in health, education, welfare, and other voluntary fields, these kinds of gifts are particularly vital as a component of total contributions income.

In the case of higher education, it is estimated that gifts of appreciated property account for about one-fourth of total voluntary support from all sources. In 1971-72, for example, roughly $500 million out of the estimated total of $2.02 billion of voluntary support from all sources consisted of gifts of property other than cash. With respect to gifts and bequests from individuals, contributions in the form of property make up about 45% of the total, and more than 60% of the total for gifts of $5,000 or more.[5] Corporate gifts of appreciated property are much less important

[4] An exception is provided in the case of foundations making qualified distributions of such gifts within a specified time limit.

[5] Julian H. Levi and Sheldon Elliot Steinbach, *Patterns of Giving to Higher Education II*, Washington, D.C., American Council on Education.

in the context of total corporate support of higher education, yet they involve tens of millions of dollars worth of assets of significant value to the recipient institutions.

It is clear that the present tax treatment of gifts of appreciated property has resulted in a very considerable tax incentive for charitable giving on the part of those who have such property, and that gifts in this form constitute an important part of the total voluntary support of higher education. The proposed change in the tax law amounts to the imposition of a tax on the donor by reason of his having made the gift. If they wish, taxpayers can avoid this tax by simply not making gifts. It is probable, therefore, that the proposed legislation, if enacted, would very drastically reduce the flow of large gifts in the form of appreciated property. And since the property not contributed is merely retained by the taxpayer, the capital gains would continue to be unrealized.[6]

Under these circumstances, it is difficult to envision how the public interest would be served by the proposal with respect to gifts of appreciated property. There would be little or no increase in tax revenue to the government, yet there would almost certainly be a large decrease in the voluntary support of higher education and other public charities. In view of the increasing financial difficulties of colleges and universities, such a decrease in voluntary support could well make the difference between survival and extinction for some institutions. It would clearly reduce the quality of education at most institutions, public and private alike, or increase the burden of governmental support of higher education, or both.

Charitable Bequests

Under the present estate tax law, there is no ceiling on the amount of a charitable bequest which may be deducted from the gross value of the estate for tax purposes. One may, therefore, bequeath his entire estate to charitable recipients, in which case the taxable estate would be zero and no estate tax liability would arise. Any part of the estate may be taken as a charitable deduction in arriving at the taxable estate, and the gift may be in the form of either a specific bequest or a residual bequest.

In recent years there has been a significant upsurge in the total amount of charitable bequests. In 1950, for example, they amounted to $274 million; by 1960 they had risen to $951 million, and by 1972 they had reached an estimated level of more than $2.7 billion. The factors accounting for this ten-fold increase include (a) an increase in the number of estates of taxable size, (b) an increase in the total value of estates for which tax returns have been filed, and (c) the fact that charitable bequests have been rising as a percentage of total estates. Much of this reflects the fact that increasing proportions of the population are reaching the senior age groups in a state of economic independence and affluence. In addition, there is the effect of inflation on the value of property vis-a-vis the constant exclusions and deductions in the estate tax law.

This dramatic rise in the total amount of charitable bequests has served to call attention to instances in which wealthy persons bequeath very large fortunes to both private foundations and public charities. The question posed by the tax critics

[6] Under the present law, such gains may never be taxed as such. For estate tax purposes, the "value at time of death" is normally used for all of a decedent's property, and the tax is based on the gross estate, so valued, less certain deductions.

in this area is essentially one of political philosophy, with overtones not of equity but ethics. They feel that no one should have the right to leave as much as 100% of a large estate to a favorite charity, tax free; that every estate in excess of some arbitrary size should provide some income to the public Treasury, regardless of how it is distributed. They propose, therefore, that there should be a limitation on the contributions deduction for estate tax purposes, and that the limitation should be 50% of the adjusted gross estate. The regular rates of tax would apply to the remaining taxable estate even if the entire balance were left to charitable beneficiaries.

Since all estates are ultimately liquidated, it is clear that charitable and educational beneficiaries would bear the full burden of such a change in the estate tax law, even though it is the decedents' estates that actually make the tax payments. The proposal therefore amounts to a recommendation for a tax on charity, since it would have no other effect than to divert some part of the flow of bequests from charitable agencies and organizations to the Treasury.

The impact of such a change on the voluntary support of higher education and other philanthropies would be severe. As indicated above, total annual bequests to charitable beneficiaries are now about $2.7 billion and rising. This source of funds, therefore, accounts for roughly 14% of voluntary giving by individuals to the philanthropic sector of society. As for higher education, bequests account for between one-fourth and one-third of voluntary support by individuals, and the total in recent years has been in excess of $300 million annually.

A very high fraction of the bequests received by colleges and universities is designated for endowment and other capital purposes. The proposed change in the estate tax law, therefore, would not have as large and immediate an impact on operating budgets as would the proposed changes in the income tax law. However, such a change would have a long-run impact in that it would slow the growth of endowment funds and thus slow the growth of endowment income which is an important part of the operating budget for many of the institutions of higher education.

The total endowments of all colleges and universities amounted to about $15 billion in market value at the end of academic year 1971-72. The annual increase averaged about $500 million in the preceding five years. Bequests, therefore, constitute an important source of the growth of endowment funds. The income from endowment funds is an important part of the operating budgets of most private, and many public, colleges and universities. The growth of endowments, and the accompanying increase of endowment income, is a factor that is essential to the ability of the institutions of higher education to meet the rising costs due to inflation and expanding enrollment. It would be tragic if the law were changed so that this source of endowment principal were significantly restricted; the percentage increase in the annual revenues of the Treasury would be insignificant, while the decrease in the annual flow of voluntary support to the institutions of higher education would be appreciable.

The Minimum Taxable Income Proposal

One source of the interest in tax reform is the widespread belief that there are many loopholes in the present tax law which enable persons with high incomes to escape

their "fair share" of total taxes. There are, in fact, many provisions in the Internal Revenue Code which either give preferential treatment to income earned in certain ways or which allow special exclusions and deductions to certain groups of taxpayers. It is, indeed, possible for a person to enjoy a very high income and yet pay little or no income tax on that income.

The provisions in the tax law which make this possible were enacted to achieve various purposes which Congress thought desirable at the time. For example, the percentage depletion allowance granted to the producers of mineral resources was adopted for the express purpose of giving encouragement to the search for and the development of these resources. In other cases, the provisions were thought necessary to correct inequities that had developed with the passage of time. And, as with long-term capital gains, the preferential tax treatment of some kinds of "income" arose from a genuine belief that it is not ordinary income and should not be taxed as such; other examples of unusual types of income would include the "bargain element of a stock option at the time of exercise," and certain income earned outside the United States.

Some taxpayers are able to utilize these and other provisions of the tax law so as to eliminate most or all of their taxable income and thus be liable for little or no tax. There are three alternative tax reform proposals designed to prevent this and to insure that most individuals would be forced to pay some minimum amount of income tax, regardless of the sources of that income and regardless of the exclusions and deductions that the taxpayer might legitimately claim.

The Administration's "Minimum Taxable Income" proposal (MTI), as it is now structured, would have an important impact on voluntarism because it does not distinguish between charitable contributions and other personal deductions. Instead, charitable contributions are lumped in with all other personal deductions, such as medical expenses, taxes, interest payments, and casualty losses, and the total of all such deductions would, in effect, be subject to a limitation of 50% of income.[7]

The effect of this proposal, therefore, is to reduce the maximum allowable deduction for charitable contributions below the present 50% of adjusted gross income. The amount of the reduction would vary from case to case, but for numerous taxpayers the allowable deduction for charitable gifts would become zero. In a great many instances, therefore, this proposal would penalize philanthropic giving.

In these circumstances, donors would be discouraged from making any gifts beyond a variable limit. Contributions would be deductible only to the extent of the difference between 50% of income and the total of all other deductions. Consequently, many taxpayers will reduce their giving in order to avoid the implicit tax penalty.

Although the concept of the MTI has many desirable features as an expression of policy, the absence of any special provision for the encouragement of charitable giving is contrary to the long-standing public attitude on this subject. Charitable contributions should not be treated the same as other personal deductions, because they result from voluntary and discretionary decisions on the part of the taxpayer which are not motivated by financial gain, but rather by the desire to help worthy

[7] Under the MTI proposal, this is "expanded adjusted gross income," defined as adjusted gross income plus four items of preference income, less personal exemptions and a "low income floor."

causes which need such help. All other deductions either provide the taxpayer with some tax relief for involuntary costs (e.g. medical expenses and casualty losses) or provide him with a partial offset to some expenses for which he receives a benefit (e.g. local taxes and interest payments on borrowed money).

Philanthropic giving is a form of voluntary tax; [8] it would be consistent with the purpose of the MTI to treat charitable contributions as payments for public purposes in lieu of taxes.

The current MTI proposal would reduce charitable giving in another way. It contains no provision for a carryover of any excess deductions. Large contributions, which under the present law qualify for a five-year carryover for any amounts in excess of the permitted maximum, would be discouraged because any excess would be lost forever as a tax deduction. While large gifts are relatively few in number, they account for a disproportionate share of the voluntary support of higher education. In 1970-71, for example, gifts of $5,000 or more represented only 5% of the number of gift transactions, yet they accounted for 75% of all voluntary support received by the institutions of higher education. [9]

According to Treasury estimates, only about 130,000 out of the 35 million taxpayers who itemize their deductions would be affected by the MTI proposal, and the total contributions of this group of taxpayers is estimated currently at $800 million. The loss in charitable contributions from the MTI rule would, according to the Treasury, be in the neighborhood of $300-500 million, depending on how these taxpayers react to the reduction in their tax incentive.

What the Treasury did not estimate is the impact that this loss in contributions would have on charitable beneficiaries. Were it all to fall on higher education, for example, it would represent a decrease of between 15% and 25% in the total of voluntary support. It is hard to believe that this kind of a result could be considered to be in the public interest in any way.

Another proposal, similarly designed to force high-income taxpayers to pay some minimum tax, is a modification of the provision adopted in the Tax Reform Act of 1969 that imposes, as an additional tax, a minimum tax on those individuals who have substantial amounts of "preference" income. This proposal would include as an item of preference income the excess of the taxpayer's total personal deductions over 80% (or 75%) of his adjusted gross income. This means that a taxpayer who would otherwise entirely escape taxation by reason of having deductions equal to his adjusted gross income would have to pay a preference tax on a minimum of 20% (or 25%) of his adjusted gross income regardless of the nature of those deductions.

A third approach to minimum taxation was developed in the course of the Ways and Means Committee's consideration of tax reform legislation in 1974. This "compromise" proposal, like the MTI proposal itself, involves an alternate tax rather than an additional tax as is the case with the present tax on preference income. Under the original concept, individuals would compute a minimum tax based on their "economic" income, defined as adjusted gross income plus a number of items of tax preference and less three deductible items. One of the permitted

[8] Government entities are first on the list of eligible recipients in the definition of "charitable contributions." See Section 170(c)(1) of the I.R.C. of 1954, as amended.
[9] Levi and Steinbach, pp. 10-11.

deductions would be charitable contributions, but only to the extent of cash gifts plus cost (or other basis) of gifts of appreciated property. In subsequent debate the Committee decided to permit the full deduction for all charitable gifts, including the fair market value of gifts of appreciated property. As indicated previously, however, the final bill was not acted upon by the House.

The three proposals taken together illustrate how difficult it is to resolve the conflict between two principles of tax policy. It is possible to continue the present tax incentives for private philanthropy, but only if the policy of encouraging charitable giving takes precedence over the policy of requiring every taxpayer to pay some tax. Likewise, it is possible to structure the tax system so that every taxpayer pays at least some tax, but only if it is acceptable as a matter of policy that this be accomplished at some cost in terms of voluntary philanthropy.

Other Proposals

The preceding discussion dealt with the tax reform proposals that are of the most immediate significance to higher education, both because of their potential impact and because of the serious attention being given to them by the tax-writing committees. Other suggestions have been advanced from time to time which also would have an important impact on the voluntary support of higher education.

One of these is the proposal for a threshold or floor, typically 3% of adjusted gross income, below which no charitable contributions would be deductible. While this is said to represent an effort at tax simplification, it would penalize charitable giving by the majority of taxpayers. In 1970, for example, about 29 million taxpayers out of the 35 million who itemized their deductions were in the income groups in which the average charitable contribution amounted to less than 3% of income. The threshold proposal, therefore, would affect the multitude of small contributions that are so vital to the voluntary sector. While the small gift is less important than the large gift to higher education, the total of voluntary support received as small gifts constitutes a significant share of all support, and the removal of this particular tax incentive would seriously impinge on the effectiveness of college and university fund raising.

Another proposal would impose a tax on the unrealized appreciation of long-term property at the time of death, without making any exception for property bequeathed to charitable institutions. Under this proposal, virtually every estate would be reduced in size by the amount of the tax, so that the amounts available for distribution to all beneficiaries, including educational and charitable institutions, would also be reduced. Such a tax would clearly impose a burden on the taxpayer in planning for charitable bequests in the context of his total estate and his preferred disposition. Since about two-thirds of the value of estates bequeathed to colleges and universities is in the form of property, the indirect impact of such a tax on the voluntary support of higher education could be very significant. Here again, the proposal would effectively reduce voluntary giving without increasing substantially the tax revenue to the Treasury and without affecting in any way the fairness of the tax laws as they apply to different income groups.

Finally, it has been proposed to eliminate the charitable contributions deduction entirely and to substitute in its place a tax credit equal to some arbitrary per-

centage of the total amount of the taxpayer's gifts. The taxpayer would not deduct his charitable contributions from his income prior to calculating his tax, rather he would calculate his tax without taking his contributions into account and then offset some fraction of his contributions against the amount of the tax due. The recommended percentages for the tax credit have varied from 27% to 50%, and there are several variations on the basic proposal in terms of other personal expenditures that might be included.

The proponents of the tax credit proposal assert that it would enhance tax equity. It is argued that the present deduction arrangement is unfair because the Treasury "subsidizes" the small contributor less per dollar of gift than the large contributor. This differential "subsidy" arises because the progressive tax rate structure necessarily results in a larger tax "saving" for a gift deduction by a high-income taxpayer than for one by a low-income taxpayer. The tax credit would be more fair, it is said, because this "subsidy" would be equal, per dollar of gift, for all taxpayers.

The argument is faulty in many ways.[10] Among other things, it reflects the view that while it is equitable to tax income according to a progressive rate structure, it is somehow inequitable to untax that income according to the same rate structure when it is voluntarily given by the taxpayer for a philanthropic purpose.

Even if the argument were valid, however, the tax credit proposal is by no means a desirable alternative to the present arrangement. In theory, it would be possible to substitute a tax credit for the charitable deduction and to set the percentage at such a level that the increased contributions of the lower income taxpayers would precisely offset the decreased contributions of the high income taxpayers. While the result would be no change in the total amount of philanthropic giving, there would be a very marked change in the distribution of this total among all the recipient agencies and institutions.

Recent econometric studies have indicated clearly that any such change in the distribution of total giving would involve a very significant shift away from the voluntary support of education toward the support of other fields of charitable activity. It is estimated, for example, that for a tax credit of 25% there would be little or no change in total charitable giving, but a decrease of roughly one-fourth in the amount of such giving to educational institutions. To be neutral in terms of the impact on higher education, the tax credit would probably have to be set at a level between 35% and 40%; at such a level the amount of total charitable giving would rise as much as 50% above the dollar total resulting from the present system, and the cost to the Treasury would be so high as to make such a change politically impossible.

Moreover, fund-raising activities would become more complex and less efficient. There would be a decline in the number and importance of large gifts and an increase in the number of small gifts. Charitable solicitation, therefore, would face an increase in the fund-raising cost per dollar of contributions received, thus widening the gap between what the donors give and the donees receive. Such a development would clearly be undesirable.

[10] A complete discussion of the equity question would be much too lengthy for this paper. A technical memorandum on the subject will be made available by the Council for Financial Aid to Education and provided to the interested reader upon request.

III. The Importance of Voluntarism to Higher Education

Almost all of the proposals for changing the tax laws with respect to the charitable contributions deduction would, if adopted, have the effect of discouraging the voluntary support of higher education. This is especially true for those proposals which are being given any serious consideration. In view of the other financial problems of academia, any diminution of voluntary support could hardly come at a more inopportune time. What higher education needs now is more support, not less.

In the past 25 years, higher education has undergone a marked transformation as a social institution and its influence has become deeper and more widely diffused than ever before. It no longer provides education primarily for the small segment of society able to afford the costs involved, rather it provides educational opportunities of an extraordinarily diverse character to a substantial proportion of the population. It is no longer concerned principally with the traditional programs centered on the liberal arts and the professions, rather it is concerned with the totality of educational needs for a technological society characterized by social and economic mobility. It is no longer a collection of "ivory towers" isolated from the mainstream of American life, rather it is a far-flung enterprise intimately concerned with and involved in human welfare and the social issues of the day. It is no longer simply a community of scholars dedicated to teaching and to expanding the frontiers of knowledge, rather it is an aggregation of centers of learning and scholarship, deeply involved with the nature of man and his relation to his environment. In short, it has become a highly-organized instrument for the achievement of many national goals. In this context, voluntarism has come to have a profound effect on the destiny of both the individual and society.

The Importance of Voluntary Support

The voluntary support of colleges and universities has become much more important than its numerical magnitude would indicate. Private gifts and grants to higher education, which were less than $200 million in the mid-1940's, reached a level in excess of $2.2 billion in 1973-74. This latter figure represents only 6.3% of the total expenditures (operating and capital) of all colleges and universities combined, yet the function of voluntary support is so unique that it exerts a disproportionate influence on the capacity of higher education to serve society.

For the private colleges and universities, which account for nearly 60% of the number of institutions, such support is clearly vital to solvency and survival. These schools traditionally rely on private support to meet a substantial share of their operating budgets and virtually all of their capital requirements. It is thus a source of income basic to the ability of private institutions to be free and independent of political authority, and to provide diversity to the system of higher education.

For the public colleges and universities, voluntary support has been essential to their ability to offer education of high quality. Gifts and grants from private

sources often provide the "vital margin for excellence." Since appropriations from state and local government budgets are necessarily determined in the context of total tax revenue and the entire complex of competing demands for such funds, the allocations to the institutions of higher education tend to be limited to the most essential functions. There is seldom any extra money for the marginal activities and programs that make the difference between mediocrity and superiority in education.[11] Private gifts and grants thus provide the public colleges and universities with additional leeway for experimentation, for going beyond the minimum educational effort, and for providing the additional services which are being increasingly demanded of all higher education, public and private alike.

In larger terms, voluntary support provides the underpinnings for a diversity in higher education that is vital to the independence of all colleges and universities in carrying out their high purposes. Such independence is indispensable to the preservation and extension of educational quality.

The excellence of higher education in the United States is in large measure due to its exceptional diversity. There are now more than 2,700 colleges and universities, some public, some private. They differ enormously in size and structure, and they offer a broad range of programs oriented toward an extensive array of educational objectives. Some are national institutions, independent in outlook from the part of the country in which they are located; others are local in orientation, closely identified with the people and problems of their particular communities. Their constituencies are as varied as the institutions themselves, some serving primarily the members of a religious denomination, others serving special minority groups, and still others are aimed at serving the needs of a cross-section of the population. Some are highly specialized, organized to serve the particular needs of agriculture, the arts, science and technology, religion, medicine, the law, and even education itself. Others are more generalized, with curricula which span a variety of disciplines.

This diversity among the institutions of higher education is a reflection of the pluralistic society of which they are a part. It has arisen because of the pluralism which has been so important in the evolution of all American institutions, political and economic as well as social. Higher education as it exists today was unplanned. It developed at first through the individual initiative of countless educators and philanthropists who perceived a need for particular kinds of colleges and universities in particular places at particular times, and who gave of themselves and their resources that the institutions might be formed, maintained, and expanded. In the past hundred years, public authorities at all levels of government have also come to perceive and value the benefits which accrue to the nation and to all its subdivisions from the broadest possible base of educated citizenry. In this way the great state universities, land-grant colleges, community colleges, and other public institutions have been added to the higher educational establishment to serve the needs of the growing society. Many of these institutions bear the stamp of voluntarism in

[11] "Legislators do not look with favor on the extras that will make the difference between adequacy and excellence. If public institutions are to strive for exceptional performance, they are forced to look to private funds to lift them above the commonplace or the mediocre. Those public institutions that have achieved greatness have done so with the help and encouragement of private resources and private leadership."
Howard R. Bowen, President, University of Iowa, speaking to businessmen in Dallas, Texas, at a CFAE luncheon meeting, March 7, 1969.

Table I

Private Gifts and Grants Received by Colleges and Universities
(millions of dollars)

	1909-10	*1919-20*	*1929-30*	*1939-40*	*1949-50*	*1953-54*	*1957-58*	*1961-62*	*1965-66*
Current Funds:									
Educational and General	3.6	7.6	26.2	40.6	118.7	191.3	325.0	450.8	651.1
Less: Contributed Services[a]				7.9	17.8	25.0	37.4	46.6	60.0[d]
	3.6	7.6	26.2	32.7	110.9	166.3	287.6	404.2	591.1
Student Aid[b]						16.8	32.8	57.0	86.6
Total current funds	3.6	7.6	26.2	32.7	110.9	183.1	320.4	461.2	677.7
Capital Funds:									
Physical plant funds	8.4	7.9	51.4	22.7	72.6	103.9	157.2	226.5	366.1
Physical plant assets[c]							29.0	49.9	73.0
Endowment funds					62.8	100.1	192.7	230.2	282.2
Student loan funds	11.2	51.5	63.5	36.3	1.5	1.9	3.2	8.5	10.4
Other capital funds					2.5	4.5	7.8	19.8	34.5
Total capital funds	19.6	59.4	114.9	59.0	139.4	210.4	389.9	534.9	766.2
Total gifts and grants	23.2	67.0	141.1	91.7	240.3	393.5	710.3	996.1	1,443.9

[a] Not separately collected until 1931-32.
[b] Not separately collected until 1953-54.
[c] Not separately collected until 1957-58.

[d] Estimated by Division of Research, CFAE

Source: U.S. Department of Health, Education, and Welfare, Office of Education: *Digest of Educational statistics* (1971 Edition), Table 129, p. 100: Surveys of *Financial Statistics of Institutions of Higher Education* (1957-58 to 1965-66); *Biennial Survey of Education in the United States* (1949-50 to 1955-56).

addition to their sponsorship by state and local governments. Private financial support has been an important source of income for many of these institutions, and in numerous instances the buildings, grounds, and other physical facilities were donated by interested and concerned individuals.

The voluntary contribution of money, time, and energy was responsible for the founding of higher education in the United States, and voluntarism in all its dimensions has been a key element in its development for more than 300 years.

The Early History of Voluntary Support

During the Colonial period private gifts were the dominant source of funds for higher education. Among the nine colleges founded before the Revolutionary War, only one received any substantial assistance from governmental sources; the other eight were established and maintained almost entirely by philanthropists. The survival and growth of these institutions during the seventeenth and eighteenth centuries was possible only because of a continuous flow of gifts and bequests for operating funds and physical facilities.

During the period from 1780 to 1860, it is estimated that as many as a thousand colleges were organized. Most of these institutons were founded by clergymen and supported by local congregations, and their continuance depended directly on their success in raising money. Despite the efforts of many dedicated individuals and the frequency with which appeals for support were directed to the urban centers in the northern and eastern areas, only a small number of these colleges survived as permanent institutions. While it was voluntary giving at the local level that made this boom in new colleges possible, it was philanthropy in its wider dimension that determined which institutions should be maintained and encouraged to grow.

In the years following the Civil War the flow of voluntary support overshadowed all earlier gifts to higher education. Individual benefactors made single gifts measured in millions of dollars, whereas contributions previously had been reckoned in thousands. Many of the older colleges, including those founded in the Colonial period, were transformed into major universities as a result of large gifts from philanthropically-minded citizens. In perhaps two dozen instances, multi-million dollar gifts were responsible for the establishment of new universities as going concerns; these institutions flourished and grew as a result both of large endowments provided by their founders and of continuing support which was attracted to these new centers of learning. This period also saw the creation and development of many of the state universities and land-grant colleges, most of which received financial support from private citizens as well as from the Congress and the state legislatures.

The Period After 1910

In 1889-90, the U.S. Office of Education began to compile some information pertaining to the income and property of colleges and universities. For 1909-10 and later years, the published data included basic figures on the annual level of private gifts and grants, and with the passage of time this information became more detailed and more comprehensive. Summary data from this source, covering the period from 1909-10 to 1965-66, are shown in Table I.

These figures reveal an extraordinary growth in the overall total of private gifts

and grants received by colleges and universities. From $23.2 million in 1909-10, the total of voluntary support of higher education rose to more than $1.4 billion in 1965-66. This increase represents a growth rate of 7.7% per year, on the average.

It is very probable that this rate of growth exceeded that of the period before 1909-10 and that the acceleration in the growth of voluntary support is related to the tax laws and their treatment of private philanthropy.

As indicated in Table I, the rise of voluntary support after 1909-10 was by no means uniform. Between 1909-10 and 1929-30, the average growth rate was 9.4% a year. This was followed by the decade of the Great Depression when private gifts and grants fell by a third. After 1939-40, however, voluntary support resumed its upward course, and for the 26-year period ending 1965-66 the growth rate averaged 11.2% a year. For the entire period, the growth of voluntary support exceeded that of the national economy and that of higher education itself.

The rapid growth of educational philanthropy after 1909-10 coincided with the enactment of the income tax and the adoption of the contributions deduction. The jump in the growth rate following 1939-40 occurred immediately after the upward shift in income tax rates at the onset of World War II. There can be little doubt that these relatively high rates of growth were due in no small part to the effect of tax incentives. In 1964 and 1965 there was a reduction in tax rates, and since then the growth of voluntary support of higher education has slowed appreciably.

Voluntary Support Since 1965-66

The only consistent information on overall educational philanthropy since 1965-66 is that compiled in the annual *Survey of Voluntary Support of Education.*[12] Although these Surveys are less comprehensive than those conducted by the U.S. Office of Education, the participating institutions have consistently accounted for about 85% of the private gifts and grants received by the entire higher educational community. Estimated totals for all colleges and universities are shown in Table II.

It is clear that the growth of voluntary support has been slower in the period since 1965-66 than it was in previous years. For the eight years ending 1973-74, the estimated totals show an average annual increase of only 5.7% as compared to the growth rate of 11.2% during the period from 1939-40 to 1965-66. With the exception of 1968-69, the percentage increases in every year since 1965-66 have been smaller than the average growth rate in the prior period.

This decrease in the rate of growth of voluntary support is one of the causes of the financial crisis that has overwhelmed higher education in recent years. Between 1965-66 and 1973-74, college and university expenditures increased at an average rate of 11% per year, which is about the same as the rate of increase between 1949-50 and 1965-66. The factors responsible for the earlier growth of institutional expenditures — increasing enrollment and rising costs per student — continued throughout most of this recent period, and in addition the rate of inflation accelerated. Although the growth of expenditures has begun to moderate with the slowing in the rise of enrollment, it remains high by historical standards.

[12] For 1966-67 and later years, the U.S.O.E. figures are either inconsistent with earlier definitions or narrower in coverage. Since 1967-68, for example, only fragmentary data on capital funds have been compiled.

Table II

Estimated Total Voluntary Support Received by Colleges and Universities
(millions of dollars)

	1965-66	*1966-67*	*1967-68*	*1968-69*	*1969-70*	*1970-71*	*1971-72*	*1972-73*	*1973-74*
Current Operations	675	710	800	870	960	1,050	1,110	1,230	1,300
Capital Purposes*	765	770	800	930	820	810	910	1,010	940
Total	1,440	1,480	1,600	1,800	1,780	1,860	2,020	2,240	2,240

* Includes gifts for endowment, whether earmarked or placed there at institutions' discretion.
Source: Council for Financial Aid to Education, *Voluntary Support of Education* (various dates).

The decline in the growth rate of voluntary support in the last eight years, therefore, has resulted in a significant decrease in the relative importance of educational philanthropy as a percentage of total institutional expenditures, from 9.5% in 1965-66 to 6.3% in 1973-74. The difference between these two figures implies a "loss" of more than $1.1 billion of gift income in 1973-74 as compared to what voluntary support would have been had it continued to grow at its earlier rate of increase. This sum is equal to nearly $400,000 per institution, a figure that could easily have spelled the difference between a serious deficit and a balanced budget for many small and medium-sized colleges.

In view of the impact of inflation and growing enrollment, this estimated "loss" in voluntary support has an even greater significance. The data shown on Table III indicate clearly the character of this development. Prior to 1949-50, the growth of

Table III

Voluntary Support of Higher Education in Relation to Inflation and Enrollment

	Voluntary Support (millions of current dollars)	*Consumer Price Index (1947-49 = 100)*[a]	*Voluntary Support (millions of 1947-49 dollars)*	*Total Enrollment (thousands)*[b]	*Voluntary Support per Student (1947-49 dollars)*
1909-10	23	38.4	60	355	169
1949-50	240	102.3	235	2,659	88
1965-66	1,440	136.8	1,053	5,526	191
1971-72	2,020	175.9	1,148	8,116	141
1972-73	2,240	184.3	1,215	8,265	147
1973-74	2,240	200.3	1,118	8,520	131
Average annual percentage change:					
1909-10 to 1949-50	6.0	2.5	3.5	5.2	−1.6
1949-50 to 1965-66	11.9	1.8	9.8	4.7	5.0
1965-66 to 1973-74	5.7	4.9	0.8	5.6	−4.6

Sources:

[a] U.S. Bureau of the Census, *Historical Sta tics of the United States, Colonial Times to 1957*, Washington, D.C., 1960, Series E113, E158, E159, pp. 125-127; *Economic Report of the President*, Washington, D.C., 1975; data converted to 1947-49 base by Division of Research, CFAE.

[b] U.S. Department of Health, Education and Welfare, Office of Education *Digest of Educational Statistics* (1971 Edition), Table 103, p. 77; *Projections of Educational Statistics* (1974 Edition), Table 6; resident and extension degree-credit enrollment for 1965-66 and later years, extension students excluded for prior years. Non-degree-credit enrollment, which was about 900,000 in 1973-74, is not included.

educational philanthropy had not kept pace with the combination of rising prices and growing enrollment, with the result that support per student, in constant prices, decreased by about 50% in the forty years after 1909-10. Between 1949-50 and 1965-66 the situation was reversed, and real support per student made up all the lost ground and more. Concurrent with the slowing in the growth of voluntary support between 1965-66 and 1973-74, however, there was an acceleration in the rate of inflation and an acceleration in the growth of enrollment. As a result, voluntary support per student, adjusted for inflation, *decreased* nearly 5% per year, on the average, and in 1973-74 reached a level more than 22% below that of 1909-10.

This development indicates clearly that there is an urgent need for a further encouragement of educational philanthropy, not the kind of discouragement that would result from some of the proposals for the tax reform.

As a result of the decrease in the growth of voluntary support and other sources of income, and the continued upward pressure on costs, many institutions of higher education have encountered budgetary deficits. The academic community as a whole has entered a period of severe financial stress. The character and extent of this financial crisis has been well-documented elsewhere,[13] and need not be repeated here in detail. It should be pointed out, however, that educational expenditures grew at an unprecedented rate throughout the fifties and the sixties, and that this growth was made possible by a favorable combination of political and economic factors and public attitudes. At the same time, the upward push on the costs of higher education reflected factors that were largely beyond the control of the colleges and universities.

All this is now changed. Virtually all the sources of college and university income have encountered resistance to further growth, and some of the factors which have tended to increase the costs of education have now begun to moderate. Colleges and universities themselves have taken many of the necessary steps to improve their management procedures and to economize on their use of the available resources. Much has been done in this area and much yet remains to be done, but there is some chance that the institutions of higher education will be able to maintain a viable degree of financial stability in the years ahead.

Their success in this area, however, will depend directly on the continuation of a favorable climate for voluntary support. In this regard, perhaps the most critical single factor of all is the character of public policy with respect to the tax incentives for philanthropy.

---

[13] R. H. Atwell and C. W. Atwell, *Adjustments of the Major National Universities to Budgetary Distress*, (1972).

G. Hudgins, *et al.* *Peoples Colleges in Trouble* (A Financial Profile of the Nation's State Universities and Land-Grant Colleges), (1970).

W. W. Jellema, *The Red and the Black* (Special Preliminary Report on the Financial Status of Private Institutions of Higher Learning), (1971), and *Redder and Much Redder*, (1971).

Earl F. Cheit, *The New Depression in Higher Education (A Study of Financial Conditions at 41 Colleges and Universities)*, Carnegie Commission on Higher Education, (1971), and *The New Depression in Higher Education – Two Years Later*, (1973). In his latter book, Professor Cheit states "that (financial) stability is fragile, for it is the product of unusual cuts in expenditure growth and is based in part on favorable assumptions about external conditions – inflation, enrollments, private support, and public policy at the state and federal levels. Clearly, then, it would not take much to destroy the stability and force the institutions on a downward course again."

IV. The Future of Voluntarism in Higher Education

There do exist some provisions of the Internal Revenue Code that are in need of revision. However, those related to the charitable contributions deduction have already been purged of abuse. Philanthropy needs more, not less, encouragement. The charitable deduction has been a continuing fixture of the tax law for over 55 years; it has withstood the test of changing conditions, through prosperity and depression, through peace and war, and through very substantial changes in the relationship between the individual and society. It has served effectively as an instrument of public policy in channelling voluntary initiative and voluntary funds into a host of socially-desirable philanthropic activities, thus helping to preserve some of the fundamental tenets of American character and political philosophy.

It is a fact, however, that at a time when philanthropic needs are growing the charitable contributions deduction and several related provisions of the tax law have come under attack. All of the tax reform proposals which deal with charitable contributions, although designed to achieve other goals, would have the effect of reducing the incentives for philanthropic giving. If enacted into law, such proposals would be certain to result in a decrease of the voluntary support of higher education and other charitable activities. The cost to society of this result is likely to be much greater than any benefits that might be achieved in other directions.

Potential Consequences of Tax Reform

Americans have long had impulses toward generosity that are independent of any tax considerations; philanthropy was a thriving institution before the income and estate taxes came into being. However, the encouragement to voluntary action in the public good which arose from the adoption of the present tax structure has resulted in an upward shift in the levels of giving, and the effects of this change are now built into the economic structure of higher education and other voluntary sectors. The predictable downward shift in giving habits that would result from reduced tax incentives for philanthropy will inevitably do violence to the fragile solvency of all charitable institutions. The probable magnitude of this effect, under present conditions, is likely to destroy much of the cherished pluralism in American life.

Higher education, in particular, will suffer many undesirable changes. At a minimum, there will be a retrenchment of educational programs and other services at many colleges and universities. Among other things, this will involve significant reductions in educational opportunity for substantial numbers of young people who have only recently begun to have any real hope of obtaining a college education. It will also involve some decrease in the quality of education available to those who can continue to attend college. In the extreme, the loss of voluntary support could lead to widespread insolvency among the private institutions of higher education, with all the resultant dislocations of students, faculties, and institutional resources. The losses to society implicit in such developments are incalculable.

Substitution of Government Support Unlikely and Undesirable

It is often argued that any reduction in institutional income as a result of decreased private giving could be replaced by additional governmental appropriations, either through existing programs or through entirely new legislation. Such a development is possible, but it would require significant changes in public policy that are unlikely in the context of national priorities and undesirable in the climate of opinion that continues to favor a pluralistic society. Moreover, since many of the private institutions of higher education are church-controlled, the constitutional principle of separation of church and state, as embodied in the First Amendment, would bar any general appropriations to these colleges and universities from governmental sources.

Even if there should be a willingness to substitute Treasury funds for private funds in the financial structure of higher education, there is an important allocation question. The distribution of funds to the institutions of higher education by public authority is typically on a formula basis, and such formulae are inevitably arbitrary and rigid. By contrast, the allocation of voluntary support is determined by the decisions of many individual and corporate donors who determine their own allocations on the basis of perceived needs and opportunities.

The recipients and the purposes of private gifts and grants are thus determined by millions of private decisions, each of which reflects the preferences of the individual giver as to the uses to which his money should be put. Such preferences, molded in the light of individual knowledge of particular educational institutions and educational priorities, constitute a rich composite of the value standards of an important segment of the population. The sum of many private decisions with respect to the distribution of resources to higher education is inherently preferable, in a free society, to the rigid allocations dictated by any formulae, just as in a free economy the sum of the market decisions of producers and consumers is preferable to the arbitrary dictates of any centralized authority.

Aside from these considerations, the substitution of additional government support for any part of the existing private support is undesirable by reason of the potentially adverse impact on the character and quality of higher education. Any increase above the present 50% share of total governmental funding in the income structure of the institutions of higher education[14] implies that public authority would become dominant in the direction of educational effort. The concentration of the financial support of higher education in government hands necessarily leads to the concentration of influence and control in educational matters, and such authority would all too easily be dictated by political and other non-educational considerations.

Any rise in the importance of governmental funds would weaken the values which are today inherent in the diversity of college and university funding. In due course, there would be a decline in the freedom and independence of educational institutions to determine their own policies and programs. The communities of

[14] The income structure of all institutions of higher education combined has been relatively stable in recent years. General appropriations, support for research and other programs, and student-aid funds provided by Federal, state, and local governments constitute roughly 50% of the total. Income earned by colleges and universities for themselves from tuition, fees, room and board payments, and the revenues of academic departments and enterprises account for about 40%. Private gifts and grants and the income from endowment investments make up the remaining 10%.

69-516 O - 76 - pt. 7 - 7

interests that now direct the activities of colleges and universities would necessarily become subservient to the monolithic interests of governmental bureaucracy. Uniformity would replace diversity in educational programs and institutional services, rigidity would replace flexibility in educational policy, and the latitude for innovation and experimentation in educational matters would be severely constricted. Colleges and universities would become less responsive to the interests of their students, their supporters, and their communities.

Ultimately there would be an erosion of the capacity of higher education to maintain and extend its contributions to American society. Economic and social progress would be jeopardized, and the vital dynamics of American political life would be seriously impaired. Much of the strength of the United States as a leader in world affairs might well suffer as a direct consequence of this eventuality.

The achievements of higher education in contributing to the welfare of American society have been made possible in large part by the voluntary initiative of countless individuals who have given their time, their talent, and their money to support the colleges of their choice. It is imperative that voluntary support should continue to be encouraged by public policy, and that the provisions of the Internal Revenue Code which provide tax incentives for such support should be maintained and strengthened.

CFAE Board of Directors

Frank W. Abrams
Founder Director

John T. Connor, *Chairman*
Chairman
Allied Chemical Corporation

Curtiss E. Frank, *Chairman*
Executive Committee

Raymond C. Johnson
President

Courtney C. Brown, *Honorary Director and Treasurer*
Dean Emeritus
Graduate School of Business
Columbia University

Robert O. Anderson, Chairman
Atlantic Richfield Company

Derek C. Bok, President
Harvard University

Ernest L. Boyer, Chancellor
State University of New York

Abram T. Collier, Chairman
New England Mutual Life Insurance Company

John E. Corbally, President
University of Illinois

Justin Dart, Chairman
Dart Industries Inc.

George S. Dively, Chairman
Executive and Finance Committee
Harris Corporation

Clifton C. Garvin, Jr., Chairman
Exxon Corporation

Richard C. Gilman, President
Occidental College

John D. Harper, Chairman
Executive Committee
Aluminum Company of America

Vivian W. Henderson, President
Clark College

Philip G. Hoffman, President
University of Houston

Horace C. Jones, Chairman
Burlington Industries, Inc.

Edward R. Kane, President
E. I. du Pont de Nemours & Company

Ralph Lazarus, Chairman
Federated Department Stores, Inc.

T. Vincent Learson, Retired Chairman
International Business Machines Corporation

William L. Lindholm, Vice Chairman
American Telephone and Telegraph Company

Oscar A. Lundin, Vice Chairman
General Motors Corporation

C. Peter McColough, Chairman
Xerox Corporation

Martin Meyerson, President
University of Pennsylvania

Steven Muller, President
The Johns Hopkins University

Daniel C. O'Connell, S.J., President
Saint Louis University

Jack S. Parker, Vice Chairman and
Executive Officer
General Electric Company

Ellmore C. Patterson, Chairman
Morgan Guaranty Trust Company of New York

Martha E. Peterson, President
Beloit College

Shermer L. Sibley, Chairman
Pacific Gas and Electric Company

Arthur M. Wood, Chairman
Sears, Roebuck and Co.

CFAE Board of Advisors

Gerald L. Andrus, Retired Chairman
Middle South Utilities, Inc.

Ernest C. Arbuckle, Chairman
Wells Fargo Bank, N.A.

Earl L. Bimson, Senior Vice Chairman
Valley National Bank of Arizona

James H. Binns, President
Armstrong Cork Company

Edward L. Bond, Jr., Director
Young & Rubicam, Inc.

R. Manning Brown, Jr., Chairman
New York Life Insurance Company

Berkeley G. Burrell, President
National Business League

Edward W. Carter, Chairman
Carter Hawley Hale Stores, Inc.

Michael N. Chetkovich, Managing Partner
Haskins & Sells

Edward S. Donnell, Chairman
Montgomery Ward & Co., Incorporated

Gaylord Donnelley, Chairman
Executive Committee
R. R. Donnelley & Sons Company

Wayne E. Glenn, President
Western Hemisphere Petroleum Division
Continental Oil Company

William T. Gossett, Partner
Dykema, Gossett, Spencer, Goodnow & Trigg

William D. Grant, Chairman & President
BMA Corporation

Richard L. Kattel, Chairman and President
The Citizens and Southern National Bank

Louis B. Lundborg, Retired Chairman
Bank of America National Trust &
Savings Association

Malcolm MacNaughton, Chairman
Castle & Cooke, Inc.

Dean A. McGee, Chairman
Kerr-McGee Corporation

Ruben F. Mettler, President
TRW Inc.

J. Irwin Miller, Chairman
Cummins Engine Company, Inc.

Franklin D. Murphy, Chairman
The Times Mirror Company

Robert T. Person, Chairman and President
Public Service Company of Colorado

Henry R. Roberts, President
Connecticut General Insurance Corporation

Robert H. Stewart III, Chairman
First International Bancshares, Inc.

James A. Summer, Vice Chairman
General Mills, Inc.

John F. Watlington, Jr., Chairman
Wachovia Bank & Trust Company, N.A.

Eugene F. Williams, Jr., Chairman
St. Louis Union Trust Company

Vincent C. Ziegler, Chairman
The Gillette Company

George G. Zipf, Chairman and President
The Babcock & Wilcox Company

CFAE Staff Officers

Raymond C. Johnson, President

Z. Kris Bent, Vice President

J. Moreau Brown, Vice President

Donald M. Elliman, Vice President

Arthur C. Kammerman, Vice President

DuBois S. Morris, Jr., Vice President

Hayden W. Smith, Vice President

Anne Ellison, Secretary

Bertha Donner, Assistant Treasurer

West Coast Consultant
William W. Gordon
P.O. Box 2183
La Jolla, California 92037

The Ohio 1% Committee
The Alcazar Hotel
2450 Derbyshire Road
Cleveland, Ohio 44106

WEBSTER, KILCULLEN & CHAMBERLAIN,
Washington, D.C., April 21, 1976.

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

DEAR MR. LONG: This letter represents a written statement on behalf of Sand Springs Home, Sand Springs, Okla., urging the committee's action on H.R. 5815, a provision dealing with the classification of certain charitable organizations under section 509 of the Internal Revenue Code. An original and five copies are supplied for the committee's information.

I. INTRODUCTION

In a release dated December 21, 1973, Mr. Al Ullman, acting chairman of the Committee on Ways and Means, requested comments on a number of tax bills which had been introduced in the House. Among them was H.R. 2258—93d Congress, 1st session—which would have amended section 509 of the Internal Revenue Code to provide that a charitable organization operated, supervised, or controlled by or in connection with an organization described in section 501(c) (8) or (10)—fraternal beneficiary associations including Masons and Shriners—would be classified as other than a private foundation. On April 13, 1973, representatives of Sand Springs Home appeared before the House Ways and Means Committee and testified in support of H.R. 2258. Written comments were also submitted in support of the bill. See, public hearings before the Committee on Ways and Means, House of Representatives, 93d Congress, 1st session, on the subject of general tax reform, pages 6518 to 6528.

In a bill report dated December 10, 1973, copy enclosed, the Treasury Department approved H.R. 2258 with the added suggestion that its relief be expanded.

On September 25, 1974, the Committee on Ways and Means approved H.R. 2258 in executive session, and ordered it reported. The 93d Congress adjourned before the bill was actually reported to the House.

In the 94th Congress, H.R. 5815 was introduced on April 9, 1975, and it is identical to H.R. 2258—93d Congress. No new hearings have yet been scheduled by the Ways and Means Committee on this bill, or any other, dealing with public charities or foundations. It is understood that Mr. Ullman will deal with these matters as part of "Phase II" tax reform plan.

In a telegram dated March 30, 1976, due to the number of witnesses, Sand Springs Home was not able to provide oral testimony on H.R. 5815 to the Committe on Finance. It was, however, invited to submit a written statement for the record and this letter is for that purpose.

II. THE PROBLEM IN BRIEF

The 1969 Tax Reform Act caused the classification of the Sand Springs Home as a private foundation because virtually all its income is derived from its endowment. Its endowment is adequate for its support and the home does not need public funds. A counterpart organization, with a similar source of support is not treated as a private

foundation if controlled by publicly supported section 501(c) (3), (4), (5), or (6) organizations—charities, civic leagues, labor unions, or business leagues. Since 1925, the Sand Springs Home has been controlled by a board of trustees appointed by the Oklahoma grand master of the Ancient Free and Accepted Masons, a fraternal beneficiary society described in section 501(c)(8) of the Internal Revenue Code. Thus the home is subject to the requirements imposed on private foundations.

As required by chapter 42 of the Internal Revenue Code, a private foundation must pay a 4-percent excise tax on its income and is required to distribute the greater of its income or a fixed percentage of its assets each year—now 6 percent—or pay a 15-percent tax on undistributed income—or corpus, as the case may be. Many of the home's assets consist of investments which were part of its original endowment. The yield on these properties, in relation to current value, is not sufficient to meet the 6-percent minimum pay out—6¾ percent for fiscal year 1977. The annual income of all investment properties is insufficient to meet the current distribution requirements of 6 percent of the value of its endowment. It must therefore pay out principal if it is to avoid paying taxes required by section 4942.

III. THE PROPOSED SOLUTION

H.R. 5815 would do nothing more than give organizations such as the Sand Springs Home, directly controlled by a publicly supported fraternal organization, the same exemption from private foundations status enjoyed by a charitable organization controlled by a labor union, public charity, civic, or business league. We are certain that if this problem had been considered by Congress at the time section 509(a)(3) was enacted organizations such as the home would not have been excluded from the exemption from private foundation status provided by that section. This view is shared by the Treasury Department. In a letter written in December 10, 1973, a copy of which was earlier furnished the committee, Frederic Hickman, then Assistant Secretary of the Treasury, states, with reference to the predecessor of H.R. 5815:

> The Treasury Department supports the enactment of H.R. 2258. [Now H.R. 5815] Affiliation with a fraternal beneficiary society, order, or association insures indirect public scrutiny of the activities of the affiliated organization through the supervision of the parent organization.

IV. DESCRIPTION OF THE SAND SPRINGS HOME

The Sand Springs Home was founded by the late Charles Page on June 2, 1908. On August 9, 1922, it was incorporated under the laws of the State of Oklahoma. At the time the home was founded, there was no Federal income tax since a Federal income tax could not be imposed until 1913, after the passage of the 16th amendment. The home was originally formed for the purpose of caring for needy children; however, in 1914, recognizing that there was a need for a facility which would also provide a place for needy widows to raise their children, there was formed a Widows' Colony. See generally, Sand Springs Home, 6 B.T.A. 198 (1922), Acq. C.B. VI-1, 5. These activities have continued until the present time. During 1976, the 71 dependent chil-

dren in residence and in the Widows' Colony there are 40 widows with a total of 207 children.

Orphaned children are committed to the home by the order of the Oklahoma State district court, which charges the home with the duty of the care, maintenance, and education of the children. Widows and their children are admitted to the Widows' Colony under rules and regulations authorized by the Sand Springs Home, rather than court order, and the children remain under the guardianship of their mothers. The mothers are both guardians of the person and guardians of the property of their children.

Personal assets of orphaned children are held in trust under guardianships established under the probate divison of the district court of Tulsa County, Okla. Individual bonded guardians are appointed by the court, and all personal assets, including social security survivorship payments, veteran's survivorship benefits, etc., are impounded in the duly established guardianships. They are administered by the court until its approval of the final accounting distribution by the guardian of assets to said child on reaching his or her majority. No personal funds of any child are ever accepted into or comingled with the accounts of the Sand Springs Home. The home's legal department protects each child in effecting settlement claims for death, insurance, social security, and veteran's benefits from which such guardianship assets customarily accrue.

The home makes available to the Public School System of Sand Springs and to the various churches of Sand Springs and immediate area, lands belonging to it, as long as such lands are occupied and used for educational or religious purposes, as the case may be.

Much of the endowment of the home consists of property bequeathed to it in 1926. The home's assets consist, in addition to the land and buildings directly utilized for the carrying out of the exempt activities, of large tracts of grazing land and woodland, stock in several small but prosperous wholly owned companies (e.g., the Sand Springs Railway Co.), oil properties, and investments in governmental obligations and certificates of deposit. For historical perspective on the railway corporation, see Sand Springs Railway Co., 21 BTA 1291 (1931) and 31 B.T.A. 392 (1934). It is difficult to assess the total value of the assets (this being one of the problems presented by Internal Revenue Code sec. 4942); however, the total endowment is substantial and at a minimum this value exceeds $12 million.

The board of trustees of the home are appointed by the grand master of the Ancient Free and Accepted Masons of the State of Oklahoma, Most Worshipful Grand Lodge, Guthrie, Okla. The grand lodge is a section 501(c)(8) organization. See, "Cumulative List of Organizations, described in section 170(c) of the Internal Revenue Code of 1954," IRS publication No. 78, revised 1-75, at page 33.

The Sand Springs Home, since its formation, has expended in excess of $20 million for charitable and philanthropic purposes and has cared for a total of 800 dependent children and widows. The home is unique, since Mr. Page, recognizing the need for such organizations at an early date, provided the organization with an endowment which has resulted in its never having to request that the public make contributions to it. The home has been able to operate without having

to further burden the public with requests for funds. However, what would be considered a virtue is now a detriment since if the home had requested additional funds through the years from the public for its support, it would undoubtedly be able to qualify as a public foundation. However, due to the original bequest of funds to the home, it now finds itself in the position of being classified as a private foundation.

The Sand Springs Home should be entitled to hold assets which probably will maintain their value during inflationary times to insure that it will be able to meet the continuing responsibility to the children and widows for whom it has accepted responsibility. This is, of course, even more important with the current trend of food, shelter, clothes, medical expenses and education costs. The home must be in a position to invest for the future as well as for current income. The original donor to the home shrewdly provided it with investments the value of which has permitted the home to offer its services to the needy. However, the artificial payout rate prescribed for the home has the effect of distributing principal not in furtherance of its original charitable purposes or forcing it to engage in wasteful, needless spending for its current residents.

Indeed, if current welfare and population trends continue, there may be no need for orphanages or homes which take care of needy widows and their children. Perhaps when that juncture is reached, a new public service role for the home may be devised by Oklahoma or Federal courts but until that time, the home fulfills its stewardship of its residents in an efficient, effective manner giving due regard to its properties, their yield and value, and the possible needs of women and children which the future may insist be served.

V. CLASSIFICATION OF CHARITABLE ORGANIZATIONS

When the Tax Reform Act of 1969 [Public Law 91-172] was enacted, two classes of charitable organizations were created—"private foundations" and "other than private foundations" also called public charities. Section 509 of the code provides the definitional provisions which govern which organizations are to be treated in one of the two respective classifications.

Prior to the Tax Reform Act of 1969, and before the substantial restrictions imposed on private foundations, there had been differences between charitable organizations but these differences involved the income tax deduction available to individuals in any taxable year.

For example, there were charities that were "20 percent" charities and "30 percent" charities. Contributors to organizations classified as 30 percent charities under section 170(b)(1)(A) of the Internal Revenue Code, prior to 1969, were permitted to deduct up to 30 percent of their adjusted gross income and carry over any excess to succeeding years. Contributors to organizations classified as 20 percent charities could deduct only that percentile and no carryover was permitted for excess contributions. Since Sand Springs did not solicit contributions, these provisions of section 170 were of no importance to the home.

With the changes in the law in 1969, the former provision with respect to charitable contribution deductions was picked up and placed into the definitional provision—section 509—which distinguished between private foundations and these "public charities." Thus an organization which could qualify as what was then a 30 percent—now a 50 percent—charity because of other changes in the law—would qualify as other than a private foundation. See generally, IRC section 170(b)(1)(A) (i) through (vi). This is provided under section 509(a)(1) of the code. Organizations covered by this provision include churches, medical research units, schools, hospitals, and publicly supported organizations such as the Red Cross, United Fund, Boy Scouts, and other such broadly based publicly supported organizations.

Because of definitional problems that existed under section 170(b)(1)(A), certain organizations, even though they had broad based public support, could not be classified as section 170(b)(1)(A)(vi) organizations because they received support in the form of exempt function income rather than contributions. Into this category fall educational and scientific societies which received dues and similar income. With respect to these organizations, since they were broadly publicly supported, enactment of section 509(a)(2) provided a means by which they could qualify as other than private foundations.

In general with respect to organizations classified under section 509(a)(1) and 509(a)(2), there was a requirement that the organization receive more than one-third of its support from the general public, or in the case of section 509(a)(1), be among other types of organizations listed in section 170(b)(1)(A). With respect to 509(a)(2), there was a limitation upon the amount of investment income which could be received.

In addition, there was provided another mechanism by which organizations could qualify as other than private foundations. Under this method, an organization was required to demonstrate that it was controlled, supervised or operated by or in connection with an organization described in section 509(a) (1) or (2) and that it operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of a section 509(a) (1) or (2) organization. Thus if there were an organization which was operated or controlled by a public organization, it qualified as a publicly supported organization. This was provided by section 509(a)(3).

Differentiation between foundations and other charitable organizations was necessary because—

> * * * the ability of donors to engage in financial transactions with their foundations is adversely affecting taxpayer morale. Many feel that allowing contributions to a foundation to be deductible in situations in which the donor has not irrevocably parted with the "donated" property is improper. The belief is becoming more widespread that the creation of a private foundation is a tax dodge used by some taxpayers to obtain tax advantages, much as expense account living was regarded. Under our self-assessment tax system it is important that the public have confidence in the fact that every taxpayer is paying his fair share of the cost of government.

See Treasury Department Report on Private Foundations, February 2, 1965 at p. 16. The assumption was that an organization responsive to or dependent upon public support was less prone to abuse of

assets dedicated to charitable uses. Thus a distinction was needed to differentiate between organizations likely to be responsive to the public and those endowed organizations, operated on a discretionary basis, often controlled completely by a donor or his family, for which there is no real accountability. See floor statement of Senator Curtis, Cong. Rec. Dec. 4, 1969, at S. 15646 (daily ed.) proposing what is now IRC sec. 6056.

VI. DEVELOPMENT OF SECTION 509(a)(3)

A review of relevant material after the publication of the Treasury's foundation report revealed little testimony on the need to differentiate between private and public organizations. Cf., Written Statements of Interested Individuals, etc., vol. 1 (89th Cong., 1st sess.) at pp. 478–479. Apparently, the term was thought to be self-defining. Congress came soon to realize that, in drafting a definition of what was not to be treated as a private foundation, that many public charities were directly supported by or assisted in their endeavors by section 501(c) (3) organizations—for example, charitable trusts—which the public charity supervised or controlled or which were operated in connection with such charity. See, Press Releases Announcing Tentative Decisions on Tax Reform Subject, dated May 27, July 11, and July 25, 1969, 91st Cong., 1st sess. at pp. 5–6).

Thus when H.R. 13270 was introduced on August 1, 1969, a section 501(c)(3) organization controlled by a public charitable organization was exempt from the private foundation provisions. House Report 91–413 Part 1 (91st Cong., 1st sess. at pp. 40–41). It was recognized that the provision was aimed at a foundation—known as the Hershey Trust—which supported a school—known as the Hershey School. See House Report 91–413, supra, at p. 41 and Congressional Record, December 6, 1969 (daily ed.), at pp. S 15982–3. The Milton Hershey School was originally a school and home for orphaned boys. In reviewing pertinent testimony before the Finance Committee on the problem of defining a private foundation, no witnesses supported the proposition and a number expressed strong opposition to its exclusiveness. See, Summary of Recommendations on Private Foundations, submitted to Committee on Finance, on the subject of tax reform (Joint Committee Print), dated October 25, 1969 at pp. 18–20. On October 28, 1969, the Finance Committee announced that—

> Foundations Related to Certain Publicly-Supported Exempt Organizations.—The committee adopted the rule that a foundation operated in conjunction with a publicly-supported exempt organization (such as social welfare organizations, labor and agricultural organizations, business leagues, real estate boards etc,), will be treated as meeting the public support test for purposes of being a public charity and would not be a private foundation.

In its report (H. Rept. 91–552, 91st Cong., 1st sess. at p. 59) the Finance Committee went into no definitive explanation of the rationale for its decision. No amendments were made on the Senate floor to the provision although Senator Scott, for the Hershey Trust, went into a considerable discussion of the importance of section 509(a)(3), Congressional Record, December 6, 1969, supra. Other than some further clarifying remarks about the provision by Senator Javits (Con. Rec., December 8, 1969, at S 16095–6 daily ed.) there was little to indicate the reason for the 509(a)(3) exemption except that these controlled

organizations "* * * are not the sort of organizations responsible for the abuses that occasioned the new strictures." Congressional Record, December 6, 1969, at S 15982, daily ed. The Conference Committee tion were classified as a section 501(c) (4), (5), or (6) organization, (H. Rept. 91-782, 91st Cong., 1st sess., at p. 289) but did not otherwise address the general theme of foundations controlled by exempt organizations public in nature but which are not themselves charities. It would appear that but for a communication from the North Carolina Masonic Lodge (1969 Senate Hearings, vol. 7 at p. 6196) and the Sand Springs Home (Hearings, supra, at 6218) no one gave much thought or attention to charities operating under the aegis of fraternal societies.

SUMMARY

As was indicated earlier, as vacancies in the office of trustee occur, the trustees of the Sand Springs Home are appointed by the grand master of the Masonic Lodge of Oklahoma. If this masonic organization were classified as a section 501(c)(4), (5), or (6) organization, the home would qualify as other than a private foundation. This would result under regulations (§ 1.509(a)-4(g), example (3)) since the trustees are appointed by the Masonic Order through its presiding officer. Also, the home does carry out a type of activity which is closely identified with charitable activities of Oklahoma Masonry.

However, as indicated, the Masons are not a section 501(c)(3) or a section 501(c)(4), a section 501(c)(5) or a section 501(c)(6) organization. Thus even though an organization which is responsive to the public and which has broad public support has, by virtue of its grand master's power of appointment over trustees, control over the home, the home may not utilize such circumstances to qualify as a public charity. The treatment of charities controlled by section 501(c)(4), section 501(c)(5), and section 501(c)(6) organizations should be extended to charitable organizations affiliated with fraternal orders, such as the Masons which are exempt under section 501(c)(8), or fraternal units under section 501(c)(10).

From the glimpses of the congressional intent cited earlier for the enactment of the last sentence of section 509(a)(3), it is clear that Congress was assuring that public foundation status would be conferred based upon a relationship with a public organization and its responsiveness to the organization, its members or its hierarchy. We would amend section 509(a)(3) to provide as follows:

> For purposes of paragraph (3, [section 509(a)(3)] an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), (6), (8) or(10) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).

The new language adds sections 501(c)(8) and 501(c)(10) as approved parent organizations.

When the Treasury Department initially approved the concept (in its December 10, 1973, bill report) now embodied in H.R. 5815, it was called fair and sound. It is fair to exempt these organizations from chapter 42 because—

> * * * the relationship between the parent organization and the support organization insures that the support organization will be as responsive to the public interest as the parent organization itself. Ibid.

Public scrutiny exists as to fraternal organizations merely by the size of the membership and the democratic election procedures which exist to preclude its status as a captive of a donor, family, or business corporation.

The Masons, Shriners, Knights of Columbus and other societies have charitable affiliates who would benefit from this law. It is timely for the Congress to redress the oversight which occurred in 1969 by extending section 509(a)(3) to their charities.

Very truly yours,

WEBSTER, KILCULLEN & CHAMBERLAIN,
CHARLES E. CHAMBERLAIN.
WILLIAM J. LEHRFELD.

STATEMENT BY COUNCIL OF JEWISH FEDERATIONS AND WELFARE FUNDS REGARDING TAX PROPOSALS AFFECTING CHARITABLE CONTRIBUTIONS

The Council of Jewish Federations and Welfare Funds is the association of central Jewish community organizations located in almost every major city in the United States. These organizations obtain over $480 million annually from 1,000,000 contributors. In addition to these federated campaigns, related Jewish agencies directly raise about $140 million annually, for an annual total of $620 million.

THE SCOPE OF SERVICES PROVIDED BY CONTRIBUTIONS

The vast network of Jewish humanitarian services made possible by these gifts include 61 hospitals and clinics, 88 institutions and agencies for care of the aged, 101 agencies providing family and child welfare, 250 youth and community centers, 260 centers for college youth on campuses, and a variety of other forms of assistance. A minimum estimate of persons individually served annually is over 1,200,000. Many are served without regard to race or creed, particularly in Jewish hospitals where most of those served are other than Jewish.

EFFECT ON SERVICES BY SIZE OF CONTRIBUTIONS

Expenditures for these services total over $2 billion annually. Thus, contributed dollars have a multiplier effect because the services they finance generate additional support.

Any proposals which would have the effect of reducing charitable support could set off a reaction in which much more could be lost than the level of charitable support, in term of dollars, of agencies' services to individuals, and of volunteer services to charities.

Our concern is with the humanitarian services financed by charitable contributions. Such contributions are in the form of cash, appreciated property, and bequests, and are affected by provisions of law for computing income tax and estate and gift taxes.

HISTORIC ENCOURAGEMENT OF CONTRIBUTIONS BY CONGRESS

We concur fully in the encouragement which has been given in the last half century by Congress through tax incentives to help increase

charitable gifts, particularly the rise in the ceiling for individual giving from 15 percent of adjusted gross income to 20 percent to 30 percent and (in 1969) to 50 percent for cash gifts. A positive governmental posture encourages citizens to contribute and to work as volunteers for charitable causes. The obverse of this statement is that any sign from Congress that the value of the need of the charitable enterprise is subject to serious question has a depressing effect on the resources required by charitable agencies.

LARGE GIFTS AND BROAD BASE ESSENTIAL

The example set by most generous givers—especially the larger contributors who provide 80 percent of the income of our Jewish charities—has a profound effect on the mass of gifts made to Jewish charities, helping to encourage the enrollment of more than 1 million contributors (including more than half of all Jewish families in the United States), and inspiring the higher level of their gifts.

GIVING AFFECTS THE QUALITY OF THE COMMUNITY

The congressional encouragement of publicly supported charities mirrors one of the proudest attributes of the American people: the impulse toward voluntary association to meet human needs. This impulse sometimes occurs before there is governmental recognition of a particular responsibility, sometimes side by side with such responsibility, and sometimes independent of it. Innovative development of service programs frequently results from the initiative of voluntary agencies.

The most generous Americans are those who give not only of their dollars but of their time and their energy. The dollar value of volunteer services is incalculable, far beyond the total of funds cited above. Volunteer service often is crucially tied to and inspired by the financial gifts of these persons.

Giving patterns affect the quality of the community. If Government discourages giving, and people are thereby encouraged not to care, there will be more unsolved human problems, not less.

VOLUNTARY GIVING IS UNIQUE

Charitable contributions should be treated separtely as a subtraction from adjusted gross income because this conforms to the reality of the contributor's option to reduce his net income. No one is compelled to give; hence enough discouragement can simply result in losses of gifts when individuals exercise their option not to give.

It has been unfortunate that some proposals (notably those affecting minimum tax) treat voluntary charitable contributions in the same way as other deductions with which they have nothing in common. When a man contributes to a charity, whatever the tax abatement, he reduces his own net income and net worth voluntarily. It is self-imposed. This has nothing in common with such mandatory economic transactions as interest payments and State and local taxes. The charitable contribution should not be lumped with these dissimilar deductions in any proposals affecting ordinary income tax or minimum tax.

ULTIMATE IMPACT ON BENEFICIARIES OF SERVICES, NOT ON TAXPAYER

The criterion for evaluating proposals which deal with the tax aspects of voluntary contributions should be the impact upon the beneficiaries of the charitable gifts, mainly the persons in need who are served and assisted by charitable agencies. If tax revision proposals regarding charitable gifts have the effect of reducing the income of charities, they hurt the neediest peole by depriving them of assistance, and impair their well-being of society, such more than they affect the taxpayers involved. It would be a disservice to the individuals who are helped by charity if that help is diminished.

TAX INCENTIVES

Tax incentives are a major, crucial factor in encouraging giving. Anyone who has given a substantial gift or who has sought to encourage his fellow citizens to give can readily testify to the effectiveness of maximum tax incentives for giving. Recent studies by Dr. Martin Feldstein of Harvard University and by others have shown conclusively that these incentives are substantial and result in much more in income to charities than might theoretically be lost by Government. Similarly, the least generous contributors tend to be inadequately interested and informed about charitable deductions.

SIMPLIFICATION

Simplification is to be desired in tax administration. But the price must not be to do more harm than good. That is the danger when a particular form of tax simplification results in removing or reducing the tax incentives for charitable gifts. This is not necessary: A simple subtraction for contributions from gross income would not complicate tax returns to any marked extent.

By allowing contribution deductions to those who use the standard deduction, giving can be spread more widely, greater sums can be made available for charities, and all this can be done consistent with simplification.

GOVERNMENTAL OFFSET FOR LOSSES IN CONTRIBUTIONS

The value of the charitable tax deduction is about 1.5 percent of Federal revenues. To chip away at the contribution level would hardly solve the revenue problems of the Government. Indeed, forcing attrition in voluntary charities can lead to offsetting pressures for governmental outlay, with little or no net gain. The human needs being met by voluntary philanthropy will not vanish or diminish if the charitable assistance is not forthcoming; instead, they will have to be met in other ways. In such circumstance, there would be inevitable pressures for government support.

Despite such pressures, there are no guarantees and little basis for confidence that the Government will, in fact, offset the drop in contributions by rises in governmental aid and some would be ineligible for governmental support, such as church-related programs.

LOSSES TO CHARITIES BUT NO GAIN TO GOVERNMENT

Reduction of tax incentives for charitable giving can also lead to decisions by individuals to take acts which would result in losses to charities while creating no gain to Government, as when an individual does not realize gain on appreciated property. A person deterred from giving appreciated securities to charities could simply retain them; he does not have to sell them. The charities would lose his gift. The Government would get no tax income.

In the light of these principles and facts, we offer the following evaluations of tax proposals affecting charitable giving which have been brought to the Congress:

CRUCIAL ROLE OF APPRECIATED PROPERTY DONATIONS

It has sometimes been proposed with regard to publicly supported agencies that gifts of appreciated property be taxed, or the deduction be disallowed in whole or in part in computing taxable income and deductible bequests in estates.

This is a most seriously harmful proposal. Fortunately, the House Ways and Means Committee has rejected this proposal. We urge continued rejection of proposals of this type.

The givers who provide 80 percent of the support of Jewish charities remit a substantial portion of their gifts in the form of appreciated property, especially appreciated securities. Together with indirect receipts, as much as one-half of the support of our Jewish charities is received in this form. The continued viability of our agencies depends upon the retention of the current provisions regarding deductions of contributions in the form of appreciated property. The destructive effect of this proposal is manifest further from the fact that two-thirds of collections for endowment purposes, generally in the form of bequests, for our Jewish federated charities was paid in the form of appreciated property.

The importance of large gifts was illustrated by the example, in recent years, of the availability of these gifts to provide immediate emergency financial aid by Jewish Federations to the victims of the Wilkes-Barre flood, filling vital needs not met by Government aid.

This aid exceeded $2 million, contributed immediately by more than 150 Jewish communities. It was made available before Government aid could be provided and filled critical gaps in governmental assistance. Among the services provided by these funds were shelter, clothing, personal family counseling in dealing with the disaster, scholarship aid so that students would not have to drop out at their universities; it provided operating funds to enable Jewish communal institutions, religious schools and synagogues to continue their services; helped in the initial flood damage cleanup and in the continuing restoration of their buildings and facilities.

MINIMUM TAX

The charitable contribution (including appreciated property gifts) should not be made part of the computation of minimum tax. Proposals to increase the yield of this tax are not dependent on such inclusion.

More important, the unique and voluntary aspect of contributions makes it incorrect to treat this item as though it were a tax preference.

Since there is no capital gains tax on lifetime gifts of appreciated property to charities, there should be no tax for such gifts upon a person's death. No lifetime tax is being avoided.

Some proposals for revision in minimum tax, such as that contained in H.R. 10612, or in the revised Treasury recommendation would have only a minimal effect on charitable contributions. Other proposals would be harmful: for example, "allocation of deductions," "limit on tax preferences", the original Treasury proposal or any other variation, unless provision were explicitly made to avoid any diminution of tax incentives for charitable gifts.

We do not oppose minimum income tax proposals as such, but such proposals should not result in a reduction in tax incentives for contributions.

CEILING ON CHARITABLE BEQUESTS

It has been proposed that charitable contributions in the form of bequests be allowed up to a ceiling of 50 percent (or similar level) instead of the current 100 percent deduction. Publicly supported agencies utilize receipts from bequests for current needs, and for their endowment funds which must meet unexpected and unbudgeted emergencies, for innovative demonstration and pilot projects to find new solutions for new and old problems, and to provide a corpus to generate current income.

Jewish Federations have found this bequest income uniquely valuable. They rely heavily on the 100-percent deduction in the estate tax. To change the deduction would have a corrosive effect on these efforts and on the services they can generate.

The size of some charitable bequests is huge. Some contributors bequeath far more than they give in their lifetime—among them people who live on the income of investments and give modestly not knowing how long they will live and reluctant to invade the capital base of their income during their lifetime.

We urge that there be no change affecting charitable bequests to publicly supported agencies.

Our recent statement on this subject to the House Ways and Means Committee is appended.

For all of the above reasons, we strongly urge that no deterrent be placed in the way of existing tax incentives to charitable giving, and rather that incentives be extended to encourage even more generous contributions. This would serve historic American purposes and principles, and best help to meet the pressing needs in health, education, culture, and welfare through voluntary philanthropy.

We are also appending a copy of the resolution on "Tax Legislation Affecting Philanthropy" which was unanimously adopted in November 1975 at our general assembly by delegates representing central Jewish Federations in over 200 cities in the United States encompassing the concern with philanthropy of over 1 million Jewish families.

Statement by Council of Jewish Federations and Welfare Funds Regarding Estate and Gift Tax Proposals Affecting Charitable Bequests and Gifts

The Council of Jewish Federations and Welfare Funds is the association of central Jewish community organizations which are located in every major city in the United States and which provide funds for human needs for health welfare, aged, and similar services. These Federations obtain over $480 million annually from more than 1 million contributors. In addition to these federated campaigns, related Jewish charitable agencies raise directly about $140 million annually.

There are great benefits in tax incentives for contributions to charities in the estate and gift tax laws. They should remain unimpaired. We share this conviction with major philanthropic agencies which have testified or submitted statements to the Ways and Means Committee. We have associated ourselves with the statement presented by the Coalition for the Public Good.

Current tax provisions encourage bequests to charitable organizations by permitting the full value of such bequests to be transferred to charities without being taxed. Some proposals have been made with regard to these tax incentives for charitable bequests which would have a harmful effect on philanthropic agencies and on the ultimate individual beneficiaries served by these agencies. Such harmful proposals would limit the extent to which gifts or bequests can be made to charitable organizations unreduced by transfer taxes.

Publicly supported agencies utilize receipts from bequests for current human needs, and for their endowment funds required to meet unexpected emergencies, and to pioneer innovative programs to find new solutions for unresolved problems.

Jewish Federations have found this bequest income uniquely valuable. A sampling of reports of agencies has identified at least $22 million annually in bequests to Jewish agencies. On the basis of these data, one can conservatively project the total annual bequests to Jewish agencies to be more than double that sum. This is consistent with the ratio of bequests to total contributions for the country as a whole.

Jewish charitable agencies rely heavily on the 100-percent charitable deduction in the estate tax. To reduce this deduction would have a critically damaging effect on the services generated by these agencies. The size of some charitable bequests is very large. A number of contributors bequeath far more than they give in their lifetime.

Expert testimony before this committee in 1973 emphasized the need to maintain the current provisions involving deductions for charitable bequests to publicly supported agencies.

In addition, the American Law Institute, in its major study of the estate and gift tax laws, recommended that the 100-percent charitable deduction should be retained.

We urge that there be no change affecting charitable bequests to publicly supported agencies.

69-516 O - 76 - pt.7 - 8

TAXATION AFFECTING PHILANTHROPY

The principles defined in the resolution adopted by the general assembly in 1973 are especially timely and pertinent in view of the proposals before the Ways and Means Committee and the Congress. We strongly reaffirm that resolution.

Resolution adopted by the General Assembly of the Council of Jewish Federations and Welfare Funds, New Orleans, November 1973.

TAX LEGISLATION AFFECTING PHILANTHROPY

The millions of people served and assisted by the voluntary charitable welfare, education, and health organizations have a profound stake in tax laws affecting philanthropic gifts.

We are deeply concerned about the harmful consequences which would result from certain tax measures under consideration in the U.S. Congress. We urge that the Administration and Congress act in accordance with the following principles:

A. Existing tax provisions which enable generous charitable giving should be continued and extended. These measures are rooted in the historic American principles of making possible the discharge of voluntary responsibility for human needs. Legislation which would reduce or prejudice philanthropic support of welfare, education, and health services, would be self-defeating for it would necessarily shift burdens to government, which is presently spared the financial burden carried by voluntary contributions. Recent restrictions on governmental aid put greater pressure on voluntary agencies. Voluntarism, and the participation of millions of volunteers in voluntary agencies aiding citizens in need of health, education, and welfare services, should be strengthened by governmental policy which encourages such participation, while recognizing the vital role played by Government in these areas. Voluntarism encourages the individual to serve his fellow man. It brings a unique warmth and concern to the services provided by voluntary agencies. It provides a choice of services to the public in those areas where both voluntary and Government facilities are available. Because of the flexibility of voluntary services, they encourage innovation in service projects. Without the tax incentives which encourage voluntarism, the continued vitality of voluntary institutions could be substantially impaired.

B. Tax reform can be attained without diminishing tax deductibility which encourages generous charitable giving. A tax system which erodes the provisions for charitable deductions would be inequitable since the beneficiaries of service would be injured. It would also discourage volunteer service which is often tied to and inspired by financial gifts to these persons.

C. Charity is not a loophole. Charitable giving is unique. It is unlike any other deduction in the tax law. A person's gift is a voluntary act. He thereby reduces his income. This act should not be lumped in tax considerations with the very different transactions involved in other forms of tax reductions, which are mandatory, and with which charitable gifts have no relationship in regard to character or policy. Provisions to amend tax laws should clearly separate the impact on philanthropy from other aspects and provide sanctuary for contributions.

D. Proposed measures to tax appreciation of property donated to charities, or to disallow deductions for charitable contributions because of unrelated tax preference or to include any portion of charitable contributions in income subject to tax, would be particularly harmful. Provisions which encourage large gifts in the form of appreciated property and in bequests should not be diminished nor should ceilings be lowered for deductible contributions or bequests, nor should there be a reduction in the carryover provisions which encourage gifts by spreading tax benefits beyond a single year.

E. Tax measures to encourage philanthropic giving should be provided for people at all economic levels. Gifts from persons at middle income and lower income should also be encouraged by appropriate tax incentives without lowering incentives for large gifts. Many charities are critically dependent upon the generosity of the largest contributors.

F. The thorough review of tax provisions related to charitable giving made by the Congress in 1969 resulted in changes in the laws intended to assure the operation of these provisions with the full integrity consistent with their purposes. Proposals related to charitable giving which were then carefully evaluated and rejected should not now be enacted.

G. The proposals to disallow the first 3 percent of gross income as a deduction for charitable contributions would drastically reduce the number of taxpayers receiving tax incentives to a very small fraction of the public.

H. The proposals to substitute tax credits for tax deductions or to include charitable contributions in income subject to tax would be harmful in deterring leadership gifts. They would result in delays in decisions in gifts until the end of the year and would result in diminished support for the services which benefit those in greatest need.

Senators and Representatives are generally familiar with the vital services of voluntary philanthropic agencies in their States and districts. But the leaders of these agencies locally, and the Council of Jewish Federations nationally in cooperation with the other charitable organizations, should bring to the administration and Congress a full understanding of the damage which any such proposed legislation would unfairly inflict upon these services.

LUTHERAN COUNCIL,
New York, April 22, 1976.

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

DEAR SENATOR LONG: This statement is submitted in lieu of oral testimony by the Lutheran Council in the United States of America on behalf of the following church bodies: American Lutheran Church, Minneapolis, Minn.—2,437,000 members; Lutheran Church in America, New York, N.Y.—2,990,000 members.

The church bodies listed above have a significant supporting relationship to 30 colleges and universities, 12 theological seminaries, and 250 hospitals and welfare agencies and institutions.

The Lutheran Council, continuing a long history of Lutheran cooperation in the United States, was organized in 1966 and has among its functions, as stated in its constitution, "To represent the interests of the council and the interests of a participating body so requesting, in matters that require common action before * * * the national government. * * *"

The church bodies listed above desire to register their conviction that certain aspects of proposed tax reform legislation could have important effects upon giving to and through the churches.

We understand that the committee is seeking comments on the broad area of general tax policy. Knowing that the testimony of others representing the voluntary sector will focus on the practical and technical aspects of possible legislation, we would like to take this opportunity to enumerate six principles which we would encourage the committee to take into account as it considers the tax reform measures now before it.

1. VOLUNTARY ORGANIZATIONS ARE BASIC TO A FREE AND OPEN SOCIETY

That your legislative predecessors established the concept of tax exemption for contributions to charitable, educational, and religious organizations was not by chance. Through the years congressional actions have been helpful by providing liberal incentives for charitable giving. Were it not for the encouragement of Federal, State, and local governments and the generosity of our citizens, American voluntarism could not be the vital element that it is in our society.

A free and open society depends upon the activity, dynamics and spontaneity of the variety of free associations within its ranks. Our government is characterized and enhanced by the genuine and lively pluralism which is thus produced.

By contrast, a society which exists for the sake of the State has no such pluralism. In a totalitarian state and society the state organizes, pays for, and controls all forms of association. Social organizations for children, young people, and adults—all schools and education, all health programs and activity, all churches and religious organizations—are sponsored and paid for by the state, are components of the state and ultimately are dominated by the state.

2. FREE ASSOCIATIONS CONSTITUTE A TRAINING GROUND FOR DEMOCRACY

Many of our citizens are trained in the democratic process within the free associations produced by American voluntarism. While true for all age groups, this training and experience is especially important for our youth.

Free and solvent associations such as Boy Scouts of America, Campfire Girls, Inc., Boys Clubs of America, Junior Achievement, and Girl Scouts of the U.S.A. are basic training centers for a democratic society. In such associations our youth are groomed to elect officials, debate issues, and develop wholesome respect for the views of the minority as well as the majority. Throughout, they are maturing in the democratic process of effective decisionmaking. We should think twice before adopting any legislation that would undercut or weaken such associations.

3. RELIGIOUS INSTITUTIONS MAKE A SPECIAL CONTRIBUTION BY PROVIDING A MORAL BASIS FOR SOCIETY

The founders of our Nation and their successors in Government have consistently shown their appreciation for the significant role and contributions of religious institutions to our society. While they opposed State support for religious organizations, they wanted at the same time to make certain that citizens would enjoy the freedom and encouragement to generously support religious institutions.

These institutions have traditionally provided a moral basis for decency and honesty within society. This still is the case. For the Government to assume primary responsibilities for inculcating these virtues would be alien to the American way. The temptation could be too strong to impose a set of mores or concepts of honesty and decency designed to serve the self-interests of the state.

Religious institutions have also served, as Martin Luther said, to "admonish conscience." In this prophetic role they have constructively assisted the state in defining what justice requires and the moral imperatives behind the state's responsibility in caring for the basic needs of its citizens. They do this out of a religious obligation central to their mission to society. This is an essential contribution to society uniquely, if not exclusively, expected of the churches.

4. TAX RELIEF IS NOT SUBSIDY

Tax relief for private donations to voluntary associations does not constitute subsidy of them. The principle involved is that gifts given for nonprofit, charitable purposes shall flow in full, undiluted by any tax responsibility on the part of the giver or the receipient.

Such money is neither "saved" by the individual giver nor ultimately "lost" to the Government. A significant portion is paid out in salaries to those who are employed by these labor intensive associations. Other portions are given in services to the poor and unfortunate, services which the Government would be obliged to provide if the association did not. Some funds are spent in the construction or rent of buildings to house staff and service functions. One way or another these funds flow back into the economy with no small part ending up in withholding and excise taxes and social security. Our point is that gift dollars do not finally escape taxation.

We are not asking for gifts of tax dollars from Government and, by extension, from those who are not voluntarily supporting our work. We are asking that the flow of gifts from our contributors not be intercepted or diminished by taxing either the giver or receiver of these gifts. By not taxing the dollars given or received for charitable purposes, the Government assures that such dollars help optimize the purposes of the receiving organization. To alter this policy would only serve to impede vital services.

5. TAX LAW CHANGES MUST BE CAREFULLY CONSIDERED

We favor a continuing search for more equitable tax policy and administration through a tax reform. We also see tax law as an instrument which helps to shape social policy.

Some States have decided that to levy a sales tax on food purchases is improper. This is a decision of social policy.

The Federal Government has decided not to tax profit from the sale of a personal home if within a certain span of time the funds are used for purchase of another residence. This is a decision of social policy. So also is the decision not to tax the portion of a person's income used for the barest essentials of life (the personal exemptions). Tax paid to a State government is exempt from Federal tax. This is a decision of social policy no doubt based on a conceptualization of the distribution of powers.

Our testimony argues that to permit and further to encourage the activities of voluntary associations on the basis of their value to the persons they serve and for their value to society in general is reasonable social policy.

6. PRIVATE INITIATIVE SHOULD BE ENCOURAGED BY TAX POLICY

The nature of man is such that he must always have a relationship to associations which center on his concerns and interests. Human beings are always organizing into interest groups. This is true in both totalitarian and democratic societies. Moreover, the services provided by voluntary associations are essential in one form or another to our common life—educational institutions, hospitals, homes for children and the aging, and the like.

Already hard-pressed institutions are unquestionably dependent on the gifts which tax deductions stimulate. If the U.S. Government ceases to encourage the private support of free associations, it confronts the alternatives of either supporting these associations directly, in which case they would no longer remain free, or letting them die for lack of support and then confronting the financing of new agencies which would seek to provide similar functions. The result in both cases is destruction of the vitality and the role of free associations. This is not simply a question of tax dollars; it is primarily a question of the nature and dynamics of American society and American democracy itself.

If we want a democratic society and Government, every effort must be made to encourage the private initiative of citizens to maintain and strengthen the rich diversity and pluralism of free associations and organizations. This has been done and in the future can be done by giving citizens tax relief to support such organizations.

CONCLUSION

While we have limited our comments to philosophical considerations, we have done so only because we know that others in the voluntary sector will address a whole range of practical concerns.

We, too, are concerned about the financial implications of certain elements of the tax reform legislation now being considered but would in conclusion press for your particular attention to the potential effect of some currently proposed legislation in decreasing the effectiveness of and increasing the control over the free associations so essential to our society.

Therefore, on behalf of the above-mentioned participating church bodies and the more than 290 colleges, seminaries, hospitals and welfare institutions they support, the Lutheran Council in the U.S.A.

respectfully urges that any tax law continue the long-established and essential tax incentives to charitable giving which mean so much to the financial stability and program effectiveness of America's voluntary institutions.

Sincerely yours,

GEORGE F. HARKINS,
General Secretary.

STATEMENT OF PRESIDENT JAMES H. ZUMBERGE, SOUTHERN METHODIST UNIVERSITY, DALLAS, TEX.

I. INTRODUCTION

A. Mr. Chairman, and members of the committee: I am James H. Zumberge, president of Southern Methodist University, Dallas, Tex., and a member of its board of governors.

I am very grateful for this opportunity to submit this statement on matters before this committee during your hearings on the general subject of tax reform for the record of your hearings. This statement is submitted on behalf of Southern Methodist University and its board of governors and board of trustees. The membership of each board is provided to this committee through the list provided in appendix A herein included to be a part of this statement.

B. Southern Methodist University was founded in 1911 and enrolled its first students in 1915. At its opening session the university had two buildings, 706 students, a faculty of 35 and an endowment of $279,178 on a 700 acre campus. Today, Southern Methodist University inventories more than 80 buildings in its physical plant, some 60 of which were constructed since World War II, a faculty of 477 employed on a part-time basis, and an endowment fund of nearly $48 million. Our student enrollment has averaged 10,000 in the past few years. In the 60 years since our founding we have conferred over 40,000 baccalaureate degrees. Today we offer courses in eight schools leading to 237 bachelors', masters', and doctoral degrees in 110 fields of study. Southern Methodist University is now one of the largest independent universities in the combined South and Southwestern geographic areas of the United States, although it is considered moderate in size when compared with other major institutions of similar academic scope. Our total annual budget for the 1975–76 academic year is in excess of $36 million.

The reason for this data on Southern Methodist University is to familiarize you with our specific institution. This data is, however, typical and representative of other independent colleges and universities. And like many other independent universities, we are struggling with rising costs, reduced income and the necessity of increased tuition. We have an accumulated deficit resulting from current operations approaching $5 million incurred essentially within the past decade.

II. HISTORY OF FINANCIAL SUPPORT

A. The university was founded and established by a commission of the Methodist Church when the citizens of Dallas raised $300,000 in private subscriptions to construct the first building, and donated over

700 acres, which provided the land and original endowment. At that time, even in our early years, 100 citizens of Dallas gave $1,000 or more to the founding of the fledgling university. A gift of $110,500 from the general education board, founded by John D. Rockefeller, was of utmost importance in insuring the success of the new university.

B. Contributions to Southern Methodist University from private citizens, corporations, and foundations for capital purposes and current restricted and unrestricted purposes is detailed in appendix B to this report for your information. The United Methodist Church continues a strong tie with the university through support received from the Texas Methodist College Association, an agency of the higher education board of the United Methodist Church. While the contribution to the entire university budget may be considered small when compared to the entire operating budget, it represents approximately 5 percent of the annual operating budget for the university as a whole. These resources are also from the private sector, in that contributions from the United Methodist Church are funded by conference askings of all of the separate United Methodist Church congregations. Appendix C attached to this report details the revenues for current operations in the past 10 years. These figures illustrate our annual budget and annual revenues showing an increasing spread between our sources of revenue and the costs of operations. This spread must be filled by increased support from individuals, businesses, and foundations.

The tuition charged our students is also illustrated indicating the increasing cost per student to attend a private church-related institution. While great effort is made to keep the increase in tuition at a modest level each year, the result has been an even greater reliance on the private gift to maintain an essentially deficit-free operation each year. This has resulted in a growing disparity between the cost of tuition and the cost of education. A student enrolled in 1975–76 academic year, paying full tuition actually contributes approximately 60 percent of the cost of operations. Total tuition and fee revenues for 1975–76 academic year are projected at $22 million or 61 percent of the projected cost of operations of $36,135,000. The balance of revenues must come from (1) income from endowment, (2) auxiliary enterprise income, (3) fees charged our students, and (4) gifts from private sources. We are projecting a shortfall in revenues of approximately $750,000 for the current fiscal year, of which $400,000 is represented by a shortfall in current gift income. Bequests and lifetime transfers in the deferred gift category have become increasingly important in the past few years. Substantial resources have been developed through outright bequests of money or property in the first half of the present decade. In addition, the current year has seen substantial sums released for the university's purposes from deferred gifts which have terminated amounting to over $300,000 with the major portions being added to the endowment of the university to augment endowed scholarship resources.

III. COMMENTS AND RECOMMENDATIONS ON CERTAIN SECTIONS OF THE HOUSE-PASSED TAX REVISION BILL (H.R. 10612) CONCERNING CHARITABLE CONTRIBUTIONS

A. Minimum tax proposals contained in section 301 of H.R. 10612 applying to transfers of appreciated property to short-term charitable

income trusts, as defined in section 170(f)(2)(B) of the Internal Revenue Code of 1954.

These trusts, as in the case of charitable remainder annuity trusts and unitrusts and pooled income fund trusts should be exempt from the provisions of section 701; H.R. 10612. It is illogical to include them because their essential purpose remains the same, that of providing a vehicle through which resources may be diverted to qualified charitable institutions—even if for a period of time—during which no benefit inures to the donor (maker) during the period of the trust. To so include, would indeed create an undeserved penalty, and surely offer no incentive to prospective donors. These trusts are highly beneficial to charitable organizations, including Southern Methodist. Their use would be discouraged if the provisions apply. In a transfer of appreciated property to this form of trust, the income which is diverted to support the charitable purposes, need not be distinguished between the proceeds which are created from the appreciated portion of the trust assets, and the cost basis portion of the assets. To not have included these trusts appears to be an oversight in the House bill because of the exclusion from the provision provided the unitrust, annuity trust, and life income pooled-fund trusts. The great preponderance of property placed in charitable remainder trusts is appreciated in nature, and this would create an undue—and surely underserved—penalty on donors (makers).

IV. COMMENTS ON OTHER TAX REVISION PROPOSALS WHICH ADVERSELY AFFECT CHARITABLE GIVING

1. The Tax Reform Act of 1969 was far reaching. Not only did it provide substantial legislation governing the operation of pooled income trusts by qualified charitable institutions, which was an effect we applaud, it included several over corrections which in their impact have removed several important incentives to charitable gifts.

A. Contribution of inventory, crops, works of art, and short-term property.

Under prior law

A donor was allowed an income tax charitable contribution deduction for the property's full present fair market value.

Current law

The charitable contribution deduction is allowed for the fair market value discounted (reduced) by the amount which would be taxed as ordinary income on a sale, in effect providing a charitable contribution for the property's cost basis only.

Recommendation

A charitable contribution deduction should be allowed providing the gift qualifies under all provisions of the code as directly attributable (applicable) to the exempt purpose of the qualified charitable institution, for the property's full fair market value minus one-half the amount which would be taxed as ordinary income on a sale. We feel that this is a reasonable compromise between the former and current law. Reducing the charitable contribution deduction by one-half the amount which would have been taxed as ordinary income on the sale insures that a donor is not unjustly enriched through the sheltering of other income through the use of contribution deduction.

B. Contribution of appreciated long-term tangible personal property, for a related use to charitable institutions.

We oppose proposals which would limit the charitable deduction to the property's cost basis, or to the property's fair market value minus one-half of the appreciation. We also oppose the proposals which would tax the value of appreciation just as if the donor had sold the property and contributed the proceeds, or those proposals which would require a longer holding period (e.g., 1 year) for a donor to be allowed a charitable contribution deduction for the fair market value, or subjecting the property's appreciation to the 10 percent or other suggested minimum tax. In addition we oppose any tax of the appreciation element of gifts of appreciated property given to charitable organizations at death.

Gifts of appreciated tangible personal property, whether given during life or at death, are an important source of enrichment of the educational enterprise. Often, items for research, objects of art, libraries, having a related use to our education programs are given outright during life or at death through one's estate which add measurable quality to the offerings of our institution. Many items would be impossible to acquire because of prohibition of costs. Yet they are directly responsible for the quality of our instruction. Our libraries are full of outstanding items which become important to our instruction, our art museum as part of the school of the arts, has been enriched through contribution of important items, once held by individuals and now shared by many through their availability to students, faculty, and the community at large.

Recently, Southern Methodist University was bequeathed an entire estate, less some minor specific bequests, to support research, teaching, and operation of the chemistry department.

Tangible personal property in the estate not bequeathed to others, will add measurably to the resources which will be available to the growth and development of the department of chemistry at this institution. When final distributions are made, this estate will approximate $2 million for the benefit of our programs in the department of chemistry. It will enable this institution to hold and secure outstanding faculty, which is the heart of any educational enterprise. If a ceiling on deductibility of bequests were enacted, one simply has to question, what resources the Federal Government is prepared to provide, to match the same enrichment to this particular program, within the framework of a free and independent educational institution.

C. Contribution of personal residence or farm with retained life estate or outright.

The Tax Reform Act of 1969 has effectively crushed this form of gift vehicle through the problems presented when mortgaged property is considered. When a donor makes an outright contribution of mortgaged property, he is considered to have made a bargain sale to the charitable donee. Under regulation section 1.1011-2(a)(3), the donor is deemed to have sold the gift property to the charitable organization for the amount of the mortgage—and this is so even though the donee organization does not agree to assume or pay the indebtedness.

When the donor makes the contribution of a personal residence or farm with retained life estate, the matter becomes even less attractive, it is not impossible. Here are the problems:

1. Self-dealing

Regulation section 4941 is held to be applicable under self-dealing provisions. Thus, a donor cannot transfer a mortgaged asset to fund a charitable trust of any kind if the mortgage was placed on the property within the previous 10 years.

2. Capital gains

The mere transfer of mortgaged property (even held more than 10 years since the mortgage was placed upon it) is considered again a bargain sale generating capital gain for the donor.

3. Unrelated business income

Charitable remainder trusts of all forms are not exempt from income taxes if they have unrelated business taxable income under section 664(c). This is an overcorrection in the Tax Reform Act of 1969. In the instance where a charitable organization may have to borrow to make annual payments, the Treasury believes that the resulting indebtedness creates deft-financed income in the trust, taxable as unrelated business taxable income. A charitable organization accepting mortgaged property in exchange for its promise to pay an annuity would itself be subject to tax on unrelated business taxable income. This is so, even if the charitable organization has made no commitment or liability in satisfying the mortgage.

SUGGESTED CHANGES

1. An outright charitable gift or mortgaged property should not be considered a bargain sale.
2. The prohibition on transferring a mortgaged asset—even when the mortgage was placed upon the property within the past 10 years should not apply to charitable trusts, or gifts of personal residence or farm with retained life estate.
3. Capital gains should not be incurred in the same kind of transfers.
4. Unrelated business taxable income should not be incurred merely because the trust holds mortgaged property or borrows to meet trust payments.
5. A charitable gift annuity funded with mortgaged property should not give rise to unrelated business taxable income.

V. CLOSING STATEMENT

As an independent institution Southern Methodist University must rely heavily on gifts as shown in these appendixes. We obtain our operating revenues from tuition and fees paid by our students, income from investments, and (importantly) annual contributions from alumni, business firms, friends, and foundations. In a unique adventure designed to supply our growing budget with vital operating capital, the citizens of Dallas, including alumni, nonalumni and

business firms, annually contribute more than $700,000 to the university's unrestricted resources in a communitywide annual sustentation drive.

It is interesting to note that a parallel may be drawn between the increasing financial support received from the private sector for Southern Methodist University on the one hand, and the encouragement the Federal Government has provided through tax incentives for making charitable gifts on the other. Congress first provided a contribution deduction with a 15 percent ceiling on gifts in 1917, almost concurrently with the founding of this university. This incentive has been reaffirmed over the years, and increased to the present 50 percent of adjusted gross income ceiling with a 5-year carryover for any excess earned deduction, thereby providing a substantial incentive for our growth and development through support from the private sector.

There is a practical reason for the Government to encourage voluntary support for charitable uses. While the loss in revenue to the public treasury occasioned by the thoughtful use of the tax considerations provided by the contribution deduction is small indeed, the reduction of the incentives suggested in the current debate would create devastating results for those privately supported institutions which must rely heavily on the private gift, and which do so in large measure, without seeking or requiring substantial Government resources to carry on their vital role in the fabric of American social and academic development.

We are aware of the opinion held by many that the charitable contribution deduction is held to provide a shelter under which persons may escape paying their fair share of Federal taxes. We are also cognizant of the pressure from those of liberal persuasion to formulate methods to redistribute the wealth, and failure to do so continues a history of malappropriation of American wealth and resources.

In response we most strongly assert that the contribution deduction cannot fairly be said to be a malappropriation of American wealth and resources, nor does it substantially contribute to the reduction of tax assessment considered unethical or unlawful by the wealthy. It is occasioned by the voluntary and free will charitable contribution of money or property in support of those institutions which are perceived by the donating public as those which respond most effectively to the problems of our society or which seem, in the public's mind, to preserve and protect for generations yet to be born, that which is important, characteristic or symbolic of American society. Of all the deductions made available to individuals and corporations, the charitable contribution is uniquie in that the benefit occasioned by the deduction resulted from an act which inures not the the donor but to the charitable donee.

The proposals under consideration in H.R. 10612 and the debate before this committee manipulate the essential difference between the charitable contribution deduction and other deductions in our tax laws which give rise to reduction in tax liability of one form or another,

as being essentially of the same character. Such is not the case, and such is our assertion. The Congress of the United States should have the benefit of our considerations through recommendations from this distinguished committee. You bear a deep responsibility to assure that the character of American generosity is not so altered as to render this important flow of American wealth and resources from the private sector to the public good, ineffective, indeed nearly impossible to maintain.

The benefactor referred to earlier, was in fact a benefactor of several qualified charitable institutions, by bequeathing nearly her entire estate for public charitable purposes, including, universities, hospitals, art museums, and health organizations. Without a ceiling on her testamentary transfer, the properties were placed directly into the programs at 100 percent of their value. This wealth, and it was substantial numbering several millions of dollars, has in effect been equitably redistributed by now moving from privately held wealth of one person, into several funds which respond to public needs and purposes. As such, this wealth has been permanently diverted to fund activities which the Government would not, or could not, undertake.

The treatment of charitable gifts was thoroughly considered by Congress in connection with the Tax Reform Act of 1969 and reflects an evident purpose to retain tax incentives except where in some instances overcorrections resulted. We strongly urge that Congress does not undertake to reform the tax laws again so that the incentives we have cited, and others which have been testified to are not eroded. In a charitable transfer whether outright or through an estate, or a transfer reserving a life estate, a donor has, after all, made a completed gift or irrevocable transfer of both his cost basis and the value of appreciation, both of which support the charitable institution. The charitable institution need make no distinction in most cases, between that value represented by a donor's cost basis and that value represented by appreciation. A taxation on any part of appreciation on donated property will reduce a major source of support for charitable purposes, and in effect, impose a tax on that which a donor has given away.

Mr. Chairman, and members of the committee, I want to extend to you the deep thanks on behalf of SMU, its board of governors and board of trustees for this opportunity to present this statement for the record of your committee. We hope that you will do nothing to reduce the incentives for charitable giving on behalf of all institutions which must rely upon the private generosity of our citizens to maintain healthy and viable independent educational enterprises.

APPENDIX A

Board of Trustees, Southern Methodist University, Dallas, Tex.

The Honorable Carl Albert, The Speaker, U.S. House of Representatives, Washington, D.C.

Mrs. Jack Blanton, 3390 Inwood Drive, Houston, Tex.

Dr. Marvin L. Boyd, 6116A Bullard Drive, Austin, Tex.

Bishop Alsie H. Carleton, the United Methodist Church, 1201 First National Bank Building (East), Albuquerque, N. Mex.

Mr. O. V. Cecil, 1566 Dallas Federal Savings Tower, 8333 Douglas, Dallas, Tex.

Mr. James M. Chambers, Jr., chairman of the board and chief executive officer, the Dallas Times Herald, Dallas, Tex.

Mr. Richmond C. Coburn, Coburn, Croft, Shepherd & Herzog, attorneys at law, 411 North 7th, St. Louis, Mo.

The Honorable James M. Collins, U.S. Congressman, U.S. House of Representatives, 2419 Rayburn House Office Building, Washington, D.C.

Dr. Emmett J. Conrad, 4432 South Oakland, Dallas, Tex.

Mr. O. Paul Corley,[1] executive vice president and director, American Liberty Oil Co., 4100 First National Bank Building, Dallas, Tex.

Mr. Leo F. Corrigan, Jr.,[1] president, Corrigan Properties, 211 North Ervay, 17th Floor, Dallas, Tex.

Mr. Edwin L. Cox,[1] vice chairman of board of trustees, 3800 First National Bank Building, Dallas, Tex.

Mr. Frank M. Crossen, chairman of the board, Centex Corp., 4600 Republic National Bank Tower, Dallas, Tex.

Mr. Trammell Crow, Trammell Crow Co., 32d Floor, Bryan Tower, Dallas, Tex.

Bishop Finis A. Crutchfield, the United Methodist Church, 1915 American Bank Building, 200 Carondelet, New Orleans, La.

Mr. George P. Cullum, Jr., president, Cullum Construction Co., Inc., P.O. Box 8455, Dallas, Tex.

Mr. Robert B. Cullum,[1] chairman of the board, Cullum Construction Co., Inc., 14303 Inwood Road, Dallas, Tex.

Bishop A. D. Davies, Episcopal Church of Dallas, St. Matthews, 1630 N. Garrett Street, Dallas, Tex.

Mrs. Wilfred S. Dietrich, Ray Oil Co., 1348 One Energy Square Building, 4925 Greenville Ave., Dallas, Tex.

Bishop Ernest T. Dixon, Jr., the United Methodist Church, 4201 West 15th Street, Topeka, Kans.

Mr. G. Alan Dunlap, president, Farmers and Merchants Bank, Milford, Nebr.

Mr. Robert C. Dunlap, Jr., 5405 Falls Road, Dallas, Tex.

Mr. J. Lindsay Embrey, First Continental Enterprises, P.O. Box 30326, Dallas, Tex.

Mr. Wilton H. Fair, Fair Oil Co., P.O. Box 689, Tyler, Tex.

Mr. Charles W. Ferguson, Apple Tree Hill, Mount Kisco, N.Y.

Mr. Robert S. Folsom, Folsom Investments, P.O. Box 20955, Dallas, Tex.

Mrs. W. W. Fondren, 3755 Knollwood, Houston, Tex.

Bishop Eugene M. Frank, the United Methodist Church, 723 Center Street, Little Rock, Ark.

Dr. Stanley Friesen, professor of surgery, University of Kansas Medical Center, Kansas City, Kans.

Bishop Paul V. Galloway, The United Methodist Church, 5215 South Main St., Houston, Tex.

---

[1] Also member of board of governors. 10 bishops plus 74 others. Total 84 trustees. Officers of the board of trustees: Mr. C. A. Tatum, Jr., chairman; Bishop O. Eugene Slater, vice chairman; Mr. Edwin L. Cox, vice chairman; Mr. Harry A. Shuford, secretary; and Miss Phoebe A. Davis, assistant secretary.

Mr. E. Wilson Germany, E. B. Germany & Sons, P.O. Box 12266, Dallas, Tex.

Mr. Robert E. Glaze, Trammell Crow Co., 2001 Bryan St., Suite 3200, Dallas, Tex.

Dr. Josué González, pastor, Emmanuel United Methodist Church, 200 Brushy St., Austin, Tex.

Mr. Kenneth M. Good, Good Financial Corp., 2001 Bryan Tower, 25th Floor, Dallas, Tex.

Bishop Robert Goodrich, Jr., The United Methodist Church, 55 Plaza Sq., St. Louis, Mo.

Mrs. Cecil H. Green, 3908 Lexington Ave., Dallas, Tex.

Mr. James S. Hall, president, First Arkansas Bankstock Corp., Worthen Bank Bldg., Little Rock, Ark.

Mr. Jake L. Hamon, P.O. Box 663, Dallas, Tex.

Mr. Jess Hay,[1] Chairman of the board and chief executive officer, Lomas & Nettleton Financial Corp., P.O. Box 5644, Dallas, Tex.

Mr. W. Owen Henderson, president, The Huntingfield Foundation, Huntingfield Farm, Rock Hall, Md.

Bishop Don W. Holter, The United Methodist Church, Box 4553, Lincoln, Nebr.

Mr. Bob Hope, 10346 Moorpark, North Hollywood, Calif.

Mr. Floyd B. James,[1] chairman of the board of directors, T. L. James & Co., Inc., P.O. Box O, Ruston, La.

Mr. George R. Jordan, Jr., president, Great Southern Life Insurance Co., P.O. Box 1972, Houston, Tex.

Mr. Arthur Kungle, Sr., P.O. Box 186, Joplin, Mo.

Dr. Carl F. Lueg, The United Methodist Church, 839 Monrovia St., Shreveport, La.

Mr. John F. Lynch, director, Texas Eastern Transmission Corp., P.O. Box 2521, Houston, Tex.

Dr. Wayne H. McCleskey, pastor, Marvin United Methodist Church, 300 West Erwin St., Tyler, Tex.

Mrs. Eugene McElvaney, The Athena, Apartment 915, 6335 West Northwest Highway, Dallas, Tex.

Mr. Gerald C. Mann, P.O. Box 45306, Dallas, Tex.

Mr. Stanley Marcus, Carter Hawley Hale Stores, Inc., 4800 Republic National Tower, Dallas, Tex.

Mr. Algur H. Meadows,[1] chairman of the board and executive committee General American Oil Co. of Texas, Meadows Bldg., Dallas, Tex.

Bishop Paul W. Milhouse, The United Methodist Church, P.O. Box. 60565, Oklahoma City, Okla.

Mr. Henry S. Miller, Jr., chairman of the board, Henry S. Miller Co., 2001 Bryan Tower, 30th Floor, Dallas, Tex.

The Hon. Alfred P. Murrah, U.S. Senior Circuit Judge, U.S. Court of Appeals, 10th Circuit, P.O. Box 1238, Oklahoma City, Okla.

The Honorable James L. Noel, Jr., U.S. District Judge, U.S. Court House, Southern District of Texas, Houston, Tex.

---

[1] Ibid.

Mr. Peter O'Donnell, Jr.,[1] Investments, 4275 First National Bank Bldg., Dallas, Tex.

Mrs. J. J. Perkins, 2303 Farington Rd., Wichita Falls, Tex.

Mrs. Charles Prothro, 3301 Harrison St., Wichita Falls, Tex.

Mr. James Redman, chairman of the board, Redman Industries, Inc., 2550 Walnut Hill Lane, Redman Plaza East, Dallas, Tex.

Mr. Ralph B. Rogers, chairman of the board, Texas Industries, Inc., 8100 Carpenter Freeway, Dallas, Tex.

Mr. Jackson S. Ryan, president, Corpus Christi Brick & Lumber Co., P.O. Box 247, Corpus Christi, Tex.

Dr. Joe B. Scrimshire, First United Methodist Church, 1526 Montana, El Paso, Tex.

Dr. Cleo C. Sessions, The United Methodist Church, P.O. Box 156, Waxahachie, Tex.

Mrs. Charles S. Sharp,[1] 5227 Meaders Lane, Dallas, Tex.

Mr. Mark Shepherd, Jr.,[1] president, Texas Instruments, Inc., P.O. Box 5474, Dallas, Tex.

Mr. Harry A. Shuford, secretary of the board of trustees, chairman of the board, First National Bank in Dallas, P.O. Box 6031, Dallas, Tex.

Bishop O. Eugene Slater, vice chairman of board of trustees, the United Methodist Church, P.O. Box 28509, San Antonio, Tex.

Mrs. Robert E. Smith, 2000 West Loop St., Suite 1900, Houston, Tex.

Mr. Robert H. Stewart, III,[1] chairman of the board, First International Bancshares, Inc., P.O. Box 6031, Dallas, Tex.

Bishop W. McFerrin Stowe,[1] the United Methodist Church, P.O. Box 8124, Dallas, Tex.

Mrs. Robert B. Sunderland, 4115 Sylvan Oaks, San Antonio, Tex.

Mr. Andrew W. Tarkington, 920 Porpoise, Lakeway, Austin, Tex.

Mr. C. A. Tatum, Jr.,[1] chairman of board of trustees, Texas Utilities Co., 2001 Bryan Tower, Dallas, Tex.

The Honorable John G. Tower, U.S. Senator, 142 Senate Office Building, Washington, D.C.

Mr. W. B. Trammell, W. B. Trammell Co., 601 Southern National Bank Building, Houston, Tex.

Mr. George M. Underwood, Jr.,[1] president, Richardson Heights, Inc., 7540 L. B. J. Freeway, 620 Park Central West, Dallas, Tex.

Mrs. W. F. Whitfield, P. O. Box 3279, Albuquerque, N. Mex.

The Reverend Richard B. Wilke, the First United Methodist, 330 North Broadway, Wichita, Kans.

Mr. Philip Wilson, c/o Brady, Drake, & Wilson, 3275 First National Bank Building, Dallas, Tex.

Mr. John D. Wisenbaker, president and chairman of the board, Core Laboratories, Inc., P.O. Box 10185, Dallas, Tex.

Mr. Sam Wyly, chairman of the board of directors, University Computing Co., P.O. Box 6228, Dallas, Tex.

---

[1] Ibid.

Mr. Robert A. Young III, president and chief admiinstrative officer, Arkansas Best Corp., 1000 South 21st Street, Fort Smith, Ark.

Mr. Donald Zale, president and chief executive officer, Zale Corp., P.O. Box 2219, Dallas, Tex.

Board of Governors of Board of Trustees, Southern Methodist University, Dallas, Tex.

Mr. James W. Aston, chairman of the board and chief Executive officer, Republic of Texas Corp., P.O. Box 22105, Dallas, Tex.

Mr. O. Paul Corley,[2] executive vice president and director, American Liberty Oil Co., 4100 First National Bank Bldg., Dallas, Tex.

Mr. Leo F. Corrigan, Jr.,[2] Vice Chairman of Board of Governors, president, Corrigan Properties, Inc., 211 North Ervay, 17th Floor, Dallas, Tex.

Mr. Edwin L. Cox,[2] Chairman of Board of Governors, 3800 First National Bank Bldg., Dallas, Tex.

Mr. Robert B. Cullum,[2] chairman of the board, Cullum Companies, Inc., 14303 Inwood Rd., Dallas, Tex.

Mr. Robert C. Dunlap, Jr.,[2] 5405 Falls Rd., Dallas, Tex.

Mr. Jess Hay,[2] chairman of the board and chief executive officer, Lomas & Nettleton Financial Corp., P.O. Box 5644, Dallas, Tex.

Mr. Floyd B. James,[2] chairman of board of directors, T. L. James & Co., Inc., P.O. Box O, Ruston, La.

Mr. Algur H. Meadows,[2] chairman of the board and executive committee, General American Oil Co., of Texas, Meadows Bldg., Dallas, Tex.

Mr. Peter O'Donnell, Jr.,[2] Investments, 4275 First National Bank Bldg., Dallas, Tex.

Miss Bette Perot, 7171 Forest Lane, Dallas, Tex.

Mr. Charles Prothro, president, Perkins-Prothro Co., P.O. Box 2099, Wichita Falls, Tex.

Mr. Robert F. Ritchie, Ritchie, Crosland & Egan, 1100 Republic National Bank Bldg., Dallas, Tex.

Mrs. Charles S. Sharp,[2] 5227 Meaders Lane, Dallas, Tex.

Mr. Mark Shepard, Jr.,[2] president, Texas Instruments Inc., P.O. Box 5474, Dallas, Tex.

Mr. Robert H. Stewart III,[2] chairman of the board, First International Bancshares, Inc., P.O. Box 6031, Dallas, Tex.

Bishop W. McFerrin Stowe,[2] The United Methodist Church, P.O. Box 8124, Dallas, Tex.

Dr. Willis M. Tate, chancellor, Southern Methodist University, Dallas, Tex.

Mr. C. A. Tatum, Jr.,[2] Texas Utilities Co., 2001 Bryan Tower, Dallas, Tex.

Mr. George M. Underwood, Jr.,[2] president, Richardson Heights, Inc., 12700 Park Central Place, Dallas, Tex.

Dr. James H. Zumberge, President, Southern Methodist University, Dallas, Tex.

---

[2] Also member of board of trustees. Officers of board of governors: Mr. Edwin L. Cox, chairman; Mr. Leo F. Corrigan, Jr., vice chairman; and Miss Phoebe A. Davis, SMU, secretary.

APPENDIX B

RECORD OF GIFTS AND GRANTS TO SOUTHERN METHODIST UNIVERSITY, 1965-75

Year	Total support	Current operations	Capital purposes	Corporation and business	Religious denominations	Alumni	Other individuals	General welfare foundations	Other groups and sources	Bequests	Annuities life contracts insurance
1965-66	4, 785, 849	1, 832, 354	2, 953, 495	182, 113	387, 183	300, 526	1, 141, 247	2, 742, 184	32, 596	0	0
1966-67	4, 132, 785	1, 965, 246	2, 167, 539	831, 737	330, 625	320, 365	1, 649, 338	926, 918	73, 802	0	0
1967-68	4, 899, 951	1, 999, 787	2, 900, 164	391, 479	517, 817	437, 227	2, 329, 634	1, 119, 042	104, 752	0	0
1968-69	6, 320, 828	2, 469, 366	3, 851, 462	616, 599	349, 891	645, 248	1, 611, 751	2, 439, 609	657, 730	118, 674	544, 867
1969-70	9, 346, 165	3, 413, 577	5, 932, 588	826, 196	577, 247	1, 227, 388	1, 812, 739	3, 806, 055	1, 096, 540	0	13, 043
1970-71	6, 915, 926	3, 807, 049	3, 108, 877	1, 093, 562	436, 585	1, 846, 763	1, 051, 563	1, 782, 352	705, 101	10, 000	0
1971-72	10, 909, 631	3, 482, 581	7, 427, 050	869, 521	490, 760	4, 331, 716	2, 217, 839	2, 232, 088	767, 707	931, 066	4, 758, 000
1972-73	8, 809, 415	4, 255, 324	4, 554, 091	1, 080, 833	526, 885	2, 215, 446	1, 312, 892	3, 049, 542	623, 817	396, 447	123, 376
1973-74	13, 430, 198	4, 842, 106	8, 588, 092	953, 161	679, 192	3, 396, 308	3, 738, 896	3, 717, 263	945, 378	2, 711, 720	21, 933
1974-75	13, 061, 042	5, 043, 119	8, 017, 923	876, 747	555, 475	2, 535, 296	7, 032, 624	1, 360, 619	702, 281	5, 444, 750	19, 131
Total 10 yr	82, 611, 790	33, 110, 509	49, 501, 281	7, 721, 948	4, 851, 660	17, 254, 283	23, 898, 523	23, 175, 672	5, 709, 704	9, 612, 657	5, 480, 350

Year	Government Research	Government Other	Government Total
1971-72	976,534	788,056	1,764,590
1972-73	1,243,605	620,602	1,864,207
1973-74	1,087,309	648,476	1,735,785
1974-75	1,776,178	261,751	2,037,929

APPENDIX C

SOUTHERN METHODIST UNIVERSITY CURRENT UNRESTRICTED REVENUE AND EXPENDITURES

[Thousands omitted]

Fiscal year	Revenue	Expenditures	Indicated surplus (deficit)[1]	Unrestricted gifts to operations
1965-66	13,621	13,584	37	1,204
1966-67	16,319	16,149	170	1,458
1967-68	18,155	18,420	(265)	1,922
1968-69	19,892	21,658	(1,766)	1,747
1969-70	23,811	24,904	(1,093)	2,101
1970-71	26,931	27,917	(986)	2,870
1971-72	27,906	27,312	594	2,688
1972-73	30,305	30,295	10	2,824
1973-74	33,204	32,734	470	3,578
1974-75	34,822	36,878	(2,056)	3,134
Total	244,966	249,851	(4,885)	23,524

[1] Deficits for years 1968-71 are largely offset by realizing gains on investments or reserves.

SOUTHERN METHODIST UNIVERSITY TUITION AND FEES CHARGED OUR STUDENTS, 1965-75

Year	Per semester tuition	Per semester fees	Total 2 semesters
1965-66	$500.00	$51.50	$1,103.00
1966-67	600.00	51.50	1,303.00
1967-68	600.00	51.50	1,303.00
1968-69	600.00	70.00	1,340.00
1969-70	700.00	75.00	1,550.00
1970-71	800.00	75.00	1,750.00
1971-72	900.00	75.00	1,950.00
1972-73	900.00	80.00	1,960.00
1973-74	1,000.00	100.00	2,200.00
1974-75	1,100.00	125.00	2,450.00
1975-76	1,100.00	125.00	2,510.00
Added utilities fee		30.00	

STATEMENT OF CHARLES E. SCONYERS, VICE PRESIDENT FOR DEVELOPMENT OF NEBRASKA WESLEYAN UNIVERSITY IN LINCOLN

I am Charles E. Sconyers, vice president for development, of Nebraska Wesleyan University in Lincoln, Nebr.

If I interpret the proposed tax changes regarding philanthropic gifts correctly, such changes would probably reduce gifts to Nebraska Wesleyan University from individuals very substantially since most of our big gifts are made with appreciated property in the form of land and securities. This is true whether the gift be current or deferred.

While the tax savings obtained by donors through gifts of appreciated property, rather than cash, can be and is in many cases very substantial, it is not the prime reason for making the gift. The foremost purpose of donors is to assist Nebraska Wesleyan University in maintaining its status of academic excellence and assist its students

on this campus in achieving their educational goals. However, the potential tax saving, though secondary in our minds and that of most donors, does have a direct bearing on the size of the gift and the point in time on which it is made.

In my opinion, most of our gifts for endowment and other capital purposes would be reduced by at least 50 percent if not eliminated entirely were it not for the tax benefits available to the donor as now provided by the regulations. To lose those benefits, would be a real tragedy and would soon impoverish Nebraska Wesleyan financially. One of the suggestions for change in the philanthropic tax benefits is to eliminate the charitable contribution deduction on the appreciation portion of the gift entirely or provide that only 50 percent of that portion of the value of the gift can be used as a charitable deduction. It is my impression that this would apply whether the gift was made by bequest; or to establish a charitable remainder trust; or retain a life estate, or an outright gift.

In the past several months Nebraska Wesleyan received four large gifts plus two bequests now in probate, that I am sure would not have been received in the amounts shown or at the time, had the suggested tax changes been in effect at the time. They are as follows:

Gift No. 1—Gift of appreciated securities to establish a charitable remainder trust	$153,000
Gift No. 2—Outright gift of appreciated securities	51,000
Gift No. 3—Gift of appreciated securities	100,000
Gift No. 4—Gift of a farm with life estate retained by donors	190,000
Total above gifts	494,000

In recent months Nebraska Wesleyan University has been advised it is the beneficiary in the wills of two individuals who have recently died and whose estates are now in probate as follows:

	Estimated value
Bequest No. 1—expected total	$1,000,000
Bequest No. 2—expected total	150,000
Total recent bequests	1,150,000

These are the larger transactions which have occurred just during the past year or so which involved gifts of appreciated property. Over the past 10 years similar gifts of appreciated property have been made by one method or other, totaling over $1,750,000, and on those gifts as well, the tax saving was an important secondary consideration by the donor at the time the gift was made. To reduce the charitable contribution deduction by all or any portion of the appreciated value would have a ruinuos effect on our deferred gift program as well as any and all campaigns for current scholarship and operating funds.

Thank you for allowing me to present my opinion. I urge that you maintain the current tax incentives for concerned citizens to continue their generosity in supporting Nebraska Wesleyan University and other independent colleges and universities of America.

Written Statement Submitted by The May Department Stores Co.

The May Department Stores Co. (the company), headquartered in St. Louis, Mo., is a publicly owned corporation that operates 129 department and discount stores in major metropolitan markets coast to

coast, 58 catalog showroom stores in the Greater New York area and northern California, and 16 regional shipping centers. Major stores or groups of stores are located in St. Louis, Chicago, Akron, Cleveland, Youngstown, Denver, Baltimore, Washington, D.C. (The Hecht Co.), Los Angeles, San Diego, Pittsburgh, Portland (Oregon), Hartford, and Jacksonville.

The May Stores Foundation, Inc. (the foundation) is a charitable corporation, established under New York law in 1945, and is a "private foundation" as defined in section 509 of the Internal Revenue Code. It receives charitable contributions from the company and makes grants primarily for various civic and educational activities. After the enactment of the Tax Reform Act of 1969, the company was a "disqualified person," as defined in section 4946 of the Internal Revenue Code, with respect to the foundation.

In 1965, 4 years prior to the enactment of the Tax Reform Act of 1969, the company conveyed to the foundation, as a charitable contribution, the company's entire fee and leasehold interests in certain improved real property north of and across Locust Street from the company's Famous-Barr Co. department store facility in downtown St. Louis. The company claimed a charitable deduction for the value of the property interests so conveyed.

Immediately after receiving the property from the company, the foundation leased it back to the company for an approximate 24-year term ending in 1989. Under the company's leases with the foundation, the property is used, as it had been previously, to provide vital support services to the department store facility, such as a receiving, sorting, and shipping center for goods involved in the company's St. Louis retail department store operations. The support property also houses the powerplant and other utilities for the department store facility and is connected with the department store facility through a system of underground tunnels and conveyors.

The provisions of the Tax Reform Act of 1969 permit the company's leases with the foundation to continue only until December 31, 1979. See section 101(1)(2)(C) of the act (Public Law 91-172). By that date the leases between the company and the foundation will have to be terminated to avoid violation of the self-dealing rules that were added to the code by the Tax Reform Act as section 4941 of the code.

Although the Tax Reform Act requires that the leases be terminated by 1979, it does not permit the company to purchase, at any price, the property previously conveyed to the foundation and presently subject to the leases. Thus the likely effect of present law will be ultimately to deprive the company of any use of this vital support property after 1979. In view of the umbilical cord relationship between the property and the company's adjacent department store, this could cause a serious disruption for the company's retail operations in St. Louis. Nor would this have any offsetting benefit for charity, because the price that any third party could be expect to pay for this property, uniquely valuable only to the company in connection with the operation of its downtown St. Louis department store facility, would be no greater than the price the company would be willing to pay.

There are apparently a number of other foundations and disqualified persons around the country faced with a similar problem. This was recognized by the House Ways and Means Committee early in 1972 when it unanimously approved, without objection by the Treasury

Department, an amendment (H.R. 9520) to the transitional rules in the Tax Reform Act. (Similar bills have been introduced in subsequent Congresses. For example, H.R. 1118 and H.R. 12546, introduced in the 94th Congress by Congressmen Schneebeli and Karth, respectively.) The amendment presented by H.R. 9520 would permit a private foundation to sell to a disqualified person, for not less than fair market value, any property being leased by that person under a lease described in section 101(1)(2)(C) of the Tax Reform Act. Although there was no known opposition to the bill, the bill was never brought to a floor vote in the House.

The reasons for the legislation are cogently set forth in the House report which accompanied this bill. See H.R. Rept. 92–965, 92d Cong., 2d sess. (1972), a copy of which is attached.[1] As that report indicates, if these situations had been called to the attention of Congress in 1969, Congress probably would have minimized the resulting hardships with a divestiture rule similar to the divestiture rule available for the disposition of excess business holdings under section 4943 of the code.

For these reasons, the company urges that the Senate Finance Committee include in any tax revision legislation an amendment similar to that approved by the Ways and Means Committee in 1972.

GRAY & ASSOCIATES, INC.,
Chicago, Ill., March 10, 1976.

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

DEAR SENATOR LONG: For the past 9 years we have been involved in assisting the American Indians on reservations, Indian missions, and urban Indian, nonprofit, charitable organizations by helping them acquire the necessary machinery and equipment from major manufacturers to implement their vocational training programs and small manufacturing facilities, as well as acquiring a minimal amount of inventories that have helped, to a slight degree, alleviate social and welfare problems of our American Indians.

Senator Long, it has practically been like pulling teeth to obtain these necessary machinery, equipment, and inventories from industry since the adoption of the 1969 tax revision, which practically halted major manufacturers from making this type of contribution, since they no longer received any incentive through tax benefits.

Since the middle of 1969 we have telephoned your office on numerous occassions, visited your office, talked with your administrative assistants, and other members of your staff and written you several letters. You responded to these letters on February 28 and March 22, 1973, and on May 21, 1974, we again wrote you a letter, a copy of which is enclosed, actually begging you and the Senate Finance Committee for an appointment to meet with you and other members of your committee. We had also requested an appointment to be heard before the junior committee when both you and Congressman Wilbur Mills cochaired this committee.

Now that you and the Honorable Al Ullman cochair this same committee, we would respectfully request of both you and the Congress-

[1] This was made a part of the official files of the committee.

man an appointment to meet with each of you privately, and then collectively, in the hopes of finally achieving the passage of our proposed tax amendment to the charitable contributions section of the 1969 tax laws. At the very least, we would like a few minutes of your time in the hopes that you could suggest the proper steps for us to take to realize our goal, and in the process help the Federal Government by relieving the unemployment compensation and welfare doles paid out to unemployed Americans, especially our American Indians. Our Indians are not looking for a handout, they are merely looking for a helping hand so that they may eventually help themselves, and by God Senator Long, we need your help desperately.

For a period of 3 years, from 1970 until the middle of March, 1973, we cajoled and pressured and finally finagled an appointment to be heard by the Committee on Ways and Means through the efforts of the General Counsel, John Martin. We were given an appointment on April 13, 1973, to present our request and testimony to the committee, but unfortunately for us and our Indians, only five members of the committee were present at the hearings, and no one heard a thing we had to say, which left us back at the starting line once again.

This was particularly disappointing after the struggle we had to arrange the appointment, and having accumulated all materials we felt necessary for our presentation, and expending in excess of $100,000 that included research and employing one of the outstanding tax consulting firms in the United States (Lybrand, Ross Brothers & Montgomery,) for their opinion and expression, only to run into yet another brick wall, and to this date we cannot get through to anyone in Washington.

The Ways and Means Committee, after a lengthy fight with the President, and trying to get heads put together on their committee, including the General Counsel of the committee, fought for their tax revisions, only, and nothing of importance was accomplished as far as charitable contributions revisions are concerned. The only tax revision that benefited any Indian in 1975 was a segment that Al Ullman and some other Congressmen put through to tax-exempt some property in Oregon. We are looking to assist all American Indians throughout the United States, whether they be on Indian reservations or have emigrated to metropolitan areas.

We are sure you are aware that there are 75 to 80 percent unemployed American Indians on reservations and 65 to 70 percent unemployed in metropolitan areas. This must indicate to you the need for vocational training for these first Americans, our American Indians.

Senator Long, since the original 1969 tax revision became law, it has stymied corporations from making contributions to any worthy charitable organizations, excluding cash, corporations can honestly throw any obsolete or dormant machinery or equipment into the junkyard, scrapping it, getting more as a tax loss, than if they were to contribute these personal properties to charitable groups that could use the equipment in vocational training programs that would actually assist unemployed people in learning new vocations and be able to open small manufacturing plants or look for employment, because they finally learned how to use this equipment, making them knowledgeable and hireable for jobs they had not been able to do prior to vocational training with obsolete or dormant equipment that should be and could be contributed.

Congress has been looking for an answer to employ the unemployed, and a fight has been going on between Congress and the executive branch since the present President took office, and we gave an answer to this problem in 1973, although we knew it in 1970, and introduced the bottom-line results to you and other Senators and Congressmen in Washington, and to some members of the executive branch, back in 1970, by letter.

Now, Senator Long, we feel, after consulting with many executives in industry and tax firms throughout Chicago, New York, California, and Detroit, Mich., there are more than $50 billion worth of dormant or obsolete machinery and equipment, lying idle in corporate warehouses and plants that should be replaced by the companies and corporations that have this obsolescence, allowing these companies and corporations to purchase new equipment and dispose of, by contributing, their dormant machinery and equipment, and idle, nonsaleable inventories and components.

We have also talked to the financial executives of these corporations and they suggest there is no benefit in contributing any of the obsolete equipment, machinery, or inventories to worthy charities, although these charities are able to utilize the contribution. Now, corporations would rather just scrap or cannibalize the equipment for components, not wanting more problems than they have with the Internal Revenue Service or the Treasury Department. But, if there were financial inducements to make this contribution to worthy charitable groups, they would be more than delighted to contribute every piece of equipment in their plants, and replace them with newer, more efficient equipment, that would help their company employ more people effectively.

Sir, we know we made one terrible mistake in trying to prepare this material with the hopes of getting the complete Senate Finance Committee and the complete Ways and Means Committee to assist us in helping the American Indians in this most worthy cause. We should have bought and paid for people in Washington (public relation people and attorneys) to get to Senators and Congressmen that would have proposed this amendment to the charitable contributions revision of 1975. Maybe that would have worked better and might have saved us heartaches and money, and enabled us to help our Indians and our Government, but, Senator Long, we were not smart enough, and certainly not effective enough, and too inept at the procedures in Washington, but we tried in our own way to get results that would also keep the U.S. Government from paying out millions of dollars to several hundred thousand unemployed in compensation for being unemployed or on welfare, but not being persuasive enough with you or other members of the Senate and House, our fight seems to be just getting started to help everybody but ourselves, and damn it, we are not going to give up.

We know that the U.S. Government, the Internal Revenue Service, and the Treasury Department will benefit tremendously, only by allowing corporations to contribute these obsolescent or dormant personal properties, but the the unemployed and the welfare recipients will eventually become employed and earn taxable dollars. Corporations will then receive a tax benefit from these essential contributions.

We are sure you are concerned, as is the Senate Finance Committee and the House Ways and Means Committee, as well as Congress,

about employing the unemployed and attempting to train and employ those on welfare that are able to work.

The President's recommendation was that industry and the private sector should find a way of employing the unemployed, and not leave this program's benefactor to be the Federal Government alone.

We feel that the Senate Finance Committee and the Ways and Means Committee should allow a tax benefit to industry for contributing, only if the contributions were to be used for vocational training programs, or social and welfare benefits. Then, industry will be able to employ those that can adapt themselves for the corporations respective job openings, with very little cost, if any, to the Federal Government. The results would be that the unemployed will, in a short time, be earning taxable dollars.

There are also thousands of abandoned plants that could be contributed to worthy charitable groups that could be transformed into usable training facilities throughout the Nation at minimal cost.

Senator Long, again, these dormant or abandoned buildings throughout the United States are lying empty, waiting for someone to either demolish them or buy them, for whatever use they can find for the properties. We can assure you that we can call most any corporation in Fortune's 1,000 major industries and get 1 to 100 plants that they are looking to dispose of or abandon the properties for tax losses. These plants could be vocational centers for the Nation, at no cost to the Federal Government, and in most cases, minimal work would be necessary to convert these properties into workable and usable facilities for vocational training programs.

In the past 9 years we have never accepted any inventories or properties for the American Indians that we could not make use of or convert to income property for the American Indians, and our intentions for the future would be the same.

Senator, we have put our case before you once again, and must implore you to give this some very serious consideration, that if our suggestions to help our American Indians and the other unemployed in the United States were just a dream for us, they have now become a nightmare, with several years of continuous effort in attempting to get a tax change into law, without results, and unless you, as the chairman of the Senate Finance Committee, and the cochairman of the joint committee give this suggestion 10 minutes of your undivided time, where you can sit and do nothing but think about this program, not just to sit and listen, but to hear what we have to say, we have failed permanently.

Sir, if at any time you want me in Washington to discuss this further with you, and you only, not with one of your staff members, I can meet with you at any hour on any day that is convenient to you, but please give our suggestion on the charitable tax amendment the attention that it needs desperately, unless you feel it has no merit.

We are enclosing a copy of our proposal to the Committee on Ways and Means, presented in April of 1973.[1]

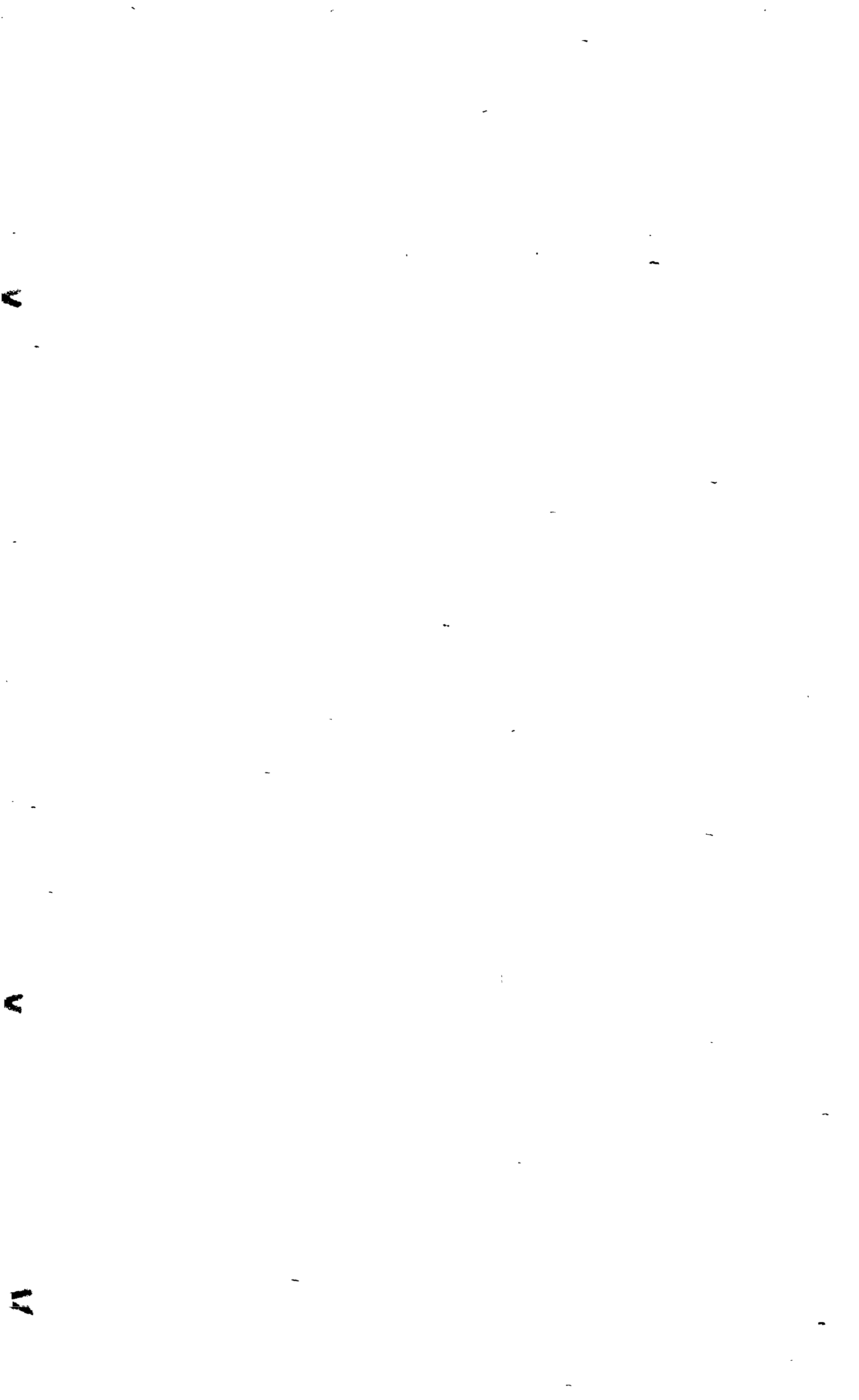
We look forward to any communication from you with the hopes that you will truly and finally show some interest in our proposal.

Respectfully,

MAURICE GRAY.

---

[1] This document, previously printed, was made part of the official files of the committee.



Deductions for Conventions Outside the United States

3012

AMBASÁID NA HÉIREANN,
EMBASSY OF IRELAND,
Washington, D.C., April 23, 1976.

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

DEAR SENATOR LONG: In connection with the current hearings of the Senate Finance Committee on section 602 of bill, H.R. 10612, concerning the amendment of existing taxation provisions in respect of attendance at conventions or meetings held outside the United States, I am enclosing for the information of the committee a copy of a note which I sent on Wednesday, April 21, to the Secretary of State. This note expresses the concern of the Irish Government at the implications of the proposed changes for Ireland, particularly in the areas of tourism and industrial development.

You may wish to include this information in the official record of the committee, and we would have no objection to this, should you so decide.

Yours sincerely,

JOHN G. MOLLOY, *Ambassador.*

Enclosure.

The Ambassador of Ireland presents his compliments to the Honorable the Secretary of State, and has the honour to refer to current proposals to amend the U.S. tax code by disallowing expenses which, heretofore, were deductible in respect of attendance at conventions, seminars or other meetings held outside the United States. In that connection, particular attention is drawn to section 602 of bill H.R. 10612. It will be recalled that when this question arose last year the Embassy of Ireland, in its note of July 23, 1975, made known to the Department of State the concern of the Government of Ireland at the implications of the proposed tax changes.

The implications of the proposed tax changes are especially serious for Ireland. Tourism is Ireland's second largest industry and also the second largest earner of foreign exchange. This industry, so vital to Ireland's well-being, has suffered a great deal in recent years because of the unfavourable publicity arising out of the civil disturbances in Northern Ireland. This adverse publicity has seriously eroded the accumulated beneficial effects of promotional efforts over many years.

Ireland is, therefore, in the position where even the maintenance of existing traffic flows requires a much stronger and lasting promotional effort than had to be mounted in the past. This is also true of foreign investment in Ireland. It is, therefore, an important aim of national policy to make a major effort on the tourism and foreign investment fronts to correct the misleading impression which has inevitably been

created abroad, especially in the United States, that the civil commotion in Northern Ireland affects the whole island. The holding of international conventions, conferences, seminars, and meetings of various kinds in Ireland serves, therefore, a double purpose. Such gatherings are directly beneficial in themselves to Ireland and, indirectly, the mere fact that they are held in Ireland helps immeasurably to dispel the widespread but false notion that Ireland is not a safe country to visit or to invest in. Thus, the Irish Tourist Board and the Industrial Development Authority of Ireland are redoubling their efforts abroad. The proposed changes in the U.S. tax code would seriously undermine those efforts.

For some years now Ireland has been striving to develop the industrial arm of the economy. Much of the success achieved to date is due to foreign investment in Ireland, especially by American industrialists. However, categorization of visitors to Ireland shows clearly that, unlike the situation in many other countries, the percentage of visitors on business, as compared with tourists in the strict sense, is very small.

This is unsatisfactory from the point of view of tourism itself but also, and more importantly, from the point of view of national policy to accelerate the industrial development of the country. It will be evident, therefore, that the attraction to Ireland of foreign industrialists, businessmen, scientists, and professional people generally is of great importance to the Irish authorities. In a world of ever-increasing interdependence there is an acceleration in the interplay of ideas and the pooling and exchange of information in all fields of human endeavor. Thus, conferences, trade exhibitions and international gatherings of many kinds have become a regular feature. The benefits are obvious: they are political, social, cultural, scientific, as well as economic. Participants inform themselves of advances and discoveries in various areas; they see new products; they discover new market opportunities; and they acquaint themselves with the local scene. From Ireland's point of view, such visitors to Ireland have an opportunity of examining possible locations for new factories, meet local businessmen and officials concerned with trade, investment, et cetera. The economic ties fostered in this way between Ireland and the United States are, of course, to the mutual advantage of both countries.

It is estimated that in 1975 approximately 7,500 American delegates attended conferences in Ireland. Much money, public as well as private, has been invested in recent years in the provision of facilities for such conferences in Ireland. It is the hope of the Irish Government that the number of American participants in such meetings will increase rather than diminish in future years. In that connection the following extract from a recently published OECD study "Tourism Policy and International Tourism in OECD Member Countries" is particularly relevant:

The tourism committee notes with satisfaction that despite the considerable deterioration of the balance of payments of most member countries, no OECD member country, with the exception of Portugal, has imposed restrictions on tourists' automatic foreign currency allowances provided for under the OECD code of liberalization of current invisible operations. This attitude is in line with the undertakings by member countries in the declaration published on May 30,

1974, by the OECD Council at Ministerial level, whereby the governments of the member countries affirmed, inter alia, their determination to avoid, for a period of 1 year, taking general or specific measures affecting other current operations. The committee also noted with considerable interest that this declaration has been renewed for a further year by the OECD Council at Ministerial level at its meeting on May 28 and 29, 1975. The committee wishes to stress that under present circumstances it is of great importance for member countries to avoid any measures which may discourage international travel.

The proposed changes in the U.S. tax code, when examined in the light of the foregoing arguments or indeed in the light of any reasonably objective standards, are drastic and discriminatory and would, if implemented, surely have consequences that were never intended. Many international conferences are held in the United States and there would probably be a good deal of pressure on other countries to introduce similar restrictions. The Government of Ireland therefore expresses the hope that the proposed amendments of the U.S. tax code already referred to will be dropped and that the Department of State will lend its support to Ireland's representations in that connection.

The Ambassador of Ireland takes this opportunity to renew to the Honorable, the Secretary of State the assurances of his highest consideration.

INTERNATIONAL ASSOCIATION OF HOLIDAY INNS,
Schiller Park, Ill., April 21, 1976.

Senator CLIFFORD P. HANSEN,
Washington, D.C.

DEAR SENATOR HANSEN: On Friday, April 9, 1976, the board of directors of the International Association of Holiday Inns met and adopted the following resolution. The association represents the owners and operators of over 1,700 Holiday Inns located throughout the United States and worldwide.

Whereas the board of directors of the International Association of Holiday Inns stands firmly in support of the free enterprise system, and

Whereas over 1,700 Holiday Inns proudly compete throughout the world for their share of discretionary travel, food and lodging, and

Whereas protectionist legislation discouraging conventions in foreign countries could well develop retaliatory measures lessening the in-flow of foreign tourists to the United States, and

Whereas the Internal Revenue Service has ample law and administrative rulings to bar unreasonable travel and convention deductions, now therefore, we

Resolve to urge the Senate Finance Committee to strike from the Omnibus tax bill the threat to freedom of travel imposed by specific limitation of income tax deductions allowed for conventions in foreign countries.

We urge you to consider this resolution during the Senate Finance Committee's decisionmaking processes.

Respectfully,

JAMES L. SCHWARTZ, President.

AMERICAN BAR ASSOCIATION,
Chicago, Ill., April 21, 1976.

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

DEAR MR. CHAIRMAN: On behalf of the American Bar Association, I am writing to inform you of the association's views on section 602 of H.R. 10612, relating to deductions for attending foreign conventions.

The association believes that while section 602 is intended to curb past abuses of such deductions, it would fail to achieve that purpose and could inhibit the holding of legitimate foreign conventions. The provision also adds unnecessary complexity to the Internal Revenue Code and creates great administrative burdens for the Internal Revenue Service, individual taxpayers, and organizations sponsoring conventions.

We understand that section 602 is intended to address situations in which otherwise-legitimate seminars and conventions are held in locations having no relationship to the business purposes for which the meeting is held. If Congress feels such abuses have been flagrant and have resulted in substantial revenue loss, it should carefully draft a provision which addresses itself solely to such abuses. The current proposal, which would arbitrarily limit deductions to two foreign conventions, regardless of purpose and location, fails to deal with the underlying problem.

The likely effect of such a provision is that certain organizations will continue to hold seminars in resort locations, and the participants will take deductions for attending one or two such meetings a year. Thus, the abuses will continue.

On the other hand, large professional organizations like the ABA whose members are involved in a wide range of transnational activities, will be discouraged from scheduling legitimate foreign conventions. You may be interested in knowing that the American Bar Association has held 137 annual and midyear meetings since the association's founding in 1878. Of these 137 "conventions," only 5 have been held outside the United States: 3 in Montreal, Canada, and 2 in London, England. These two locations were chosen because the association believed that American and British lawyers, as part of the same Anglo-American legal tradition, could profit greatly from such mutual interchange. The association is also one of the founders of three international law organizations—the International Bar Association, the Inter-American Bar Association, and the World Peace Through Law Center—each of which has an international membership and periodically holds meetings abroad. The passage of section 602 would have a decidedly adverse effect on participation by American lawyers in such meetings in the future.

Further, the recordkeeping requirements with respect to hours of scheduled business activities, hours of attendance, the use of varying per diem rates, and the other detailed requirements of the proposed section promise to create needlessly great administrative burdens for all parties involved. The proposed cure may indeed be worse than the ailment.

The American Bar Association believes that if past abuses cannot be adequately treated by regulation under the existing code, Congress should carefully draft a provision which would (1) address only the documented abuses, not all foreign conventions, and (2) would not result in increased complexity and unusually burdensome administrative requirements. Proposed section 602 accomplishes neither of these objectives. Our association would welcome the opportunity to provide further information or assist your committee in any way it can to develop a more appropriate way of dealing with this problem.

Sincerely,

JOHN P. BRACKEN,
Chairman, House of Delegates.

THE BRITISH-AMERICAN CHAMBER OF COMMERCE,
New York, N.Y., April 20, 1976.

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

DEAR MR. CHAIRMAN: The British-American Chamber of Commerce was founded in New York in 1920, and consists of over 500 corporate members engaged in international commerce, most of whom are residents and taxpayers in the United States.

We are greatly concerned that, in H.R. 10612, section 602, as passed by the House of Representatives in the previous session of this Congress, there should be a limitation placed on the tax deductions that can be claimed for overseas conventions, seminars, meetings, both as to the number each year of such meetings, and to the expenses allowed in respect of each meeting and the travel to and from it.

There is no suggestion that meetings of all sorts, or travel to them, are of themselves undesirable or subject to limitation; only those outside the United States. Yet for those engaged in international commerce, a meeting overseas may be more advantageous in every way if located at the site of operations, or where many of the participants are, than automatically held in the home country of domestic management.

The international commerce (imports plus exports) of the United States has doubled in the last 4 years, to a total 1975 figure of over $200-billion worth of goods, not including the accompanying volume of supporting services.

The continuing growth of this important sector of the U.S. economy, hand in hand with that of the country's trading partners, will not be assisted by legislation designed to set arbitrary limitations and rigid guidelines. The participation by U.S. residents in meetings overseas plays no small part in the expansion of foreign trade and provides a direct encouragement to the sale abroad of U.S. goods and services, as well as stimulating investment in the United States of America.

The healthy development of international travel is in itself of importance to the economy of the United States, as it is to that of the United Kingdom. It provides Britain with dollar earnings needed to

pay for steadily increasing British purchases of U.S. goods. Moreover, restrictions on U.S. organizations holding meetings abroad are likely, in the way of things, to lead to a discouragement of overseas organizations visiting America. As the Tokyo round of trade negotiations proceeds, fresh U.S. restrictions would hardly improve relations with other countries.

If, however, the thrust of the proposed legislation in H.R. 10612 is to deal with possible tax abuses, we consider it is unreasonably discriminatory, and should be applied equally to all similar convention activity and the like, within as well as without the United States. Moreover, we believe that the present taxation code, as administered by the IRS, is already adequate to police such abuses.

Finally, we hold that the limitation of the free choice of meeting places for those engaged in international commerce is opposed to the true concept of liberal trade, a concept that has stood the United States in good stead in the past, a concept which we hold to be of the greatest economic promise for the future, both in Britain and in the United States.

This chamber, therefore, urges your committee to avoid recommending legislation that would discriminate against legitimate business travel abroad.

Sincerely yours,

DAVID FARQUHARSON.

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

This statement is submitted by James P. Low, president and chief executive officer of the American Society of Association Executives (ASAE). ASAE is an educational organization, whose purpose is the training and education of executives for leadership positions in voluntary nonprofit organizations. In this capacity, ASAE represents 6,000 trade, professional, technical, and educational association executives. These organizations, in turn, represent an underlying membership of 22,000,000 businessmen, businesswomen, firms and professional persons.

ASAE strongly believes that a provision dealing with the deductibility of attendance at foreign conventions which was included in the House version of tax reform legislation, H.R. 10612, to be both unnecessary and inappropriate.

Section 602 of H.R. 10612 provides a series of complex rules for determining whether the expenses of individuals attending foreign conventions are deductible. At a time when many are urging simplification of the present tax code, it is highly questionable whether new, highly technical amendments should be added to the code. This argument is particularly compelling when the need for the legislation is dubious.

Each member of this committee is personally acquainted with many of the nonprofit voluntary associations which ASAE represents. You are also aware that the purposes and goals of these organizations is not to sponsor vacations for their members. Frankly, the problems facing this Nation do not allow them the luxury of this kind of activity.

What seems to have been lost in prior discussions of this topic is

what motivates people to attend conventions, seminars, or similar meetings. The primary reason for attending a convention, seminar, or similar meeting is to have the opportunity to exchange ideas and experiences with other attendees. This exchange is enhanced by program topics, speakers, and panel discussions. Nevertheless, convention planners recognize that informal discussions among attendees with similar interests may be equally as important as a heavily structured program. Thus, while the location of the convention may influence the attendance by some taxpayers, studies show that the topics to be discussed and the speakers who will be present determine the success of the convention. This was confirmed by a study conducted by Opinion Research Corp. for the United States Chamber of Commerce dealing with the reasons why people attend conventions, et cetera, wherever the meeting is held.

ASAE does not suggest that there are no abuses in this area. There are some, but the number of organizations sponsoring so-called junkets is exceedingly small. In our view, existing law is adequate to deal with these cases without regard to whether the meeting is held within or without the United States. The overwhelming number of conventions, seminars, and similar meetings—wherever held—are bona fide business meetings held for the education and benefit of the attendees.

The concern of proponents of section 602 appears to be the deduction of what is essentially a vacation. This concern is not eliminated by the establishment of arbitrary standards of deductibility. More importantly, existing law already provides an adequate framework within which the perceived abuses can be regulated. The issue involved is whether the conference in question is directly related to the conduct of the individual's business. The House bill never reaches this issue, but merely establishes complex rules which exult form over substance. Thus, no more than two foreign conventions may be deducted in 1 year, without regard to the purpose of the meeting.

On the other hand, section 274(c) of existing law requires consideration of the business purpose of the convention. Under this approach, there appears to be no reason why the IRS could not publish proposed regulations which would establish guidelines as to the manner in which the requisite business purpose is to be established. This approach would allow taxpayers and sponsoring organizations to work with the IRS in establishing a reasonable format for complying with the requirements of section 274(c). This would ease the audit burden of the IRS and permit taxpayers to comply with the requirements of this provision more readily.

The proposal to restrict conventions held outside the United States will have a serious adverse impact on U.S. air carriers and other U.S. businesses abroad, such as hotels. The plight of U.S. air carriers competing for the international travel dollar is well known to this committee and must be considered. Similarly, international hotels, controlled by U.S. interests will suffer if the proposed restriction becomes law.

Proposals to restrict foreign conventions are inconsistent with the trade policy established in 1974 by this committee. At a time when the emphasis is on freer trade and removal of tariff and nontariff barriers, we submit that the enactment of legislation will be viewed as an

obstacle to achieving the freer flow of information, products, and investment. What it does achieve is to invite foreign countries to retaliate. The State Department already has received objections from a number of foregin governments to the proposed restrictions on foreign conventions.

Further, we understand that the Department of Commerce and other agencies are making a significant effort to attract foreign visitors to the United States and that a particular effort is being made in connection with our Bicentennial. This committee should not enact legislation which will frustrate the efforts of other Government agencies.

In summary, proposals relating to foreign conventions do not address the primary purposes which induce a taxpayer to attend a convention or similar meeting. In an effort to curb foreign junkets (and with no concern for domestic junkets), these proposals will prevent most conventions from going abroad, thereby depriving U.S. members of the opportunity to draw on foreign resources for ideas which would be most beneficial. For example, soon the United States will move to the metric system. Europe has been on the metric system for many years. A meeting held in Europe to discuss with Europeans the practical considerations connected with such a change is certainly business connected, regardless of other arbitrary standards applicable to a particular taxpayer.

Another example of the arbitrary standards established under H.R. 10612 is that this bill establishes limitations on transportation expenses which are unrelated to the business purpose of the trip and which could induce convention sponsors to provide charter transportation services for attendees, to the detriment of existing regularly scheduled airlines.

Finally, the House bill establishes limitations on subsistence expenses geared to per diems allowable to U.S. civil servants. This standard is so unrealistic that it is not even followed by the Federal Government. At the present time, U.S. civil servants traveling abroad may be reimbursed for actual subsistence expenses, and not merely limited to a per diem.

In conclusion, ASAE believes that the objectives which the committee and ASAE wish to accomplish can best be achieved through a realistic compliance program, rather than through enactment of new legislation. ASAE believes that such an approach will benefit the taxpayer and achieve the desired result without inviting foreign countries to enact retaliatory legislation. Abuses can, and should, be corrected without destroying the value of bona fide meetings held outside the United States. To this end, ASAE stands ready and willing to assist this committee and the Treasury in achieving a workable and realistic approach to arrive at our mutual goal.

Statement of Gilbert Garber, Executive Vice President of Garber Travel Service, Inc., and President of the International Congress and Convention Association

I submit my statement to you in the dual capacity of executive vice president of Garber Travel Service and president of the International Congress and Convention Association (ICCA).

Garber Travel operates 22 offices in Massachusetts, New York, New Hampshire, Rhode Island, and Vermont. In 1975, our sales volume was in excess of $24 million.

A significant part of our business is the handling of arrangements related to national and international meetings, conventions and congresses; meetings which may take place in the United States and have both U.S. and foreign participation, as well as meetings held overseas with similar makeup.

The International Congress and Convention Association has membership in 67 countries and is comprised of all components of the meeting industry, including travel agents, airlines, government tourist bureaus, Congress organizing companies, meeting centers, hotels, and other services. Among our U.S. membership are: Pan American and Northwest Airlines; Sheraton, Intercontinental, Hyatt International and Loews Hotels; Hertz and Avis Car Rental Cos.; the United States Travel Service, an arm of the Commerce Department; the Convention and Visitors Bureau of San Francisco, Salt Lake City, and Atlanta. A full list of our membership as of November 1975, is submitted.

Among the functions of ICCA is the publishing and distribution of information about congresses and conventions which take place all over the world. Our membership promotes attendance and handles arrangements for such events, and in many instances is a direct influence on the choice of site for these meetings.

My understanding is that the origins of the section of the bill relating to tax deductibility for attendance at conventions was the concern that deductions were being claimed for attendance at conventions which were not of serious purpose. There were many blatant examples of such questionable meetings which advertised attractive destinations for esoteric meetings of one sort or another * * * and emphasized their tax deductibility.

It had been my contention—affirmed by the testimony of others—that violations of the intent of the law, if not the law itself, should best be dealt with by the Internal Revenue Service, who has all of the necessary tools at hand. To me it was strange, in any case, that there seemed only concern with frivolous meetings held overseas. An equally questionable meeting held in an attractive resort location such as Honolulu, Vail, or Miami was not to come under any new regulation * * *. The implication being that the IRS somehow had adequate safeguards for domestic destinations.

It has been * * * and still is * * * my contention that the meeting itself must qualify—by reason of its content of serious business or profession related substance * * * whether the meeting takes place in Honolulu or Hamburg—in Milan or Miami. The qualifying of the meeting for tax deductibility must not be based solely on its geographic location.

As originally considered in the House, the bill (as H.R. 1040) related only to conventions held overseas by U.S. organizations. It must be assumed that recognition was purposedly given to the special — and different — nature of attendance at meetings, wherever they may be held, by international organizations, whose function, interests, and membership composition may be significantly different from U.S. national societies. The effect of the bill, as originally proposed, would have been to pressure U.S. associations to plan their meetings at on-

shore locations. Whether or not this was justified is another subject. It's a matter of record, however, that the very threat of such legislation did accomplish that fact * * * to the concern of the associations, U.S. business interests around the world, and other governments of countries near and far whose economy is so closely tied to our own.

In any case, this aspect of pressure on the associations has now been removed and transferred unfairly to the individual member. Under the terms of H.R. 10612 a member of a national society whose meeting may be held in Canada, the Bahamas, or any offshore location—who may also have legitimate business or professional interest in attending two international meetings in the same year—would have to choose for himself which two to claim as a deduction. It is interesting to note that according to a reliable international source, association membership among professionals and other steady Congress participants is estimated at 3.5 associations per person.

Is this the same criteria that is applied to the general deductibility of business expense for overseas travel? No limitation is placed on overseas travel for business purpose. To do so would obviously restrict normal business development; and as a consequence, tax revenues would be stifled. Any such limitation would raise a hue and cry from the general business community and, in fact, would change the very fabric of our multinational business complex. It would be quickly recognized as restrictive and punitive to a particular segment of the business community and would promptly be labeled isolationist.

We think of business travel as commonplace for the ordinary businessman in the pursuit of his affairs * * * I wonder if we tend to think of convention attendance generally as vacationing or junketeering. Perhaps therein lies the problem.

The convention or congress is more likely to be the business travel for the medical and scientific community. That's the scene where he learns of the new scientific development, the progress in basic or clinical research. That's his marketplace for exposing his new ideas. By what logic do we determine that two such business trips for the doctor * * * the scientist * * * or others, for that matter is the proper limit?

For years the function of the U.S.T.S. has been the promotion of travel to the United States. As part of this overall goal a major effort has been to attract international organizations to hold their meetings in our country—also to attract international attendance to meetings of U.S. associations. Due to the dedicated efforts of Commerce Department employees, this has been markedly successful.

According to a research study, "The Character and Volume of the International Convention and Congress Market," conducted for U.S.T.S. in 1975, it was determined that in 1973 and 1974 an average of 390,000 foreign delegates attended a total of 1,004 congresses and U.S. association conventions in the United States and spent roughly $1.4 billion. If foreign attendance at U.S. national conventions alone were to drop by 100,000, U.S. foreign exchange earnings would decline by $25 million annually, and sales and excise tax revenues from foreign congress delegates would fall by approximately $2 million.

It is a fact of life of the international convention market that the selection of a convention site first requires an invitation from the host organization. Traditionally this has been, perhaps, the greatest hurdle to overcome in attracting meetings to the United States.

Permit me to cite an example of a typical event.

Due to the involvement of several dedicated American doctors, San Francisco will be the location in 1979 of the joint meetings of the International Surgical Society and the International Cardiovascular Society. It is expected that thousands of international delegates will attend from all over the world. In order to insure this, key U.S. members are expected to attend meetings, in the interim period, to promote attendance, encourage participation, and generally fulfill their own membership obligations. Their attendance will be expected at international meetings of associations of allied specialties such as vascular, thoracic surgery, cardiac pacing, cardiology, medical engineering et cetera. The international societies generally have area chapter structures; such as North American, South American, European, Australiasian * * * where similar involvement is expected. Under H.R. 10612 attendance at only two meetings will be allowed as deductible.

Obviously one effect of the bill will be to shut off invitations from the U.S. organizations, thwarting the efforts of the U.S.T.S and cutting off beneficial tax revenue * * * not to mention the immeasurable additional value of foreign visitors.

And another will be to raise the specter of reciprocal action by other Governments * * * a very real and significant likelihood. In this regard there has already been oral testimony given at the previous hearings and subsequent written protests by other Governments.

It is my belief that an error has been injected—not originally intended—of including in any limitation, attendance at bona fide international events.

May I point out the present IRS guidelines. Treasury regulations 1162–S states: "An income tax deduction is allowed for the expenses of education (including travel, meals, and lodging) undertaken to maintain and improve professional skills."

Attendance at a bona fide convention or Congress is educational and does maintain and improve professional skills.

As to specific details of section 602, I would further comment that, as the bill is written I believe that an administrative Pandora's box will be opened.

Section 2 allows deductibility for the "lowest coach or economy fare at the time of travel." I would ask any member of this committee * * * or any IRS investigator * * * whether "lowest coach or economy, rate" means GIT, OTC, APEX, ITX, or which lowest economy rate?

But here, too, should not the universal standard of business expense apply? Is it equitable to set different criteria for deductibility based on whether the meeting involves 2 or 3 persons or 200 or 2,000?

Section 3 and section 4 are both commendable.

Section 5 surely introduces a new concept for determining allowable deduction and will be the cause of considerable taxpayer dissent. An arbitrary limitation will be set that is not connected to the reality of available hotel charges, other costs, and the facts of life of the convention industry.

Again an arbitrary distinction is being made between the business traveler and the convention delegate. U.S. chain-operated hotels, generally of higher quality, are being discriminated against. In fact, the U.S. delegate may well be isolated from his international colleagues.

Oftentimes, hotels are chosen for reasons of their meeting facilities, which generally are offered free to the convention organizers on the basis of room occupancy. The dynamics of Congress economics may well be affected by this provision.

In conclusion, it is my firm belief that section 602 of H.R. 10612 does not address itself to its designed purpose as stated in the bill. "An Act to Reform the Tax Laws of the United States" but rather will create a schism in the business community—a schism between types of business persons—a schism between national and international involvement.

I believe that continued effort should be expended to encourage greater internationalism with all of its related economic benefits; that our own activities, both private and governmental, toward attracting international events to the United States should be encouraged and expanded; whereas, the passing of this legislation would have a countereffect. Affirmation of this position is the resolution passed unanimously at the annual assembly of ICCA in November of 1974, when H.R. 1040 was under consideration:

In regard to H.R. 1040:

Whereas conventions by their very definition signify the convening of people for the purpose of exchange of ideas.

Whereas a convention creates an atmosphere conducive to international understanding, increased knowledge and trade.

Whereas the U.S. is seeking to attract foreign conventions and meetings to its own shores which contribute to equalizing the Balance of Payments.

Whereas a foreign convention held in the U.S. itself results in international trade to the benefit of the U.S. and its Balance of Payments.

Whereas a U.S. convention held abroad creates a market for U.S. products resulting in exports of U.S. goods and services.

Whereas any further reduction in business oriented travel will further add to the present crisis facing U.S. enterprises and interests in international trade such as airlines, hotels, etc.

Whereas present regulations provide adequate safeguards against abuse of tax deduction for non-legitimate purposes.

Whereas restrictive measures against such interchange attract punitive retaliation which can only be inimical to the best interests of United States.

The International Congress and Convention Association urges that no further limiting legislation be considered which would restrict the positive results which are generated by reason of conventions and meetings held worldwide.

STATEMENT OF AMERICAN CHAMBER OF COMMERCE OF MEXICO, A.C.

DEDUCTIONS FOR ATTENDING CONVENTIONS, ET CETERA, OUTSIDE THE UNITED STATES

SUMMARY

The American Chamber of Commerce of Mexico, A.C., representing over 2,300 Mexican and American companies, is dedicated to promoting mutually beneficial ties of trade, investment, and friendship between the United States and Mexico.

The chamber is concerned over the provision in tax reform legislation currently under study by your committee that would limit tax deductibility for expenses incurred in attending conventions or conferences held outside the United States.

We believe it is unadvisable to impose geographical limitations on convention sites to guard against abuse. This assumes deliberate creating as the rule rather than the exception; yet it does not guard against cheating on convention travel within the United States. It would be more just and logical to curb abuse by enforcing existing regulations against junkets rather than enacting generally punitive measures.

The latter approach, we believe, carries with it the danger that Government-imposed guidelines will eventually abolish the freedom of business to decide when and where it should meet.

If the committee does retain a territorial restriction, we urge a return to the original language which exempts from its effect North America, defined as Canada, the United States, and Central America.

We make this proposal in the interest of good relations with a close neighbor and major trading partner.

As you know, Mexico is one of the most important markets for U.S. exports, ranking fourth in 1975.

More than $2 billion, the lion's share of Mexico's record-breaking 1975 trade deficit of $3.9 billion, occurred in transactions with the United States. If this trend continues or worsens, important restrictions imposed as a result of the midyear deficit can be expected to become more stringent.

While a deficit in favor of the United States has long characterized the two countries' trade exchange, Mexico's dollar income from tourism has helped to compensate. However, after rising steadily in recent years, this income fell off in 1975 probably due both to the U.S. recession and a temporary boycott by American Jewish organizations.

Income from border and interior tourism was $2.3 billion. Subtracting Mexico's own border purchases and tourism spending, net tourism earnings were $988 million in 1975, a 26.6-percent drop from the pervious year. Tourism receipts fell by 4.9 percent.

In view of the crucial importance of tourism to Mexico and the further points mentioned below, we oppose repeal of deductions for travel expenses to conventions in Mexico.

1. Convention spending gives Mexico dollars to buy U.S. goods. Mexico is among the United States' top customers, an important and growing market for U.S. equipment and raw materials necessary to its industrialization.

2. Conventions are a substantial part of the tourist income that plays a vital role in offsetting Mexico's trade deficit. Moreover, group travelers who would not have made the initial trip alone tend to return as individuals.

3. To legislate Mexico out of the convention market would be very damaging to its economy and would be interpreted as an unfriendly gesture.

4. At a time when the United States is seeking to draw tourists to its bicentennial celebration, restrictions on conventions abroad would backfire by inviting retaliation. The U.S. Travel Service reports that Mexico is the second largest source, after Canada, of international tourists to the United States, and that in 1975 Mexican tourists spent more than one billion dollars there.

STATEMENT

The United States–Mexico Chamber of Commerce is an association of U.S. and Mexican business firms engaged in trade or other economic activity between the two countries. (A Membership Directory of the Chamber accompanies this Statement.[1])

The Chamber's general objective is to foster better business and trade relations between the United States and Mexico. This is accomplished in part by identifying issues that might adversely affect such relations and attempting to head them off before they become serious problems. In this context, the Chamber was deeply concerned when the House of Representatives included in its recent tax reform bill (H.R. 16012) a provision which would severely curtail the deduction of expenses incurred in attending conventions held outside the United States (Section 602).

We believe that discouraging U.S. organizations from holding conventions in foreign countries is not in the best interests of the U.S. business community or of U.S. international relations, and trust that the Committee on Finance, in its deliberation of tax reform proposals, will leave unchanged the existing legal provisions for deductions of expenses incurred in attending bona fide business conventions, wherever they may be held.

The Chamber does not condone abuses of the present regulations, and agrees with those who feel that "tax-free junkets" should be eliminated, whether they involve travel within or outside of the United States. However, deliberate abuses are the exception rather than the rule with the business community, and for that reason should not be allowed to trigger an overreaction which would discourage bona fide conventions abroad. To limit the location is not to solve the problem. Abuses will occur, whether the trip be to Rio de Janeiro or to Hawaii. The solution, we think, will more likely be found through broader dissemination of the already existing and quite adequate IRS tax code regulations among the business community through business organiza-

[1] This directory was made a part of the official files of the committee.

tions such as ours, for example, than through attempting to curb a business organization's freedom to select the site for its convention or conference.

The selection of a foreign location for a legitimate business convention offers tangible benefits to the attendees, to the important travel segment of U.S. business, and to the host country, as well as the intangible benefits of better international understanding.

1. For the attendees, business conventions and conferences in foreign countries broaden an individual's education and experience, and his understanding of international relations. More specifically, however, when such travel is business-related, the traveler meets residents of the host country with similar interests and is frequently provided with valuable opportunities for new business connections, new markets, new sources of supplies—in short, the ingredients for expanded business and trade. Foreign conventions are an ideal vehicle for this type of business expansion.

2. The U.S. travel and transportation industry benefits significantly from convention business outside the United States as well as within the country. U.S. airlines serving foreign countries, U.S. hotel chains owning or managing hotels abroad, and other U.S. companies providing travel services count on convention travel for a share of their income. They have made substantial investments in facilities in Mexico and other countries, based on the expectation of continued and growing international travel—including convention travel. Any change in existing laws that would discourage foreign travel would adversely affect these U.S. business firms.

3. As is perhaps most evident, convention travel boosts the economy of the host country—and in today's interdependent world the ups and downs in any country's economy are felt far beyond its own borders through their effect on world trade, global inflation, the stability of currencies and in other ways. Specifically in the case of Mexico, tourism, including conventions, is an especially important factor in its balance of payments with the United States, as U.S. tourist expenditures are counted on to offset to some extent the very large chronic imbalances in trade. Mexico is the fourth most important market for U.S. exports, after Canada, Japan and the European Community, but its exports to the United States fall far short of earning enough dollars to pay for the U.S. goods it buys. In 1974 U.S. exports to Mexico exceeded imports from Mexico by $1.5 billion; in 1975, the trade gap grew to over $2 billion. If Mexico is to continue to be a good customer of the U.S., it must have other sources of dollars to pay for its purchases, and tourism and conventions provide such a source. The important Mexican market for U.S. exports could be seriously affected by any unilateral U.S. action which would diminish the amount of dollar exchange available to Mexico to pay for its imports from the United States.

4. Tourism, including conventions, is a "two-way street", in which reciprocity is an important element. As U.S. travelers visit other countries, residents of those countries are encouraged to visit the United States. Mexico's tourism to the United States, for example, is growing faster than U.S. tourism to Mexico. The U.S. Travel Service estimates that in 1975 a record 2.1 million Mexicans visited the

United States as tourists, and that in 1976 this number is expected to grow to 2.5 million. In our Bicentennial year, when we are encouraging tourists from all over the world to come and see the United States, it certainly is not appropriate to be thinking of discouraging U.S. travel abroad.

For these reasons, we respectfully recommend that the Committee on Finance, in drafting income tax revisions, not purpose any change in the existing provisions for deduction of expenses of attending bona fide business conventions and meetings outside the United States. However, if some restriction should be found to be necessary, we recommend that deduction of such expenses continue to be allowed for attending conventions within the United States and its adjoining countries—Canada and Mexico.

5. Mexico does not seek nor receive U.S. handouts but encouraging terms of trade and financing that permit it to help itself. Good relations with Mexico affect not only the U.S. economy but its security and, increasingly, the posture Mexico assumes as a third world leader.

6. IRS regulations exist to prevent the abuses of convention travel. More effective than territorial restrictions would be vigorous dissemination within the business community of IRS tax code regulations, and their strict application.

7. The considerable U.S. investment in Mexican tourist facilities and air service would be adversely affected. Both U.S. airlines and U.S.-owned hotel chains abroad have a huge investment based on the expectation of continued international tourism and convention travel.

8. Conventions provide an excellent opportunity for improved international understanding and for expanded trade through first-hand contacts with business partners, markets and products.

We sincerely hope that your Committee will take into consideration all of these factors and avoid territorial restrictions on conventions that, by reducing Mexico's share of U.S. trade and tourism, could undermine the prosperity of both countries and their cordial relations.

Statement of Gilbert Garber, Executive Vice President, Garber Travel Service, Inc., and President, International Congress and Convention Association

I submit my statement to you in the dual capacity of Executive Vice President of Garber Travel Service and President of the International Congress and Convention Association (ICCA).

Garber Travel operates 22 offices in Massachusetts, New York, New Hampshire, Rhode Island, and Vermont. In 1975, our sales volume was in excess of $24 million.

A significant part of our business is the handling of arrangements related to National and International Meetings, Conventions and Congresses; meetings which may take place in the U.S. and have both U.S. and foreign participation, as well as meetings held overseas with similar makeup.

The International Congress and Convention Association has membership in 67 countries and is comprised of all components of the

meeting industry, including Travel Agents, Airlines, Government Tourist Bureaus, Congress Organizing Companies, Meeting Centers, Hotels and other services. Among our U.S. membership are: Pan American and Northwest Airlines; Sheraton, Intercontinental, Hyatt International and Loews Hotels; Hertz and Avis Car Rental Companies; the United States Travel Service, an arm of the Commerce Department; the Convention and Visitors Bureau of San Francisco, Salt Lake City and Atlanta. A full list of our membership as of November, 1975, is submitted.

Among the functions of ICCA is the publishing and distribution of information about Congresses and Conventions which take place all over the world. Our membership promotes attendance and handles arrangements for such events, and in many instances is a direct influence on the choice of site for these meetings.

My understanding is that the origins of the section of the Bill relating to tax deductibility for attendance at Conventions was the concern that deductions were being claimed for attendance at Conventions which were not of serious purpose. There were many blatant examples of such questionable meetings which advertised attractive destinations for esoteric meetings of one sort or another . . . and emphasized their tax deductibility.

It had been my contention—affirmed by the testimony of others—that violations of the intent of the law, if not the law itself, should best be dealt with by the Internal Revenue Service, who has all of the necessary tools at hand. To me it was strange, in any case, that there seemed only concern with frivolous meetings held overseas. An equally questionable meeting held in an attractive resort location such as Honolulu, Vail or Miami was not to come under any new regulation . . . The implication being that the IRS somehow had adequate safeguards for domestic destinations.

It has been—and still is—my contention that the meeting itself must qualify—by reason of its content of serious business or profession related substance—whether the meeting takes place in Honolulu or Hamburg—in Milan or Miami. The qualifying of the meeting for tax deductibility must not be based solely on its geographic location.

As originally considered in the House, the Bill (as H.R. 1040) related only to Conventions held overseas by U.S. organizations. It must be assumed that recognition was purposely given to the special—and different—nature of attendance at meetings, wherever they may be held, by International Organizations whose function, interests and membership composition may be significantly different from U.S. National Societies. The effect of the Bill, as originally proposed, would have been to pressure U.S. Associations to plan their meetings at onshore locations. Whether or not this was justified is another subject. It's a matter of record, however, that the very threat of such legislation did accomplish that fact . . . to the concern of the Associations, U.S. business interests around the world, and other Governments of countries near and far whose economy is so closely tied to our own.

In any case, this aspect of pressure on the Associations has now been removed and transferred unfairly to the individual member. Under the terms of H.R. 10612 a member of a National Society whose meeting

may be held in Canada, the Bahamas or any offshore location—who may also have legitimate business or professional interest in attending two international meetings in the same year—would have to choose for himself which two to claim as a deduction. It is interesting to note that according to a reliable international source, Association membership among professionals and other steady Congress participants is estimated at 3.5 Associations per person.

Is this the same criteria that is applied to the general deductibility of business expense for overseas travel? No limitation is placed on overseas travel for business purpose. To do so would obviously restrict normal business development; and as a consequence, tax revenues would be stifled. Any such limitation would raise a hue and cry from the general business community and, in fact, would change the very fabric of our multinational business complex. It would be quickly recognized as restrictive and punitive to a particular segment of the business community and would promptly be labeled isolationist.

We think of business travel as commonplace for the ordinary business man in the pursuit of his affairs . . . I wonder if we tend to think of convention attendance generally as vacationing or junketeering. Perhaps therein lies the problem.

The Convention or Congress is more likely to be the business travel for the Medical and Scientific community. That's the scene where he learns of the new Scientific development, the progress in basic or clinical research. That's his market place for exposing his new ideas. By what logic do we determine that two such business trips for the Doctor . . . The Scientist . . . or others, for that matter is the proper limit?

For years the function of the U.S.T.S. has been the promotion of travel to the United States. As part of this overall goal a major effort has been to attract International organizations to hold their meetings in our Country—also to attract international attendance to meetings of U.S. Associations. Due to the dedicated efforts of Commerce Department employees, this has been markedly successful.

According to a research Study, "The Character and Volume of the International Convention and Congress Market", conducted for U.S.T.S. in 1975, it was determined that in 1973 and 1974 an average of 390,000 foreign delegates attended a total of 1004 Congresses and U.S. Association Conventions in the U.S. and spent roughly $1.4 billion. If foreign attendance at U.S. National Conventions alone were to drop by 100,000, U.S. foreign exchange earnings would decline by $25 million annually, and sales and excise tax revenues from foreign Congress delegates would fall by approximately $2 million.

It is a fact of life of the International Convention Market that the selection of a Convention Site first requires an invitation from the host organization. Traditionally this has been, perhaps, the greatest hurdle to overcome in attracting meetings to the U.S.

Permit me to cite an example of a typical event.

Due to the involvement of several dedicated American Doctors, San Francisco will be the location in 1979 of the Joint Meetings of the International Surgical Society and the International Cardiovascular Society. It is expected that thousands of international delegates will attend from all over the world. In order to insure this, key U.S. mem-

bers are expected to attend meetings, in the interim period, to promote attendance, encourage participation, and generally fulfill their own membership obligations. Their attendance will be expected at international meetings of Associations of Allied Specialties such as Vascular, Thoracic Surgery, Cardiac Pacing, Cardiology, Medical Engineering etc. The international societies generally have area chapter structures; such as North American, South American, European, Australian . . . where similar involvement is expected. Under H.R. 10612 attendance at only two meetings will be allowed as deductible.

Obviously one effect of the Bill will be to shut off invitations from the U.S. organizations, thwarting the efforts of the U.S.T.S. and cutting off beneficial tax revenue . . . not to mention the immeasurable additional value of foreign visitors.

And another will be to raise the spectre of reciprocal action by other Governments . . . a very real and significant likelihood. In this regard there has already been oral testimony given at the previous hearings and subsequent written protests by other Governments.

It is my belief that an error has been injected—not originally intended—of including in any limitation, attendance at bona fide international events.

May I point out the present IRS Guidelines? Treasury Regulations 1162–S states: "An income tax deduction is allowed for the expenses of education (including travel, meals, and lodging) undertaken to maintain and improve professional skills."

Attendance at a bona fide Convention or Congress is educational and does maintain and improve professional skills.

As to specific details of Sec. 602, I would further comment that, as the Bill is written I believe that an administrative Pandora's Box will be opened.

Section 2 allows deductibility for the "lowest coach or economy fare at the time of travel". I would ask any member of this committee—or any IRS investigator—whether "lowest coach or economy rate" means GIT, OTC, APEX, ITX or which lowest economy rate?

But here, too, should not the universal standard of business expense apply? Is it equitable to set different criteria for deductibility based on whether the meeting involves 2 or 3 persons or 200 or 2,000?

Section 3 and Section 4 are both commendable.

Section 5 surely introduces a new concept for determining allowable deduction and will be the cause of considerable taxpayer dissent. An arbitrary limitation will be set that is not connected to the reality of available hotel charges, other costs, and the facts of life of the convention industry.

Again an arbitrary distinction is being made between the business traveler and the convention delegate. U.S. chain operated hotels, generally of higher quality, are being discriminated against. In fact, the U.S. delegate may well be isolated from his international colleagues. Oftentimes Hotels are chosen for reasons of their meeting facilities, which generally are offered free to the Convention Organizers on the basis of room occupancy. The dynamics of Congress may well be affected by this provision.

In conclusion, it is my firm belief that Section 602 of H.R. 10612 does not address itself to its designed purpose as stated in the Bill.

"An Act to Reform the Tax Laws of the United States" but rather will create a schism in the business community—a schism between types of business persons—a schism between national and international involvement.

I believe that continued effort should be expended to encourage greater internationalism with all of its related economic benefits; that our own activities, both private and governmental, toward attracting international events to the U.S. should be encouraged and expanded; whereas, the passing of this legislation would have a counter affect. Affirmation of this position is the resolution passed unanimously at the annual Assembly of ICCA in November of 1974, when H.R. 1040 was under consideration:

In regard to H.R. 1040:

Whereas conventions by their very definition signify the convening of people for the purpose of exchange of ideas;

Whereas a convention creates an atmosphere conducive to international understanding, increased knowledge and trade;

Whereas the United States is seeking to attract foreign conventions and meetings to its own shores which contribute to equalizing the Balance of Payments;

Whereas a foreign convention held in the U.S. itself results in international trade to the benefit of the U.S. and its Balance of Payments;

Whereas a U.S. convention held abroad creates a market for U.S. products resulting in exports of U.S. goods and services;

Whereas any further reduction in business oriented travel will further add to the present crisis facing U.S. enterprises and interests in international trade such as Airlines, Hotels, etc.;

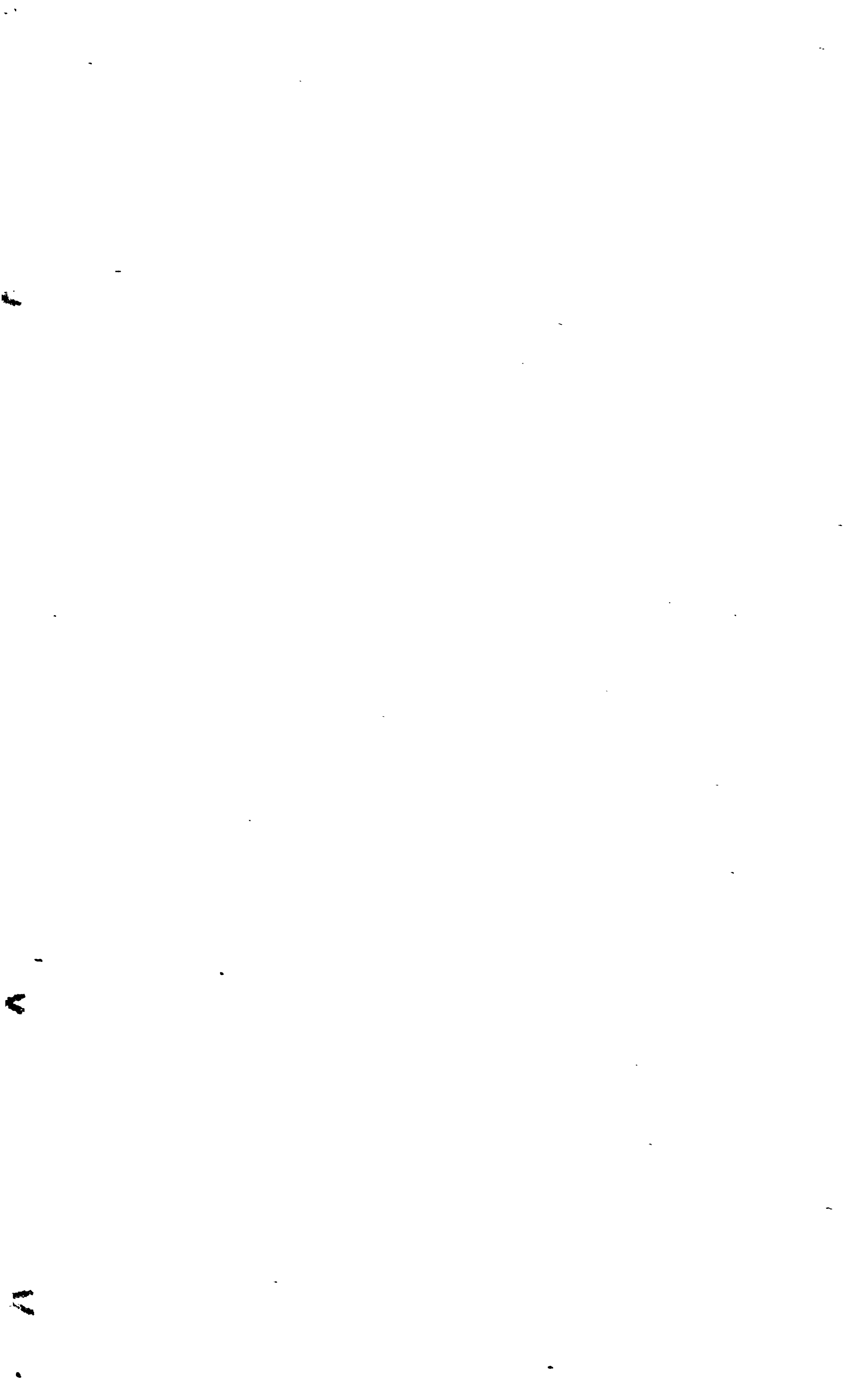
Whereas present regulations provide adequate safeguards against abuse of tax deduction for non-legitimate purposes; and

Whereas restrictive measures against such interchange attract punitive retaliation which can only be inimical to the best interests of U.S.

The International Congress and Convention Association urges that no further limiting legislation be considered which would restrict the positive results which are generated by reason of conventions and meetings held worldwide.

Deductions Allowed for Authors and Artists

69 516—76—pt. 7 —11



COMMUNITY MUSEUM OF BROOKLYN,
Brooklyn, N.Y., May 18, 1976.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee, New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: Your past performance in the Senate has proven you to be an intelligent and sensitive political leader of the Nation. I therefore, beseech you to reassess the provision of the new tax reform bill that will affect deductions for artists. This bill is most injurious to the working fine artist. The ability to deduct the expenses of his studio on his taxes has been a saving grace, financially, for many working artists in America.

The majority of the population does not purchase original art work. They buy reproductions produced and manufactured by large companies. In fact, the furniture store chains across the country have introduced fine art paintings which has eliminated considerable business for the individual artists. There is little private, city, State, or Federal support for artistic endeavors in this country. Art has always been a low priority. In France, it is the responsibility of the government to maintain the works of the outstanding French contemporary painters, such as Picasso. The artist is supported in many countries with governmental subsidies. The National Endowment for the Arts has one-tenth of the budget allocation of the National Science Foundation. There is such a great disparity in priorities regarding the arts, that it is incredible.

The artist, who many assume does not contribute greatly to the society as a whole, is the most important element in history. The artist is the recorder of history. The records of events would not exist if not for the artist. In 1933, President Roosevelt made a positive move toward government involvement in the arts. Today, the nation is suffering a similar financial crisis and the most negative move is now taking place. Sir, I protest on behalf of the artists of America. The new tax reform bill provision will affect the artists in a very detrimental manner. I do hope you will vote against the passing of this bill's provision.

Sincerely yours,

CHARLENE CLAYE VAN DERZEE,
Assistant Director/Curator,
Vice President, National Conference of Artists.

THE LAWYERS CO-OPERATIVE PUBLISHING CO.,
Rochester, N.Y.

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

We wish to submit our position with respect to a portion of H.R. 10612 for the record.

Section 1306 of H.R. 10612, "Regulations relating to tax treatment of certain prepublication expenditures of publishers" is meaningless after the Internal Revenue Service issued Information Release 1575 suspending application of Revenue Ruling 73-395. We request that a provision similar to that introduced in H.R. 13064 and reintroduced in H.R. 8736, relating to amending Internal Revenue Code section 174 to insure its uniform application to business products, be considered in place of section 1306 of H.R. 10612.

The Lawyers Co-operative Publishing Co. and its subsidiary corporations publish lawbooks, business and economic periodicals, and tax publications. In order to publish new works and improve existing publications, the company spends several million dollars each year in an extensive editorial effort. The constant improvement and updating of our existing publications and the creation of new products is the lifeblood of our business.

For many years, the publishing industry has been subjected to discriminatory and unfair treatment by the regulations issued under authority of section 174 of the Internal Revenue Code. Although section 174 on its face permits a current deduction for all "research and experimental expenditures", Treasury regulations (specifically 1.174-2(a)(1)) excludes "expenditures paid or incurred for research in connection with literary, historical or similar projects." Thus, the publishing industry is denied tax benefits accorded to businesses generally. Since part of the motivating force behind the enactment of section 174 was the desire by Congress to encourage the improvement of existing products and the development of new products and ideas, we have never understood why this tax incentive was denied to one segment of the economy. Because of this treatment, we have consistently followed the practice of carrying editorial costs in inventory until a publication is introduced for sale or until a project is abandoned, at which time a deduction is taken for the total project expenditure.

Recent developments have compounded our difficulties and left us in a difficult position. Revenue Ruling 73-395, issued in late 1973, expresses the Internal Revenue Service's position with respect to expenditures incurred by a taxpayer in writing, editing, and designing textbooks and visual aids. The ruling concludes that these expenditures not only are excluded from the benefits of section 174, but also, are not considered inventoriable. Rather, the expenditures result in a capital asset which is depreciable over the useful life of the related publication. The Service further states that it will not follow the decision of the U.S. District Court, *Stern* v. *United States*, 1971-1 USTC 86, 419 (C.D. Calif.). This case permitted a taxpayer in the business of writing books to deduct traveling expenses incurred while researching and writing.

After this ruling, we find ourselves not only denied the benefits of section 174, but also required to capitalize expenditures for which nearly every other type of business can take an immediate tax deduction. All publishers are experiencing the same unfair treatment.

The IRS suspension of Revenue Ruling 73-395 and section 1306 of H.R. 10612 are not solutions. They leave the publishing industry in limbo. An IRS study may take years. All of this may force curtailment of recovery and expansion by the publishing industry.

The solution is to allow the publishing industry the benefits of Internal Revenue Code, section 174 in the same manner as other businesses. The uncertainty created by the IRS must be removed so that the industry may make financial plans for future publications. This can only be accomplished by legislative action.

SEYMOUR FOGEL, *Vice President.*

STATEMENT OF THE AUTHORS LEAGUE OF AMERICA

The Authors League, the national society of professional writers, respectfully requests that this statement be included in the record of the committee's hearings on H.R. 10612.

This statement concerns the tax treatment of research, travel, and similar expenses incurred by a professional author in gathering information, preparing, and writing books and other literary works. As the courts have ruled, these are ordinary and necessary expenses of the professional author's trade and business of writing which he is entitled to deduct in the year they are incurred. However, a 1973 ruling by the Internal Revenue Service disputes that right.

The Authors League respectfully requests the Committee on Finance: (i) To amend section 1306 of H.R. 10612 to protect professional authors, as well as publishers, from that ruling; and (ii) to remove doubts as to the tax treatment of the ordinary and necessary expenses of professional writers by adding a new provision, set forth below, to the Internal Revenue Code.

BACKGROUND

In 1971, a district court opinion reaffirmed the right of professional authors to currently deduct research and similar expenses incurred by them in preparing and writing books and other literary works. *Stern* v. *United States*, 1971-1 USTC 86,419 [Par. 9375]. Professional authors had long followed this practice. Courts upheld it.

The IRS subsequently issued Revenue Ruling 73-395, contending that these "prepublication expenses" could not be currently deducted by publishers, and had to be depreciated over a period of years. The ruling concludes with a refusal by the IRS to follow the *Stern* decision and has been applied to authors.

Section 1306 of the House tax reform bill also submitted as an amendment by Senator Bentsen, suspends application of the ruling with respect to publishers. Professional authors are not protected by the section, although the ruling is aimed at a decision that correctly upheld their right to deduct these expenses in the year incurred. A recent

news release by the IRS announces it will "suspend audit and appellate activity with respect to cases in which the deductibility of these prepublication expenses is an issue" pending completion of a "project" which may lead to new regulations or additional rulings. However, the release is limited to publishers. And it leaves professional authors completely in the dark as to the position the IRS would take if they continued to currently deduct research, travel, and similar expenses, as the courts have ruled they are entitled to do.

RECOMMENDATIONS

For the reasons discussed below, the Authors League respectfully submits the following recommendations to the committee:

(i) That section 1306 be amended to extend it to professional authors by adding two italicized words, as follows:

(c) Prepublication expenditures defined—For purposes of this section, the term "prepublication expenditures" means expenditures paid or incurred by the taxpayer (in connection with his trade or business of *writing or* publishing) for the writing, editing, compiling, illustrating, designing or other development or improvement of a book, teaching aid or similar product.

(ii) Any future doubts as to the right of professional authors to currently deduct these expenses should be removed by adding a new provision to the code, as follows:

A taxpayer whose personal efforts created a literary, musical or artistic composition or similar property, may treat research, travel and other expenditures which are paid or incurred by him (in connection with his trade or business of writing) for the preparation and creation of such work as expenditures that need not be capitalized pursuant to Sec. 263 or depreciated under Sec. 167(a). The expenditures so treated shall be allowed as a deduction.

It should be noted that this section would apply only to professional authors; that is, those engaged in "the trade or business of writing"; a criterion often applied by the IRS and the courts.

REASONS FOR THE RECOMMENDATIONS

(i) In the case of novels, histories, biographies, and other books of general interest, it is the self-employed author, not the publisher, who pays the travel, research, and other expenses incurred in gathering information and material for a book.

As the court indicated, in *Stern* v. *U.S.*, these expenditures are not nondeductible expenditures for the improvement of a capital asset which must be depreciated. On the contrary, ruled the court:

(these) expenses were ordinary and necessary expenses of carrying on plaintiff's business of a writer and hence are deductible under 26 U.S.C. 162(a). See *Doggett* v. *Burnet* (65 F2d 191); *Brooks* v. *C.I.R.* (274 F. 2d 96.)

Traveling to conduct interviews, consulting research sources, and similar preparatory work are as much part of the process of writing a book as are putting the words down on paper. The expenses of doing this work are ordinary business expenses.

(ii) It is totally inconsistent to rule that these expenses must be capitalized and depreciated. Section 1221(3) of the Internal Revenue Code prohibits authors from treating their literary, dramatic, and musical works as "capital assets." In this and other sections, authors

are held to be persons who earn "ordinary income" by their personal efforts. As this committee stated in regard to section 401(c)(2)(C), "income from an author's writing * * * is (so) clearly a result of his individual efforts."

(iii) It would be discriminatory to relieve publishers from the inequities of Revenue Ruling 73-395. Indeed, professional authors will suffer even more than publishers under the ruling. An author must pay his research and travel expenses as they are incurred. But he does not have the financial resources to spread their deduction over a period of years. If he cannot deduct them in full in the year they are incurred, he suffers a much harder blow than a publishing corporation. Moreover, failure to include authors in section 1306 and Senator Bentsen's amendment might lead courts to disregard the prior decisions which sustain the professional author's right to currently deduct these expenses.

We thank the committee for the opportunity to submit this statement.

STATEMENT OF THE ASSOCIATION OF AMERICAN PUBLISHERS AND THE AD HOC COMMITTEE FOR EQUITABLE TAX TREATMENT OF THE PUBLISHING INDUSTRY

I. INTRODUCTION

The Association of American Publishers and the Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry wish to submit this statement in lieu of the previously requested personal appearance of witnesses before the tax reform hearings of the Senate Committee on Finance.

The Association of American Publishers, a not-for-profit trade association, represents publishers of 80 to 85 percent of the general books, textbooks, and educational materials produced in the United States. The Ad Hoc Committee for Equitable Tax Treatment of the Publishing Industry represents Harcourt, Brace, Jovanovich, Inc.; Macmillan, Inc.; W. W. Norton, Inc.; G. P. Putnam's Sons, as well as all members of the Association of American Publishers. The ad hoc committee thus represents publishers of approximately 90 percent of the books published in the United States.

The Association of American Publishers and the ad hoc committee urge the Finance Committee to act favorably on the House-passed provision that addressed the publishing industry's problems, section 1306 of H.R. 10612, with certain technical clarifying amendments relating to cost of goods sold (see attachment 1). The sole effect of this provision is to prevent the unfair retroactive application of tax accounting changes announced in Revenue Ruling 73-395.

II. NEED FOR LEGISLATION

On September 24, 1973, the IRS issued Revenue Ruling 73-395 which denied publishers the option of currently deducting expenses for editoring, artwork, and other costs of developing textbook and visual teaching aid products. Although the ruling affected the entire publishing industry, it was issued without prior notice and opportunity for industry comment.

The ruling represents an abrupt reversal of industrywide tax accounting practices that have been approved throughout decades of IRS audit experience. The extent to which the ruling would alter pervasive industry methods of accounting was clearly revealed by a recent ad hoc committee survey of the tax treatment of prepublication expenditures in the segments of the industry most affected by the ruling. This survey demonstrated that in general there has been a substantially uniform practice among publishers of currently expensing editorial and production—primarily art, design, purchasing and administrative functions—expenditures. In addition the survey revealed there are a substantial number of publishers that also currently expense plant costs, which consist primarily of expenditures for outside artwork, composition, negatives, and plates. A more detailed analysis of this survey has already been conveyed to the joint committee staff.

The ruling has proven to be discriminatory in two ways—it discriminates against the publishers as an industry and it discriminates between similarly situated publishers, even when they are competitors.

First the IRS singled out publishers, particularly those publishers that produce the Nation's educational books, for denial of a right granted by Congress to all business taxpayers under section 174 of the code either to deduct currently or to capitalize all product research, development, and improvement costs. Second, the IRS is applying the ruling unevenly between publishers, even where they are directly competing with each other. In view of the degree of uniformity of industry practice revealed by the recent survey, the nonuniform application of the ruling is demonstrably discriminatory.

The ruling is retroactive. Despite the consistent and longstanding practice of currently deduction of prepublication costs shared by most of the publishing industry, the IRS is insisting that the ruling reversing that practice be applied retroactively. On February 11 of this year, despite earlier votes by the House and by the Senate Finance Committee approving legislation to end the retroactivity, the IRS Commissioner's decision not to limit retroactive effect of the ruling was reaffirmed and a district IRS office was instructed to proceed with enforcement of retroactive tax assessments under the ruling. The subsequent IRS press release of March 11, 1976, which announced the temporary suspension of audit activity under the ruling, does not obviate the need for prompt enactment of this legislation since the IRS has given the industry absolutely no assurance it will alter its insistence on the retroactive application of the tax rules announced in the ruling.

III. LEGISLATIVE SOLUTION

The stopgap legislation proposed to deal with the problem (see Attachment 1) merely provides a do not disturb rule to preserve the status quo for the period before a long-run solution is put into effect. Under this legislation, for the period before regulations for the future go into effect, a taxpayer is allowed to treat his prepublication expenditures in the manner in which he consistently treated them before the issuance of revenue ruling 73-395.

The publishing industry will continue its cooperation with the joint Treasury—IRS task force that is studying the problem and attempting to develop a permanent administrative solution. However, if the

task force is unable to devise an adequate administrative solution, the industry will be forced to seek a permanent resolution of the problem by means of additional legislation.

IV. REVENUE EFFECT

No revenue loss will result from enactment of the stopgap legislation. Rather, the legislation will prevent the IRS from retroactively producing tax revenue by administrative action from a source never intended by Congress. The fact that the legislation will result in no revenue loss was recognized by the House Ways and Means Committee in its report to the House on the legislation as passed by the House in November 1975.

V. STATUS OF THE LEGISLATION

Legislation identical to attachment 1 (except for the clarifying technical change noted) was approved by the House Ways and Means Committee (on the motion of Mr. Burke of Massachusetts) in October 1975, was passed by the House in November, 1975 (as section 1306 of H.R. 10612), and was unanimously approved in December 1975 by the Senate Finance Committee (on the motion of Senator Bentsen) as a Committee-approved amendment for addition to an appropriate House-passed tax bill.

ATTACHMENT 1

Text of Stopgap Legislation
(Includes technical clarifying amendments)

TAX TREATMENT OF CERTAIN PREPUBLICATION EXPENDITURES

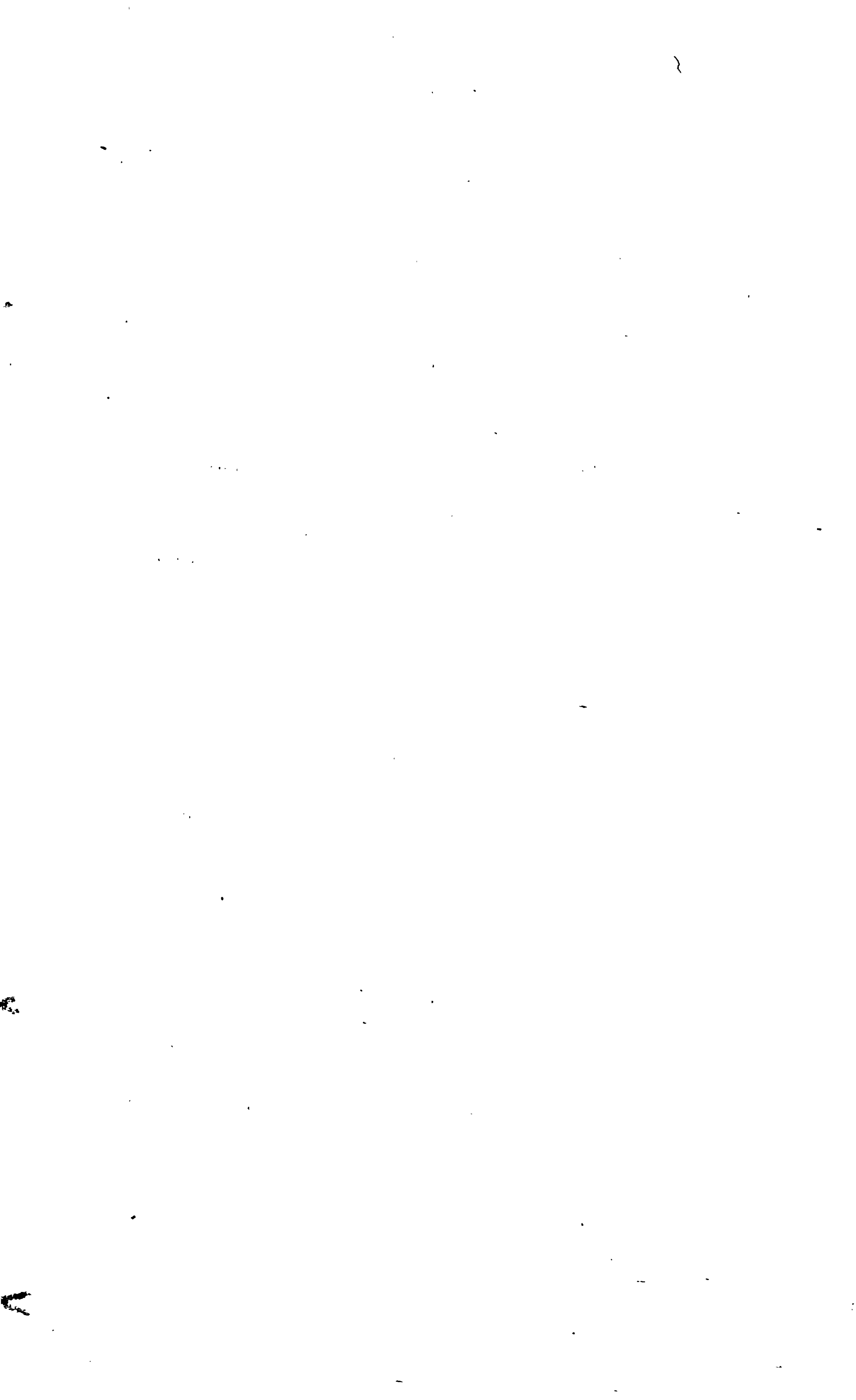
(a) GENERAL RULE.—With respect to taxable years beginning on or before the date on which regulations dealing with prepublication expenditures are issued after the date of the enactment of this act, the application of sections 61 (as it relates to cost of goods sold), 162, 174, 263 and 471 of the Internal Revenue Code of 1954 to any prepublication expenditure shall be administered—

(1) Without regard to Revenue Ruling 73–395, and

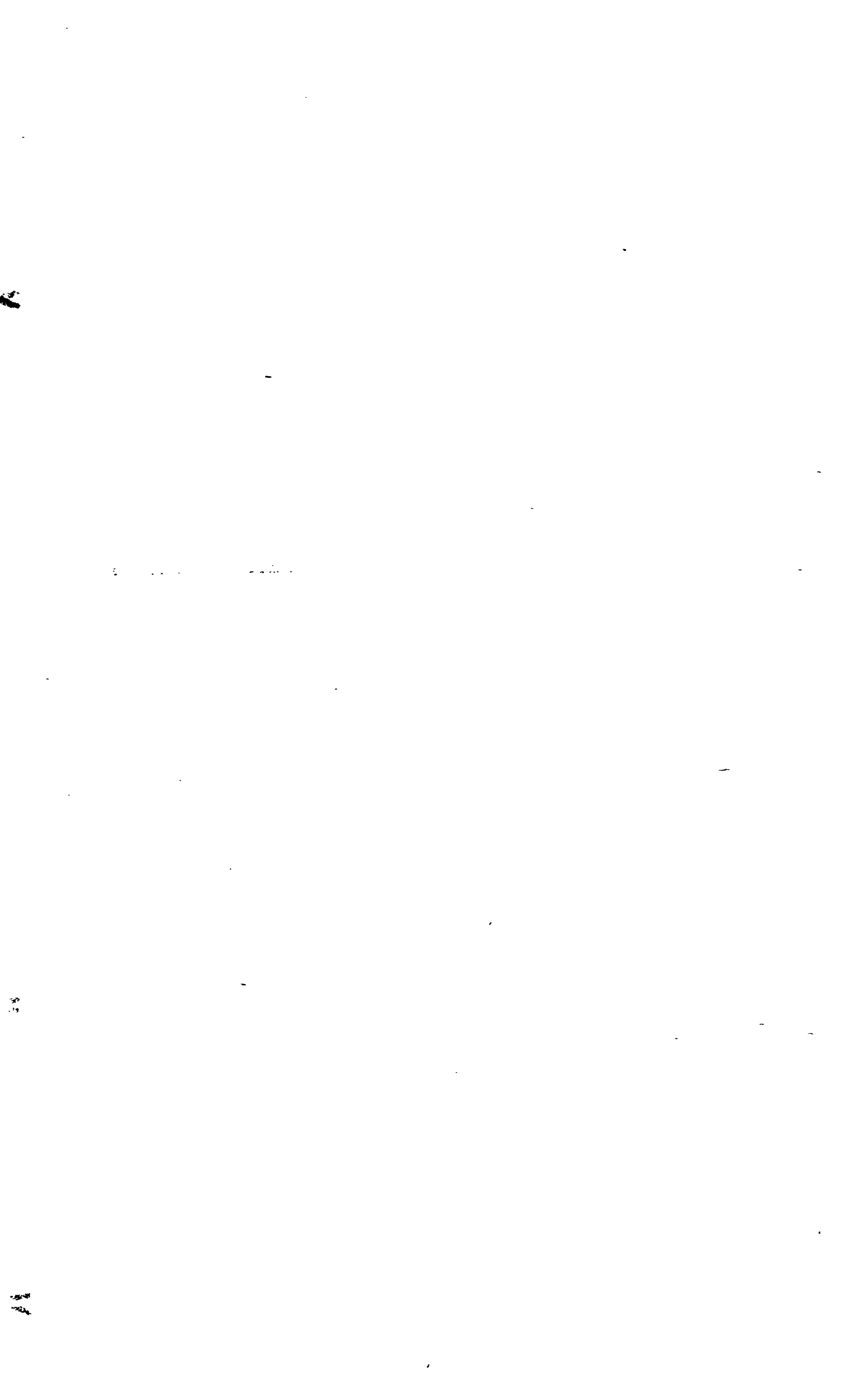
(2) in the manner in which such sections were applied consistently by the taxpayer to such expenditure before the date of the issuance of such revenue ruling.

(b) REGULATIONS TO BE PROSPECTIVE ONLY.—Any regulations issued after the date of the enactment of this Act which deal with the application of sections 61 (as it relates to cost of goods sold), 162, 174, 263, and 471 of the Internal Revenue Code of 1954 to prepublication expenditures shall apply only with respect to taxable years beginning after the date on which such regulations are issued.

(c) PREPUBLICATION EXPENDITURES DEFINED.—For purposes of this section, the term "prepublication expenditures" means expenditures paid or incurred by the taxpayer (in connection with his trade or business of publishing) for the writing, editing, compiling, illustrating, designing, or other development or improvement of a book, teaching aid, or similar product.



Qualified Stock Options



PEAT, MARWICK, MITCHELL & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., April 22, 1976.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Committee,
Washington, D.C.

GENTLEMEN: We believe that the minimum tax on tax preferences, under both the present tax law and the changes proposed by the House of Representatives, is inequitable as it applies to the exercise of qualified stock options, for the following reasons:

1. The minimum tax on the exercise of qualified stock options is a tax on a potential economic benefit as opposed to an actual benefit.
2. The effective tax rate for an individual who exercises a qualified stock option and immediately sells the stock at a gain can easily be as high as 84 percent and, in extreme cases, over 100 percent under the Ways and Means Committee proposals.
3. In addition to paying tax on gain from sale of the stock, the individual who exercises qualified stock options may have to pay the minimum tax twice with respect to that stock—once when the stock options are exercised and a second time on capital gain from the sale of the stock.

POTENTIAL BENEFIT

The exercise of a qualified stock option confers only a potential benefit upon the individual exercising that option. Many plans provide that the individual may not dispose of the acquired stock for a stated period of time—frequently 6 months. Further, in certain instances, Securities and Exchange Commission regulations prohibit the sale of stock within 6 months of acquisition. An individual who acquires stock through the exercise of a qualified stock option but cannot sell the stock for some stated period of time may never realize any benefit from the option exercise if the value of the stock drops before the stock can be sold.

In the early 1970's, many of our clients exercised qualified stock options at a time when the difference between the option prices and fair market value of the stock resulted in a substantial tax liability due to the minimum tax. However, due to various holding period requirements and a declining stock market, the fair market value of the stock often dropped to a level substantially below the price paid for the stock before the stock was sold. Thus, no ultimate economic benefit was realized by these taxpayers as a result of the exercising of qualified stock options. We do not believe it appropriate to tax gains which have not yet and, in fact, may never be realized.

84 PERCENT EFFECTIVE TAX RATE

The tax rate on the gain from the sale of stock acquired can easily be as high as 84 percent under the Ways and Means Committee pro-

posals. If a taxpayer exercises a qualified stock option and has other preferences, he may incur a full 14-percent minimum tax on the difference between the option price and the fair market value of the stock at date of exercise.

If the taxpayer is not subject to any holding period requirements, he may forego the capital gain benefit and sell the stock soon after the acquisition. The gain may be taxed at a rate as high as 70 percent, even though the gain may be earned income under section 1348. The provisions of section 1348 may not benefit the taxpayer due to the interplay of tax preferences with the maximum tax computation.

Thus, the taxpayer may pay a Federal tax of up to 84 percent on his gain from the sale of the stock under the Ways and Means Committee proposals, if the stock is purchased near the end of one taxable year and sold soon after the start of the next taxable year. In extreme cases, the combination of minimum tax and regular tax can even exceed 100 percent of the gain. This occurs because, under section 1348(b)(2)(B)(i) of the Code, a large tax preference in one year can cause a taxpayer to fail to qualify for full maximum tax benefits for the succeeding 4 years.

We do not believe this double taxation is appropriate—unless it is applied to all other tax preferences too.

INCOME TAX CARRYOVERS

Current law allows income tax paid in prior years to be used as a carryover against tax preference items in the current year. The Ways and Means Committee proposes to terminate this provision. We believe that repeal of the tax carryover offset, if effected, should apply only to tax carryovers from years beginning after December 31, 1976. Tax carryovers from years beginning on or before December 31, 1976, should be allowed against preferences in future years. Many taxpayers arranged their affairs to recognize tax preference in future years with the knowledge that the tax carryover offset exists. To eliminate the previously accumulated carryovers would create a hardship to these taxpayers.

CONCLUSIONS

Based upon the above discussion, we respectfully suggest the following:

1. The difference between the option price and fair market value upon exercise of a qualified stock option should be removed from the list of tax preferences. This would remove the minimum tax from what is only a potential benefit. It would also permit the premature sale of stock acquired through exercise of a qualified stock option to be treated as "earned income" for maximum tax on earned income purposes without reduction for the preference from options exercised. This is frequently not possible under current law due to the interplay of tax preferences with the maximum tax computation. This change would also eliminate effective tax rates which can easily reach 84 percent on the exercise of qualified options and later sale of the acquired stock. Further, the change would eliminate the double minimum tax which now frequently applies to qualified option stock transactions.

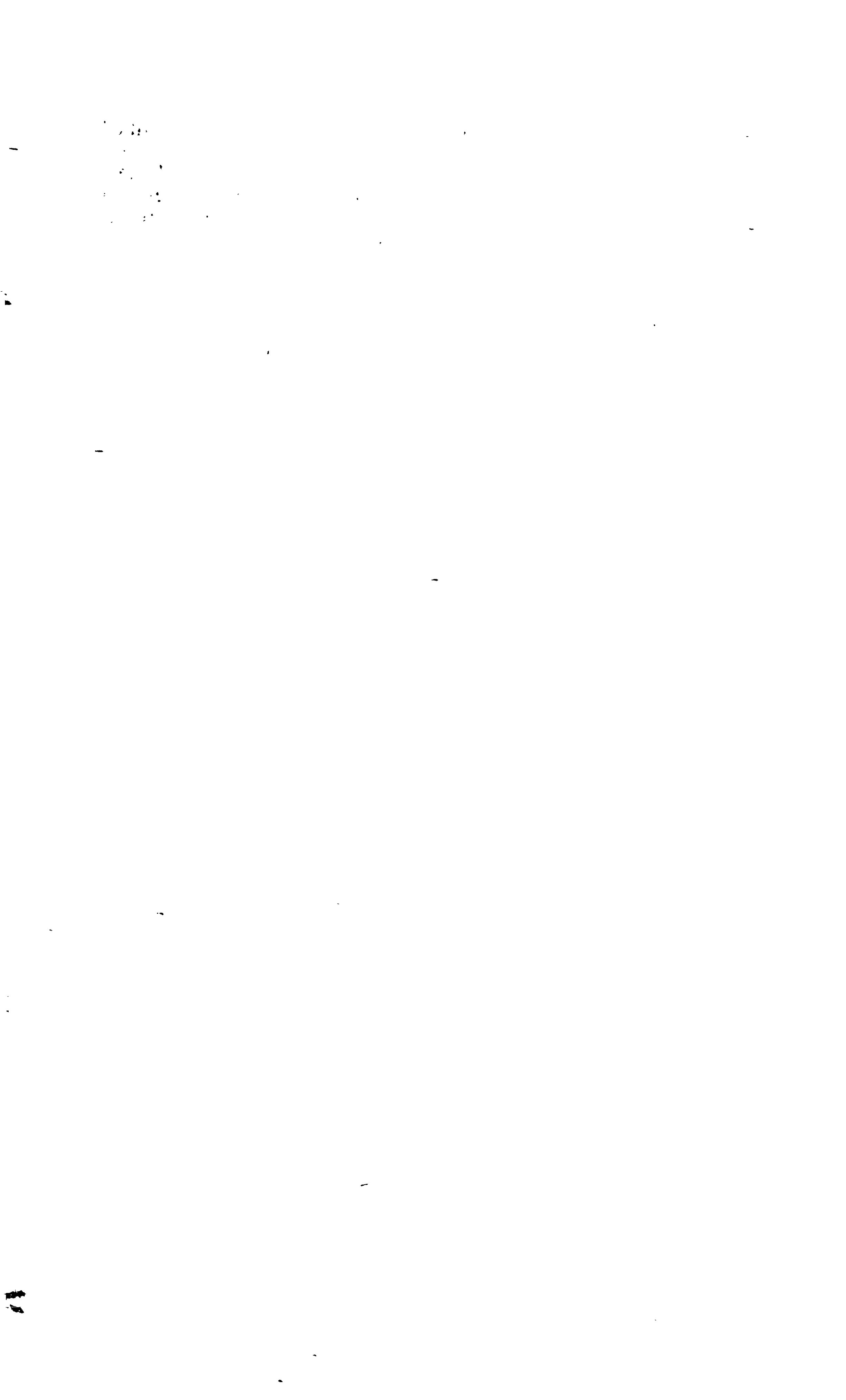
2. Alternatively, if it is determined that the exercise of a qualified stock option should continue as a tax preference item, a credit should be allowed to the taxpayer for minimum tax paid as a result of exercising an option (i) if the stock is sold prematurely and no long-term capital gain is recognized, or (ii) against minimum tax due as a result of the later sale of the stock as a long-term capital gain.

3. If the exercise of qualified stock options is to continue to result in a tax preference item, the tax carryovers from 1976 and prior years should continue to be allowed as offsets against tax preference items. If such a "grandfather clause" is not effected, taxpayers who have planned their tax situations with reliance on the carryover would be unduly penalized.

We appreciate the opportunity to provide these comments.

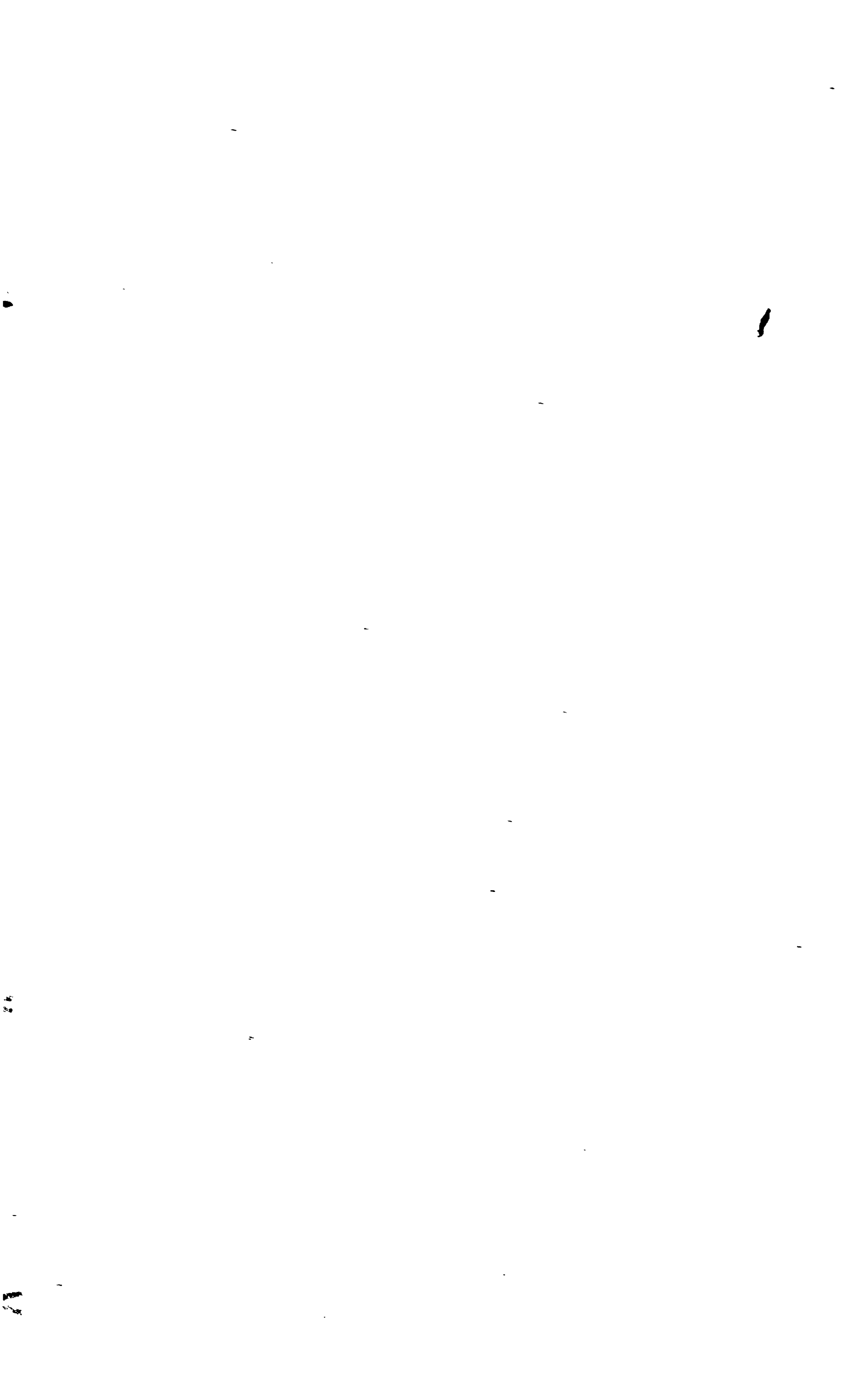
Very truly yours,

RONALD E. HOLLOWAY, *Partner.*



Real Estate Investment Trusts

69-516—76—pt. 7——12



NATIONAL ASSOCIATION OF REAL ESTATE
INVESTMENT TRUSTS, INC.,
April 22, 1976.

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

DEAR MR. CHAIRMAN: We would like to submit the following comments for the record in connection with title XVI of H.R. 10612, a bill which is now being considered by your committee. Title XVI relates to the tax treatment of real estate investment trusts.

The National Association of Real Estate Investment Trusts is a national trade association representing the real estate investment trust industry. The association has a membership of 157 trusts representing over 86 percent of industry assets, which now total $19.4 billion. At the present time, approximately 1 million people hold shares in REIT's.

Our industry, like other real estate related industries, is gradually recovering from the severe economic recession which began in 1974. Some of the present restrictions in the tax law applicable to real estate investment trusts have unduly limited operating flexibility of trusts and have seriously hampered the orderly recovery of this sector of the real estate industry.

Title XVI of H.R. 10612 contains provisions which would remedy some of these problems. The subject matter of this legislation has been reviewed previously by the Senate Finance Committee in 1974. At that time, your committee considered this legislation and approved amendments applicable to foreclosure situations of REIT's as an interim remedial measure (section 6 of H.R. 421; Public Law 93-625). On the remaining provisions, the committee commented as follows in its report on the foreclosure amendments:

> [A] series of revisions would be necessary for the tax treatment of real estate investment trusts to take into account the current practices and economic problems of the industry. However, the committee dealt with only the most pressing current problems of the industry, those relating to the treatment of foreclosure property * * * [Other REIT disqualification] problems are numerous and complex, and consequently the committee does not believe that this is the appropriate time to consider these questions. However, the committee believes and intends, that these problems should be addressed early in the next Congress.

Two years ago, the House Ways and Means Committee first approved technical amendments identical to those now included in H.R. 10612. The main thrust of these provisions was not to change the basic principles applicable to REIT's, but to provide a more reasonable system for correcting inadvertent technical deficiencies that arise, and to provide penalties that are reasonable, yet effective deterrents.

This legislation was included in H.R. 17488, "The Energy Tax and Individual Relief Act of 1974." For reasons not connected with the REIT amendments, H.R. 17488 never reached the House floor. Later,

As indicated above, a portion of the REIT amendments relating to the tax treatment of income from property acquired in foreclosure was included by the Senate Finance Committee in a House-passed bill and enacted at the end of the second session of the 93d Congress. While these amendments are helpful, they are really only the first step in corrective legislation for REIT's.

Both the Treasury and Joint Committee staffs agree in principle with the pending amendments in title XVI of H.R. 10612, and we understand they are currently drafting certain refinements and improvements. The Treasury has indicated its recognition of the urgent need to enact this legislation this year. The House Ways and Means Committee report on H.R. 10612 did not attribute any material revenue loss to these provisions. This legislation has been pending now for 2 years with the general support and approval of both the Treasury and the Joint Committee staffs. We urge that work on it be completed as soon as possible so that enactment this year may be assured.

We will not burden the record with a repetition of a summary of the substantive technical amendments included in title XVI of the bill. This has already been set forth adequately in the House Ways and Means Committee report (Rept. No. 94-658, p. 353). However, we would like to make some general comments about our legislative objectives.

The basic tax provisions applicable to REIT's were enacted in 1960. The twofold objective of this legislation was to enable small investors to secure investment opportunities normally available only to those with larger resources, and at the same time provide a source of capital for real estate development and ownership. Since 1960, the REIT industry has grown from a handful to over 200 trusts with investments in a wide variety of real estate financing and ownership. More than half of total industry assets are invested in residential properties.

Under the tax law REIT's, like mutual funds, are not taxed if they distribute to shareholders at least 90 percent of their net income. To qualify for this so-called conduit tax treatment, a REIT's income must consist of at least 90 percent investment income and at least 75 percent income from real estate, including interest income from mortgage loans. Also, its assets must be predominantly real estate or real estate related. If a REIT fails to meet any of these requirements by whatever amount, it is disqualified as a REIT and thereby made subject to full corporate taxes. Disqualification is the only sanction or penalty for noncompliance.

When the 1960 legislation was enacted, the industry was small and relatively homogeneous. The law reflects an industry structure quite different from existing conditions. During the last decade, real estate investments held by REIT's have become more diversified in range and more sophisticated in form.

As a result of rapid growth, change, and 16 years of experience under the present tax provisions, it has become clear that statutory changes are needed to make the law more workable and more realistic in light of the present character of the industry.

The principal problem results from the narrow and often technical requirements which must be met in order for a REIT to qualify for conduit tax treatment. Many of these requirements involve difficult questions of interpretation, and failure to meet any one of them can cause disqualification, despite good faith efforts to apply properly the

applicable legal standards. Disqualification results in the imposition of the full corporate tax on the REIT, notwithstanding that it has already distributed 90 percent or more of its before-tax income to its shareholders. Such a drastic penalty for minor and inadvertent failure to qualify is excessive and creates serious inequities, particularly in a situation where numerous small shareholders are involved.

Because a REIT must distribute nearly all of its earnings annually, it relies heavily on outside sources of capital. An important consequence of the uncertainty of qualification under existing law is the serious problem it creates in connection with REIT public offerings of securities and with bank borrowings. Both underwriters and creditors require opinion of counsel as to the REIT's qualification. Questions as to the qualification of a REIT over relatively minor amounts of income may make it impossible for counsel to render an opinion of sufficient certainty to satisfy either underwriters or creditors. Looking to the industry's immediate recovery and future strength, stable sources of capital are vital.

The balance of those provisions not enacted in 1974 are currently included as title XVI of H.R. 10612, a bill your committee is now considering. In the present economic climate, and particularly with the slow recovery of the real estate industry, solving the tax problems experienced by REIT's under present law has become an urgent matter. The economic pressures and uncertainties which REIT's are now facing make it imperative that legislation be enacted this year.

Sincerely,

G. N. BUFFINGTON.

NEW YORK STATE BAR ASSOCIATION,
April 15, 1976.

Hon. RUSSELL B. LONG,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Enclosed for your consideration is a report of the Tax Section's Committee on Income From Real Property on Title XVI of H.R. 10612, dealing with real estate investment trusts. Lewis Kaster is the chairman of the committee. The principal draftsmen of the report were Martin J. Rabinowitz, Philip J. Heyman, Richard J. Hiegel, Kevin J. O'Brien, Martin J. Oppenheimer, Harry E. White, Jr., and Joe W. Williams.

Sincerely,

PETER J. FABER, *Chairman.*

Enclosure.

STATEMENT OF NEW YORK STATE BAR ASSOCIATION TAX SECTION

This portion of the 1975 bill is a relief measure designed to ameliorate some of the problems that have arisen in applying the original 1960 legislation to an industry which grew as a result of that legislation.

Previously, your committee issued a report concerning the provisions of H.R. 11083, 93d Congress, 1st session (1973), the proposed Real Estate Investment Trust Act of 1973 (the "1973 Bill"). The 1975 bill incorporates the provisions of the 1973 bill with certain changes.

The purpose of this report is to update our prior report on the 1973 bill and to comment upon the provisions of the 1975 bill not found in the 1973 bill.

Consistent with our view of the 1973 bill, your committee is in general accord with the purposes and legislative changes set forth in this portion of the 1975 bill. In a number of instances, however, we believe the legislation either fails to meet its objectives or goes too far in favor of the taxpayer. Finally, and of particular concern to this committee, we believe that this legislation imposes an unduly complex scheme of taxation. As a result, this committee is unable to evaluate all of the ramifications of the proposed changes.

SUMMARY OF THE 1975 BILL AND THE COMMITTEE'S MAJOR PROPOSALS

1. Section 1601—Deficiency dividends

Adds new section 859 to provide a deficiency dividend procedure which permits a REIT to avoid disqualification where audit changes result in a failure to distribut 90 percent of REIT taxable income and the failure is due to "reasonable cause."

Adds new section 6697 to impose a penalty tax and interest upon the dividend paid.

The committee recommends that "reasonable cause" be supplemented by the words "and not willful neglect" in section 859(g) as well as significant technical changes.

As to the penalty, the committee feels that its operation is unduly harsh in some instances and unwarranted and nugatory with respect to capital gains deficiency dividends.

2. Section 1062—Relief from failure to qualify; taxation of non-qualified income

This section permits avoidance of disqualification if income adequately disclosed on the return would prima facie qualify the REIT and such return was based upon reasonable grounds after reasonable investigation. This section also would impose a complex tax at regular corporate rates on all "nonqualifying" income of a REIT as a quid pro quo for relief from the present "all or nothing" qualification standard.

The committee recommends that: (1) the standard of good faith be changed to "reasonable cause and not willful neglect"; and (2) the penalty be simplified and limited to 100 percent of the disqualified profit.

The committee's major objection is that this provision eliminates the "safety valve" provided under present law under sections 856(c)(2) and 857(b)(1)(C).

3. Section 1603—Property held for sale to customers

This section deals with the area that has been most troublesome to REIT's. Present law prohibits a REIT from any holding of property "for sale to customers" except in the case of foreclosure property. The 1975 bill eliminates this test and permits such holding provided less than 1 percent of the gross income of the REIT is from the sale of section 1221(1) property.

Your committee favors this provision but suggests a number of significant detailed proposals which it believes will make this section more effective.

Disqualified income from section 1221(1) property is subject to regular corporate taxation.

4. Section 1604 (a), (b) and (c)—Increase of 90 percent test to 95 percent—Increase in qualified income items

The 1975 bill extends the definition of qualified gross income to several items (e.g., "separate charges" for customary service and commitment fees) which previously were the subject of dispute under IRS ruling policy. As a consequence the bill reduces the permissible "basket" for miscellaneous "nonqualified" income from 10 percent to 5 percent and imposes tax thereon at regular corporate rates.

The committee favors the change only if the permissible category is further defined to clarify or change treatment of rental charges based on profit participations. The committee recognizes that this is an area subject to abuse by taxpayers but believes the committee's proposal offers reasonable alternatives to the present regulations.

5. Section 1604 (d) and (e)—Income from sales of mortgages held for less than 4 years—Options treated as real property

Under present law, a REIT may not derive 30 percent or more of its income from sales of real property (including interests in real property) held for less than 4 years. The 1975 bill would extend the definition to cover mortgages held for less than 4 years and would exclude from the numerator amounts from the sale of foreclosure property.

The committee suggests that the enactment of the "1 percent" rule is a sufficient deterrent to short-term trading as to warrant repeal of the 30-percent limitation. Technical changes in the 1975 bill are suggested.

The 1975 bill permits options to qualify as "interests in real property." The committee would extend the definition to include contract and options to acquire leasehold interests.

6. Section 1604(f)—Corporate form for REIT's

The 1975 bill would permit REIT's to incorporate. The committee favors the change.

7. Section 1604(g)—Interest based on profit participation

This provision would modify the definition of interest for purposes of the income tests to exclude, as in the case of rents, amounts that depend in whole or in part upon the income or profits of any person.

The committee does not favor this provision since (1) it will hamper a REIT's ability to renegotiate troubled loans; (2) it is inconsistent with judicial authority regarding contingent interest; and (3) it extends to the "net income or profits of any person" rather than "any borrower."

8 .Section 1604 (h) and (i)—Certain dividends—Annual accounting period

The 1975 bill would eliminate the so-called contingent dividend and force the REIT to designate the amount of the dividend and the year to which the distribution is to apply.

The committee believes that this change will not accomplish the desired result, *i.e.*, to accelerate distributions to shareholders.

The 1975 bill would require that new REIT's adopt a calendar year accounting period. The committee does not favor this change.

9. Section 1605—Excise tax

New section 4981 imposes a 3-percent excise tax on REIT's that fail to distribute during the taxable year at least 75 percent of its REIT taxable income for that year.

This committee believes that the amount of deferral of distributions to shareholders is minimal, and that this tax is, therefore, unnecessary. If the excise tax is imposed, we recommend that a REIT be granted a reasonable time after the close of the taxable year to make the required distribution.

10. Section 1606—Effective date

The 1975 bill generally would apply prospectively to years beginning after enactment. The committee suggests that, in general, consideration be given to have its provisions made electively applicable to years ending after date of enactment.

The committee favors making the deficiency dividend procedure available with respect to dividends paid after date of enactment with respect to any determination made after date of introduction of the 1975 bill.

SECTION 1601—DEFICIENCY DIVIDENDS

General comments

Section 1601 of the bill would add new section 859 to the code providing for a deficiency dividend procedure to enable a REIT to avoid disqualification as a result of inadvertent failure to comply with the requirement of existing law that it distribute 90 percent of its REIT taxable income. This procedure also could be employed to reduce or eliminate corporate tax where the REIT had met the 90 percent requirement, but had inadvertently retained a portion, or a larger portion than intended, of its REIT taxable income for the year.

The proposed code amendments would provide welcome relief in an area that has been of particular concern. Our committee is of the view, however, that proposed section 859(g), limiting deficiency dividends to situations where the "entire amount of the adjustment" giving rise to the distribution shortfall "was due to reasonable cause," should be revised in two respects: First, we propose that deficiency dividends be allowed as to adjustments attributable to "reasonable cause and not willful neglect." Second, we believe that it is unduly restrictive to deny deficiency treatment to the entire adjustment because some portion thereof is not attributable to reasonable cause. We propose, instead, that the allowable amount of the deficiency dividend be limited to that portion of the adjustment attributable to reasonable cause.

We also believe that the penalty provisions of proposed code section 6697 in certain respects are overly harsh and that there are several provisions in section 1601 of the bill which intermesh less than perfectly.

Technical discussion

Code section 859(g), as proposed under the bill, would allow a deficiency dividend deduction "only if the entire amount of the adjustment was due to reasonable cause." For reasons set forth in our comments concerning section 1602 of the bill, we believe that allowance of deficiency dividend relief should be limited instead to adjustments of errors "due to reasonable cause and not willful neglect." We also recommend that deduction should be allowed "only to the extent of the amount of the adjustment" attributable to failure to comply with the standard set forth in section 859(g).

Without such a revision, the purpose of the deficiency dividend provisions, as set forth by Congressman Landrum in sponsoring H.R. 11083 (which contains substantially identical provisions to section 1601 of the current bill), to prevent disqualification "for a REIT which in good faith believed it met the 90-percent distribution requirements, but upon audit, did not meet the requirements," would be thwarted. (119 Congressional Record No. 160, at H9381 (93d Cong., 1st sess., Oct. 24, 1973)).

For example, a REIT may have employed the component method of computing the useful life of a building for depreciation purposes and under that method have erroneously arrived at a 25-year useful life, whereas only a 30-year life could be justified. Its erroneous estimates of useful life may have been due to reasonable cause as to the major portion of the components, constituting perhaps 80 percent of the total cost of the building, but without reasonable cause as to 20 percent. Under proposed code section 859(g), the REIT would not be allowed to declare a deficiency dividend of any part of the resulting understatement of its income, even though a declaration of a small part of the understated amount would have been sufficient to meet the section 857(a)(1) distribution requirement and thus to avoid disqualification. Our committee's recommended revision to section 859(g), we believe, would eliminate inequities of this kind.

We further suggest that the congressional committee reports make clear that the reasonable cause and not willful neglect requirement would be satisfied where a REIT had, in good faith, relied on advice of legal counsel or independent certified public accountants. Precedent for this interpretation is provided by regulatory provisions under various sections of the code. See, for example, section 1.1247-1(d)(2), respecting good faith reliance on counsel or accounts by foreign investment companies in determining whether 90 percent of taxable income has been distributed for purposes of electing under section 1247(a) to have a qualified shareholder avoid the application of section 1246.

New code sections 859(b)(2) and 6697, as proposed under the bill, would in effect subject a REIT which paid a deficiency dividend to interest determined on the basis of the amount of the adjustment which gave rise to the dividend and to a penalty in a like amount but not in excess of 50 percent of the dividend. The penalty would not be deductible. (See regulations sec. 1.162-1(a)).

The formula for computing interest and penalty appears erroneous in that the amount of the deficiency dividend, while limited to the amount of the adjustment, is not necessarily correlated to the latter figure. For example, a REIT may choose to pay only a sufficient divi-

dend to avoid disqualification, which payment could be considerably less than permitted by reason of the adjustment. (See proposed code section 859(d)). Our initial recommendation, therefore, is that interest and penalty each be determined by reference to the amount of the deficiency dividend rather than the amount of the adjustment.

Moreover, in our opinion the nondeductibility feature of the penalty would place an undue burden upon REIT's which wished to avail themselves of the relief from underdistribution allowed by section 1601 of the bill. Since that feature would prevent the penalty being taken into account in determining REIT income, a REIT which distributed the full amount necessary to avoid imposition of corporate tax would have to look to resources other than income, (e.g., loans or capital distributions) to be able to meet its penalty obligation. We suggest that this inequity be remedied by an additional subparagraph (C) to proposed code section 859(d)(3), which section deals with the effect of deficiency dividends on the dividends paid deduction. The new subparagraph would read, in substance:

(C) *TREATMENT OF PENALTIES.*—An amount equal to the penalty imposed by section 6697 paid in any taxable year shall be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year.

We also believe that the penalty should not be imposed where a deficiency dividend is paid (pursuant to an election under the section 1601(c) amendment of code section 857(b)(3)(C)) because of an increase in capital gains which constitutes a section 859(b)(1)(C) adjustment. As distinct from the other circumstances of adjustment, such dividend would be paid not to prevent disqualification of the REIT or even to avoid corporate income tax upon the adjustment amount, but rather to shift the capital gain tax burden from the REIT to its shareholders.

Given the disparity of benefits flowing from deficiency dividends in the two circumstances, imposition of interest upon the amount designated as a capital gain dividend during the 120-day period provided by the amendment appears to us the maximum amount that should be exacted from a REIT as the price of allowing it to declare a deficiency dividend based upon the adjustment. If REIT's were also required to pay the section 6697 penalty as a condition of capital gain deficiency dividends, we believe that only in rare cases would they elect to declare such dividends and that, as a consequence, section 859 (b)(1)(C) would be rendered virtually nugatory. Accordingly, we suggest that section 6697 be amended so as not to apply to adjustments under that section.

If rentals or other income were erroneously treated by a REIT as qualified under section 856(c)(3) and were later determined to constitute instead net income from foreclosure property and section 1221 (1) property within the meaning of section 857(b)(4)(B) under proposed section 1603(c) of the bill, the determination would result in an adjustment under section 859(b)(1)(B). Similarly, determinations which reclassified net income from foreclosure property and section 1221(1) property to qualified income under section 856(c)(3) would result in an adjustment under section 859(b)(1)(A).

In neither situation would the REIT require section 859 relief; yet under the bill in both instances it apparently would be entitled to include the reclassified amount in determining its deficiency dividend. (See sec. 859(d)(2)).

We suggest that proposed sections 859(b)(1) (A) and (B) be amended so as to exclude increases in real estate investment trust taxable income and in net income from foreclosure property and section 1221(1) property of the type mentioned from the definition of the term "adjustment."

Section 857(b)(3), as amended by section 1601(c) of the bill, would permit designation of a capital gain dividend where the IRS successfully reclassifies ordinary income as long-term capital gain, notwithstanding that the usual period for accomplishing such a dividend would have expired. Such designation would reduce the ordinary income portion of the dividend that had been paid for the year in which the gain was realized; thus the reclassification would result in a decrease in the deduction for dividends paid (as defined in sec. 561) determined without regard to capital gains dividends under section 859(b)(1)(D).

Although we believe that the late designation of capital gain dividends is necessary, it appears that deficiency dividend relief is unnecessary in this circumstance. Pursuant to section 857(b)(2)(A), the REIT's taxable income would be reduced by the amount which had been reclassified as long-term capital gain; accordingly the reclassification would not change the amount (if any) of such income which remained undistributed. We, therefore, recommend that proposed section 859(b)(1)(D) be amended to exclude from the term "adjustment" a decrease in a dividends paid deduction to the extent that the determination resulting in the decrease also decreases the REIT's real estate investment trust taxable income.

SECTION 1602—RELIEF FROM DISQUALIFICATION WHERE INCOME TESTS NOT MET DUE TO REASONABLE CAUSE

General comments

This section of the bill, instead of disqualifying a REIT that does not meet the income requirements of section 856(c) of the Code, subjects the REIT to tax at the rate of 48 percent on the amounts realized in excess of those requirements—reduced by an allocable portion of deductions—provided that (a) the REIT disclosed the nature and amount of the sources of its gross income in a schedule attached to its income tax return for the year in question and (b) the REIT had, after reasonable investigation, reasonable grounds to believe and did believe that the nature and amount of the sources of its gross income satisfied the income requirements. We agree with the general policy underlying section 1602. We believe, however, that the condition that the REIT have reasonable grounds to believe that the nature and amount of the sources of its gross income satisfied the income requirements should be appropriately modified to conform to a similar test contained in existing provisions of the Internal Revenue Code and that the taxing provisions of section 1602 should be changed in several substantive and technical respects so as to carry out more appropriately the policy underlying the section.

Technical comments

1. New section 856(c)(8)(B)—section 1602(a) of the bill—in requiring the REIT to have "reasonable ground to believe" that its gross income satisfied the requirements of section 856(c), introduces a new test not presently found in the Code. By its nature, such a test is not susceptible of precise definition and it will undoubtedly lead to controversy—and perhaps substantial litigation—over its meaning. We therefore urge that there be substituted in the bill the test which is presently used in many analogous provisions of the Internal Revenue Code and the meaning of which has been substantially developed by regulation and case law. A good example of this test may be found in section 1247(b)(1) of the Code, which concerns the requirement that a foreign investment company distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation. Under that provision, the failure to distribute the requisite amount is excused if it is shown that such failure was "due to reasonable cause and not due to willful neglect". The regulations under section 1247(b)(1) state that reasonable cause will be found if the company exercised ordinary business care and prudence, including reliance in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission. Under such a standard, the condition in the bill that the REIT make a "reasonable investigation" would be subsumed under the basic requirement that it exercise ordinary business care and prudence.

To substitute the usual standard now in the Code, new section 856(c)(8)(B) should be amended to read as follows: "The failure to meet such requirements was due to reasonable cause and not due to willful neglect."

2. New sections 857(b) (5) and (6) (sec. 1602(b) of the bill) contain, in our view, a number of substantive and technical defects.

First, section 857(b)(5) imposes tax on all nonqualifying income whether or not the REIT has met the 95 percent and 75 percent income tests of sections 856(c) (2) and (3). It is not clear whether this is intended by Congress, as the report of the House Ways and Means Committee states in part that the tax is to be imposed "[w]here a REIT fails to satisfy one of the income source tests, but is not disqualified because there were reasonable grounds for believing that the source rules were not violated." Such taxation would place a harsher burden on REIT's than is borne by other entities which are allowed to escape taxation by meeting prescribed income tests within a certain margin of error, such as regulated investment companies and DISC's. Furthermore, the nonqualifying income may be derived from passive investment sources but may fail to qualify only because it has not met certain technical requirements of the REIT provisions of the Code (such as the special rules concerning qualification of rent) and therefore the presenec of such income may well not represent a deliberate carrying on of business activities not permitted to a REIT.

Second, it is possible that gain from the sale of section 1221(1) property which causes the REIT to fail the 75 percent and 1 percent tests would be subjected to tax three times under new sections 857(b)

(5) and (6), and such gain will also be subjected to the special tax imposed by new section 857(b)(4) of the Code. Such taxation is clearly excessive.

Third, under new sections 857(b) (5) and (6), the penalty tax operates cumulatively on a failure to satisfy both the 75 percent and 95 percent tests, even though the same income causes the REIT to fail both tests—that is, the amount by which those tests are not met is subjected to penalty tax twice. This again seems to be an excessive penalty.

Fourth, under new section 857(b)(6)(B), the formula by which deductions are allocated to the excess amounts to be subjected to the penalty tax operates in such a way that deductions directly connected with gain derived from section 1221(1) property are completely excluded and such gain is deemed to bear a proportionate part of all other deductions incurred by the REIT not directly connected with such gain. There is no apparent reason for such an illogical formula.

We believe that it would be more logical and appropriate, and would better achieve the intended deterrence purpose of section 1602 of the bill, if the taxing provisions were to operate in such a way that: (1) the amount of excess nonqualifying income to be subjected to the penalty tax would be calculated by reference to the income requirements themselves; (2) excess nonqualifying income would be subjected to penalty tax only once, but at a rate equal to 100 percent of the profit realized from the nonqualifying transaction or transactions, determined by allocating all deductions proportionately to all classes of the REIT's income; and (3) the net gain from section 1221 property would be subjected only to the 100 percent penalty tax if the gross gain exceeded the 1 percent limitation and only to the special tax under new section 856(b)(4) at the regular corporate rate if the gross gain did not exceed the 1 percent limitation. Such changes would make the penalty tax consistent with the income requirements and would avoid the incongruous result of taxing the same income—particularly section 1221(1) gain—two or three or more times, which might well result in an effective tax rate of more than 100 percent on the net income realized from nonqualifying transactions.

SECTION 1603—PROPERTY HELD FOR SALE TO CUSTOMERS

General comments

Under present law, a REIT is prohibited from holding any property primarily for sale to customers in the ordinary course of its trade or business—section 856(a)(4)); violation of the prohibition results in a termination of REIT status. While the purpose of the prohibition was reasonably narrow and salutary—prevention of a REIT's being engaged in an active business, principally subdivision of realty, see H.R. Rep. No. 2020, 86th Cong., 2d Sess. at 3-5—1960—the effect has been quite broad, largely because of the lack of certitude in interpretation and the grave consequences of its violation. Thus REIT's have generally been loathe to engage in sales of trust property, even though such sales may be quite common among other real estate investors (not dealers).[1] In addition, the prohibition has restricted REIT's in the pro-

[1] E.g., sales of loans or participations in loans (which are often necessary to diversify risks), grants to tenants of options to purchase leased property (which often is necessary to secure a major tenant or to obtain a purchase-leaseback).

viding of conveniences to tenants, where the providing of such conveniences may arguably involve the holding of property for sale (e.g., vending machines) by the landlord. Finally, the prohibition has presented trust tax advisers with severe problems in rendering opinions as to REIT status; because the prohibition applies to the holding of property primarily for sale, the tax adviser must conduct an extensive review of the trust's activities respecting all of its properties notwithstanding the absence of any sale. By repealing the prohibition and replacing it with a 1-percent gross income limit, the bill ameliorates these difficulties, without, however, permitting a trust to be engaged in too active a business enterprise. We therefore endorse the repeal of present section 856(a)(4) and the enactment of proposed section 856(c)(5). As noted below, however, we have serious reservations about several so-called technical amendments to the gross income requirements that relate to income from property held for sale to customers.

Technical amendments.—(Sec. 856(c)(2)(D), (3) and (3)(C). The bill proposes "technical" amendments to the above sections which treat as income within the 10(5)-percent "basket" gain from the sale of section 1221(1) property that is not foreclosure property and exclude from the 75-percent gross income computation gross income derived from property described in section 1221(1) that is not foreclosure property. In view of the already significant limits on section 1221(1) income, and the lack of correlation between the purpose of the special limit on section 1221(1) income (to prohibit the trust from being engaged in significant dealership activities) and the purpose of the "basket" (to permit a trust to receive minor amounts of incidental unqualified income and to provide a reserve for items whose characterization is unclear), the exclusion of otherwise qualifying gain from section 1221(1) property from the 75 and 90(95) percent classes of gross income would appear to be unwarranted and inconsistent with the treatment accorded income subject to the 30-percent limit of section 856(c)(4).

The technical amendment to section 856(c)(3) (relating to the 75-percent class of gross income) bill section 1603(d)(1) raises a further question. Section 1603 (d)(1) adds to the flushline of section 856(c)(3) the parenthetical "excluding gross income from property described in section 1221(1) which is not foreclosure property," which might be read to exclude such income from only the denominator, only the numerator, or from both the denominator and the numerator of the qualification formula. A comparable amendment is made to section 856(c)(2). Income affected by the exclusion would include otherwise qualifying nonsales income (e.g., rents, interests) from section 1221(1) property. Assuming arguendo that otherwise qualifying gains from sales of section 1221(1) property should be excluded from the 75-percent and 90(95)-percent classes of gross income, no valid purpose would appear to be served by excluding otherwise qualifying nonsales income. Accordingly, we recommend that the exclusions either be deleted or be limited to gain from the sale of section 1221(1) property.

Section 1603 (c), (d) (5)—Tax on section 1221(1) income

Section 1603(c) of the bill is the reverse side of the amendment made in section 1603 (a) and (b); income freed from restraints designed to

insure that the REIT shall be a passive investor are to be taxed to the REIT as if the REIT were an ordinary business corporation. We believe that this is a fair approach to the balancing of the policies behind subchapter M, part II with the practical problems of compliance with those policies and endorse it accordingly. While the provisions of the bill generally implement that approach, we believe that there are a few technical matters that should be considered.

Imposition of tax.—(Sec. 857(b)(4)(A)). Tax is imposed at the highest marginal corporate rate on "net income from foreclosure property and section 1221(1) property." While the term "net income" has been used in the 1954 code to describe taxable income from specific sources or activities, see, e.g., I.R.C. §§ 971(b), 1251 (b) (3) (A), (e) (2), 1348(b) (2) (A), 4942(d) (1), (f), (j) (3) (A), its use has not been consistent,[2] so that one wonders whether the cause of simplification is furthered by adding one more defined term, particularly since "taxable income" will serve equally well. See 1954 IRC § 512(a) (1).

Net operating loss.—One problem not handled is the section 172 deduction for net operating losses, which is denied a REIT in computing its real estate investment trust taxable ncome (sec. 857(b)(2) (E)). Because foreclosure and section 1221(1) income are to be specially taxed, losses attributable to such income should either be deductible as NOL's in computing specially taxed income (as they are to a tax-exempt organization that derives unrelated trade or business income, cf. 1954 IRC § 512(b) (6)), or should be deductible in computing real estate investment trust taxable income. The former approach would yield more tax and would be more consistent with the special taxation of foreclosure and section 1221(1) income.

Distribution of after tax income.—(Sec. 857 (a)(1) and (b)(2) (F)). These sections require the distribution of 90 percent of the income subject to the special tax after deduction of the tax, and make appropriate adjustments to the computation of real estate investment trust taxable income. The technical amendments contained in section 1603(d) (5) and (6) appear to achieve the intended result. In view, of the purpose of the REIT provisions—pass through treatment of REIT income—we endorse the distribution requirement. Consistency with other code provisions would require that such dividends attributable to taxed income be eligible for the 85-percent dividends received deduction and the $100 dividend exclusion.

SECTION 1604(A)—INCREASE IN 90-PERCENT GROSS INCOME REQUIREMENT TO 95 PERCENT

1604(B)—CUSTOMARY SERVICE—INDEPENDENT CONTRACTOR

1064(C)—INTEREST—NET PARTICIPATIONS

General comments

Section 1604(a) of the bill amends § 856(c) (2) by increasing the "90-percent gross income test" of that section to 95 percent (excluding gross income from property described in § 1221(1), which is not foreclosure property). The apparent justification for this tightening of the

[2] For other meanings of the term see 1954 IRC secs. 170(g)(3)(B), 401(E)(2)(B), 509(d)(3), 511(c)(1), 512(b)(17)(C).

most stringent of the gross income tests applicable to REIT's is that the most significant type of nonqualifying income, i.e., commitment fees, would hereafter constitute qualifying income. This reasoning, of course, does not apply to a trust realizing all or most of its income from rents from real property. For such an "equity" REIT, the bill provides scant relief from the uncertainties surrounding the definition of rents from real property. The only modifications proposed in the rent area concern separate charges for customary services and rent attributable to personal property leased with real property. Major areas of difficulty remain, especially with respect to the definition of "customary" services and profit participation rents.

Section 1604(g) of the bill adds new § 856(f) to define interest for purposes of the 75-percent and 95-percent tests. The new definition would exclude interest based upon net profit participations as is currently provided in the case of rents. In this respect, § 856(f) would include in the code the provisions of proposed regulations under section 856 issued in December of 1972.

As a policy matter, we believe that this change should not be adopted. Furthermore, we doubt the validity of the proposed regulations as a matter of current law, and we would recommend that they be withdrawn.

Under present economic conditions, many mortgage REIT's have been forced to reduce and otherwise modify the interest rates on outstanding troubled loans. In many cases, an effective workout requires that the interest rate be adjusted so that it is based in whole or in part on the income or profits of the borrower. In these cases, it may not be feasible to adjust the interest rate so that it depends solely upon a fixed percentage of receipts or sales. We believe that the proposed definition of interest should not be adopted because it would seriously hamper REIT's from successfully working out troubled loans.

In a report dated December 23, 1974, the tax section of the American Bar Association commented upon the identical provision that was contained in section 264(g) of H.R. 17488 (Energy Tax and Individual Tax Relief Act of 1974). We concur in the comments made by the ABA tax section which may be summarized as follows:

1. Interest based on net profits or net income of a borrower has been recognized under existing case law as interest for Federal income tax purposes and has not been treated as an equity participation.

2. Inherently, a mortgage lender is in a more passive position with respect to the realty that secures his loan than a landlord who leases real property to tenants. Accordingly, the distinctions between an active and passive landlord need not be imported into the area of mortgage loans.

3. If enacted, section 856(f) should refer only to the "net income or profits of the borrower" and not, as proposed, the income or profits of "any person." In any case, this provision should be interpreted in accordance with the suggestions below relating to rents that contain net profit participations.

4. An effective date limitation is required so that interest on outstanding loans or loans made pursuant to existing commitments is not disqualified under the new definition.

We note below the difficulties experienced by equity REIT's in policing subleases on their real estate projects. Great as these difficulties are, they would probably be greater for a REIT lending money on a mortgage, since mortgagees do not typically reserve the power to control the terms of leases negotiated by mortgagors.

In view of the uncertainties concerning the definition of rents from real property and interest, it is our view that the 10-percent "basket" of section 856(c)(2) is still required to provide an adequate margin for error and we recommend that it be retained. If however, the profit participation rules for rent and interest are changed in accordance with the suggestions contained herein, we would favor reduction of the safety margin from 10 to 5 percent.

Technical discussion

(1) *Rent attributable to personal property.*—In recognition of the fact that transactions that are essentially real estate oriented often involve the leasing of personal property, section 1604(b) amends section 856(d)(1) to include in the definition of "rents from real property":

(C) rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

For purposes of this provision, total rent for the taxable year from each property would be allocated on the basis of the ratio of the average adjusted bases of personal property to that of personal and real property at the beginning and end of the taxable year.

While differences may arise as to whether 15 percent is the appropriate benchmark, we agree that some relief in this area is warranted. In many transactions the 15-percent safety margin will preclude the need for constant detailed determinations of basis.

(2) *Providing services.*—At present, "rents from real property" is defined by section 856(d)(3) to exclude:

Any amount received or accrued, directly or indirectly, with respect to any real property, if the real estate investment trust furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the trust itself does not derive or receive any income.

The wording of the statute would appear to permit a trust to furnish services of any kind to tenants as long as the services are furnished through an independent contractor from whom the trust derives no income. The regulations, however, have added a number of murky and questionable elaborations which have raised recurrent problems for equity trusts. The regulations provide that tenants may be furnished "customary" services, defined as those "usually or customarily furnished or rendered in connection with the mere rental of real property," through an independent contractor; the trust may bear the cost of such services, and unless a separate charge is made therefor, no apportionment of income is required between rent and compensation for such services.[3] If a separate charge is made for "customary" serv-

[3] Treas. Reg. § 1.856-4(b)(3)(i)(b).

ices, it must be made and retained by the independent contractor.[4] If noncustomary services are furnished, they must be furnished by an independent contractor who must bear the cost of the services and must make and retain a separate charge therefor.[5]

Two aspects of these rules deserve comment. First, if any services are furnished to tenants for which the trust makes no separate charge, the entire rental income from the property would be disqualified if it is subsequently determined that the services were not in fact "customary." While the proposed regulations provide some guidance in determining whether a service is customary or noncustomary,[6] a trust will still proceed at its own risk in treating as customary any service other than those specifically mentioned in the regulations. Given the legislative purpose of not allowing a trust to engage in an active business utilizing real property, such as a hospital or motel, even through an independent contractor, some definitional limitation in the service area seems appropriate. Given a regime in which excess nonqualified income is merely subject to tax, rather than resulting in trust disqualification, and assuming an aggressive published rulings policy by the Internal Revenue Service defining those services which are customary in an ever-changing real estate market, equity trusts should find compliance with such rules possible.

Second, the "separate charge" rule requires that if a separate charge is made for a "customary" service, it must be made and retained by the independent contractor. This rule has been the subject of much justifiable criticism. There are any number of customary services provided to tenants of real property, such as a parking facility, telephone answering service, swimming and recreational facilities, and certain electrical, heating, and air-conditioning services, which may be desired by some but not all tenants of a property. As a result, separate charges for such services may be economically required. We can find no valid reason in terms of legislative purpose to prevent a trust from making and retaining such charges.

Section 1604(b) amends section 856(d)(1) by adding a new subsection B to provide that "charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated," would qualify as "rents from real property."

(3) *Profit participation rents.*—To assure that a trust's investments were in fact passive, and that no "profit-sharing arrangement will in effect make the trust an active participant in the operation of the property," Congress provided, in section 856(d)(1), an exclusion from the term "rents from real property" for

> Any amount received or accrued, directly or indirectly, with respect to any real property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts of sales).

Several of the embellishments added by the regulations have made this provision one of the most dangerous pitfalls for equity trusts.

---

[4] Treas. Reg. § 1.856-4(b)(3)(i)(c).
[5] Treas. Reg. § 1.856-4(b)(3)(i)(c).
[6] Prop. Reg. § 1.856-4(b)(3)(i)(b).

First, the regulations provide that when a trust leases property for a fixed sum rental and a percentage of the prime tenant's gross receipts and the prime tenant in turn subleases "all or part of such property under an arrangement which provides for a rental based in whole or in part on the income or profits of the sublessee," the entire amount of the rent from the prime tenant is disqualified.[7] Thus, the existence of one income participation provision in a single sublease of a portion of a shopping center, office building, motel or apartment complex leased by a trust to a prime tenant would disqualify the entire rental income received by the trust from the prime tenant. This provision requires the trust not only to make certain that its own lease with the prime tenant contains no income participation provision, but to satisfy itself that none of the prime tenant's subleases (or sub-subleases) contains any language which might be construed as entitling the prime tenant to any portion of the income or profits of its tenants (or subtenants). And this vigilance must be continuous; disqualification of the trust's income can arise at any time through the prime tenant's (or a remote subtenant's) execution of a new sublease, or an amendment of an existing sublease, which provides for rentals based on "income or profits."

The truly passive trust that net leases an entire project, or land underlying the project, to a prime tenant is thus at a significant disadvantage as compared to the more active trust that operates the project through an independent contractor and separately leases space directly to space tenants. In the latter case, only the gross income from a particular space tenant operating under an income participation lease would be tainted; the balance of the income from the project would continue to qualify as rents from real property.[8] This rule seems particularly anomalous in light of the fact that in the first case the offending provision is in a lease to which the trust is not a party and over which it may have rights of approval or review but not control from inception. In addition, in the net lease arrangement the trust does not operate the project and has no need for an independent contractor; as a result, the trust probably has no local representative and must arrange to have new leases, renewals, and modifications sent to its main office for review, a process often involving significant delay. In the second case, the trust has a representative on site (the independent contractor) and is a party to space leases.

Even if it were possible for a trust constantly to police the terms of all subleases on all its projects so as to prevent the receipt of even $1 of tainted income (a dubious proposition at best), it still faces the question of determining what in fact constitutes an impermissible participation in income or profits. While the proposed regulations offer some guidance in this respect,[9] the complexity and variety of lease provisions found in the real estate market in this country often make these questions extremely difficult of resolution.

We regard the bill's failure to amend section 856(d)(1) as one of its major shortcomings. Furthermore, the proposed change in the definition of interest is inappropriate and could increase the difficulties encountered in interpreting the profit participation rule. The problems

---

[7] Treas. Reg. § 1.856-4(b)(1).
[8] See Rev. Rul. 72-353, 1972-2 C.B. 413.
[9] Prop. Reg. § 1.856-4(b)(1).

of the profit participation rule could be eased by a number of statutory amendments; e.g., (i) a provision that where rent includes both fixed rent and a percentage rent based on income or profits, only the latter would be disqualified; (ii) a provision that disqualification would apply only to amounts in fact determined with regard to income or profits, rather than to the entire year's receipts from the project; or (iii) a provision that where property is subleased, only the portion of rent received by the trust which is attributable to the particular space tenant whose sublease provides for income participations would be disqualified.

It seems that some of these changes could have been accomplished by regulation. Unfortunately, the regulations are now so entrenched that only legislative correction appears feasible. Legislative change in this area is appropriate notwithstanding the provisions of the bill subjecting to tax only a trust's excess nonqualified income, as opposed to trust disqualification. Even though a trust might not be in danger of disqualification from tainted subleases, it would still have to police subleases to avoid imposition of tax on a substantial portion of its profits. The experience of the industry has been that such policing efforts are extremely onerous, and often unavailing.

SECTIONS 1604 (C) AND (E)—COMMITMENT FEES, INCOME FROM MORTGAGE SALES, OPTIONS TO PURCHASE REALTY

Section 1604(c)—Commitment fees

We agree with the general policy underlying this provision which expands the sources of income qualifying for both the 90 percent[10] and 75 percent income tests to include:

> Amounts received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase and leaseback real property (including interests in real property and interest in mortgages on real property).

Commitment fees received in connection with agreements to make mortgage loans are presently one of the major sources of nonqualified income of REIT's. Most commonly such fees are paid by borrowers for short-term commitments to provide construction financing or for longer term commitments to provide permanent financing. In both instances the commitments usually enable a borrower to obtain a lower interest rate on construction financing. In this context such fees can be viewed as essentially a substitute for interest payments. Entering into such agreements is as passive and as much a part of financing real estate as making mortgage loans or leasing real property and accordingly the inclusion of commitment fees in qualified income as consistent with the congressional purpose underlying these income tests.

Income related to equity investments will qualify under this provision only if received or accrued as consideration for entering into agreements to "purchase and leaseback real property." Although this may be the typical context in which a fee for a commitment to purchase real property is found, there does not seem to be any reason to limit the provision to a purchase and leaseback transaction. Moreover, frequently an "estate for years" is retained by the seller, and thus tech-

[10] The 90-percent test is sometimes referred to herein as the 95-percent income test.

nically there is no "leaseback". Accordingly, it is recommended that the relevant phrase be changed to "purchase or lease real property". This would also give some substance to the parenthetical language in the clause which now literally covers the "leaseback" of an "interest in mortgages".

While the proposed statutory language is broad enough to cover items in addition to commitment fees, we urge that the congressional committee reports and Treasury regulations make it clear that other similar items are intended to be included. Such other items, which arise from a REIT's qualified lending or leasing activities but which arguably may not be interest, rent, or commitment fees include, for example, forfeited good-faith deposits, loan extension fees, liquidated damages, mortgage release fees, and prepayment penalties and income, if any, resulting from borrowers payment of loan closing costs.

It may be necessary to modify the language in this provision of the bill to include these items. If so, the following is suggested:

(G) amounts received or accrued as consideration for (i) entering into agreements to make loans secured by mortgages on real property or on an interest in real property or to purchase or lease property (including interests in real property and interests in mortgages on real property) and (ii) the alteration or termination of any agreement described in (i) of this subparagraph or any instrument or agreement from which interest or rents described in this paragraph are derived;

It should be noted that sections 856(c)(2) and 856(c)(3) do not relate to the questions of whether an item constitutes gross income or when such income is to be recognized. For example, a good faith deposit or a fee received for granting a put generally is not income when received but rather when the deposit is forfeited or the put expires. Moreover, if the put is exercised the fee generally is treated as an adjustment to the purchase price of the related property. On the other hand, the Internal Revenue Service takes the position that a nonrefundable commitment fee, received as consideration for entering into an agreement to make a loan, is recognized when received or accrued regardless of whether the loan is actually made. (Rev. Rul. 70-540, 1970-2 C.B. 101, amplified by Rev. Rul. 74-607, 1974-2 C.B. 149 and Rev. Rul. 70-362, 1970-2 C.B. 147.)

Section 1604(d)—Income from sale of mortgages held less than 4 years

Items of income taken into account for purposes of the 30 percent gross income test in section 856(c)(4) would be expanded under the bill to include gross income derived from the sale or exchange of interests in mortgages on real property held for less than 4 years. In addition and in conformity with other provisions of the bill, gross income from property described in section 1221(1), other than "foreclosure property", would be included in the 30-percent limitation.

House Report No. 2020, June 28, 1960, which dealt with the original REIT legislation described the purpose for the 30-percent income test as follows (1960-2 C.B. 822):

The application of the 30 percent limitation in the case of gross income which may be derived from the sale of real property held for less than 4 years, in conjunction with the general requirement that the trust must not hold any property primarily for sale to customers in the ordinary course of its trade or business, will give assurance of qualifying little, if any, income from trading in real property, thus substantially restricting these transactions to sales of investment property.

As the above paragraph indicates, the test was intended to restrict trading in real property and not to restrict sales of investment property. In practice, the "holding for sale" restriction achieves this goal and the 30-percent income test is an unnecessary complication which serves no real purpose. Even with the relaxation of the "holding for sale" restriction provided for in the bill the 30-percent income test will remain redundant. While the retention of the 30 percent limitation may not be onerous it is a classic example of a trap for the unwary and its deletion is recommended.

If the provision is retained it should be noted that it would be the only income test the good-faith violation of which would result in complete disqualification. Section 1602 of the bill provides for a partial tax at corporate rates instead of the present complete disqualification where a REIT has reasonable grounds to believe it has met the 75-percent and 1-percent income tests, but is found to have failed either or both such tests. There is no reason why the provision should not apply to the 30-percent income test as well since it is quite possible for errors to be made in connection with the determination of holding period, basis, amount realized and whether property was held for sale to customers in the ordinary course of a trade or business. Therefore, if the 30-percent test is retained, the reasonable grounds standard of section 1602 of the bill should be expanded to cover it.

In addition, if this provision is retained, it should be noted that the bill changes the wording of the first clause of section 856(c)(4) to read: "less than 30 percent of its gross income is derived from the sale or exchange of—." The underscored portion currently reads "sale or other disposition of". It is unclear whether this change was intentional since conforming amendments were not proposed for the other two subparagraphs of section 856 in which the phrase appears, 856(c)(3)(D) and 856(c)(3)(C). Gain from a "sale or other disposition" might be recognized even though no "sale or exchange" has occurred where, for example, a noncorporate note is retired or an option is canceled. There would seem to be no reason to promote this lack of uniformity among these three subparagraphs of section 856(c) or to alter the result to a REIT under this provision depending upon whether its borrower were a partnership or a corporation. It is recommended that no change be made from the phrase currently employed in the statute.

Furthermore, if the "sale or exchange" provision is retained it should be noted that the bill's expansion of the sources of income counted for the 30-percent-income test results in inclusion of income derived from the retirement of a corporate mortgage note acquired at a market discount less than 4 years prior to retirement. Also, under the current statute income derived from the retirement of a security held for less than 6 months is counted for this test. There would seem to be no reason to discourage REIT's from purchasing corporate mortgages or other securities at a discount and holding them to maturity. This technical problem should be eliminated. We suggest modifying the bill to provide that in section 856(c)(4)(A) the phrase "(other than securities held to retirement)" be added after "securities" and in section 856(c)(4)(C) the phrase "not held to retirement" be added after the phrase "interests in mortgages on real property".

Section 1694(e)—Options to purchase real property treated as interests in real estate.

The bill expands the definition of "interests in real property" to include options to purchase real property. Such options would thus qualify for the asset tests and gains on the sale or disposition of such options would produce qualified income for the 75-percent and 95-percent income tests, assuming they did not constitute property described in section 1221(1). Under existing law it is unclear whether such options constitute "interests in real property".

Options to acquire leasehold interests as opposed to fee interests are not included in the definition of "interests in real property." This seems unnecessarily restrictive and the provision should be expanded by adding "and leaseholds of land or improvements thereon" after the word "thereon."

In addition, it may be advisable to modify further the proposed amendment to include all contractual rights to purchase real property instead of only options. It seems difficult to justify a different treatment for certain contractual ~~rights merely~~ because the party has an obligation, as opposed to an option, to purchase the related real property.

SECTION 1604(F)—CORPORATE FORM FOR REIT'S

General comments

This provision would permit use of a domestic corporation as a qualified REIT. This change is long overdue.

The present requirement that REIT's must be domestic unincorporated trusts or unincorporated associations was apparently a result of the fact that the initial sponsors of the REIT legislation were existing Massachusetts trusts which sought principally to eliminate taxation of their particular entities. This has produced the anomalous statutory rule that an entity must be taxable as a corporation in order to qualify as a REIT, but may not be a corporation. As a result, an obscure business form has become the basic operating entity for a multibillion-dollar industry. The drawbacks of the business trust form are manifest:

(1) In many jurisdictions it may expose trust shareholders to personal liability for torts and, possibly, contractual obligations as well.

(2) Trusts have been organized principally in those states (such as Massachusetts) which have the best developed law of business trusts without regard to the jurisdiction in which they do business.

(3) Trusts are unable to engage in certain types of tax-free reorganizations (e.g., mergers) because State law is adverse or offers no guidance.

(4) Trustees must take great pains to avoid personal liability for ordinary business transactions.

(5) Perpetual life is generally unavailable.

(6) The substantial body of law defining shareholder rights and providing for liabilities of directors is not available for protection of the public.

The proposed change is favored.

Technical discussion

It might be wise for the committee report to specify that the incorporation of REIT's now organized in trust form will, in general,

be treated as reorganizations under section 368(a)(1)(F). Thus, the taxable year of the trust will not be deemed to end on the date of incorporation. The IRS has wavered on this point in the past.

It is questionable whether the phrase in section 856(a)(1) [bill section 1604(f)(1)(a)(1)] which is managed by one or more trustees or directors has any real meaning or purpose. It is proposed that it be eliminated.

SECTIONS 1604 (H) AND (I) AND 1605—CERTAIN DIVIDENDS ANNUAL ACCOUNTING PERIOD, AND EXCISE TAX

In a report dated December 23, 1974, the tax section of the American Bar Association commented upon sections 264 (h) and (i) and 265 of H.R. 17488 (Energy Tax and Individual Tax Relief Act of 1974), which are included in the present bill as sections 1604 (h), (i) and 1605. We concur in the comments of the ABA tax section, which are set forth below, with the section numbers changed to correspond to the present bill.

Section 1604(h)—Certain dividends

The amendments to section 858(a) proposed by section 1604(h) would eliminate the so-called contingent dividend and would force the REIT to make on its tax return an apparently irreversible decision as to which year the dividend shall apply.

The committee report states that the amendments to section 858(a) are appropriate in view of the proposed deficiency dividend procedure. H.R. Rep. No. 93–1502, 91 (1974). The committee report also criticizes the current contingent dividend as facilitating the delay of distributions to shareholders. H.R. Rep. No. 93–1502, 91 (1974).

In considering the proposal, two points should be noted: First, section 1604(h) itself will not have the effect of speeding distributions to shareholders. The excise tax proposed by section 1605, however, may. Second, the proposed cure may be worse than the disease, particularly in periods of time, such as the present, when REITs are confronted with numerous problem loans, great financial difficulty and severe liquidity problems.

For example, assume a REIT reports REIT taxable income on its 1975 tax return of $100, of which $75 is distributed in 1975 and $25 is distributed in 1976 and assume an ultimate determination that 1975 REIT taxable income was only $80. Under the amendments proposed by section 1604(h), the REIT will not receive the benefit of a dividend paid deduction in 1975 or in any subsequent year for $20 of the $25 distributed in 1976.[11] Such amount will, however, probably be taxable to the REIT's shareholders if the REIT has current or accumulated earnings or profits in 1976. Thus, a conservative reporting of 1975 income would require the REIT to distribute $20 twice, once to protect 1975 and once to protect the subsequent year. In view of the current problems of mortgage REIT's in computing REIT taxable income, such as the effect of allowable additions to bad debt reserves, accrual or nonaccrual of interest on problem loans, and the general problems of when to accrue contingent rent or interest, the practical effect of

---

[11] Under present law that distribution would automatically be available as a deduction in the year in which distributed (1976). See Reg. sec. 1.858–1(b)(1).

section 1604(h)(2) may well be to encourage reliance on the proposed dividend deficiency procedure, rather than prompt distributions.

The amendment proposed by section 1604(h)(1), in requiring the election to state the dollar amount of the distribution to which the election relates, is appropriate, in view of the deficiency dividend procedure, so long as section 1604(h)(2) is deleted so that any dividend with respect to which an election is made under section 858 can be used as a deduction in the year in which actually paid (if not deductible in the year to which it was attributed). In fact, if section 1604(h)(2) were eliminated, the effect of combining section 1604(h)(1) and the deficiency dividend procedure may well be to encourage conservative reporting and faster, albeit subsequent year, distributions since the deficiency dividend procedure applies only if there was reasonable cause for the underdistribution.

Section 1604(i)—Adoption of annual accounting period

Proposed section 860 will require the adoption of a calendar year accounting period for new REIT's. It should be noted that a new REIT normally cannot qualify as a REIT in its initial taxable year since the 100 shareholder requirement of section 856(a)(5) and the income text of section 856(c)(2) usually present problems. Until the underwriting and security registrations are completed, there will not be 100 shareholders. Similarly, until the underwriting proceeds are fully invested, the income tests may not be satisfied. Government securities which are a logical interim investment are qualified assets, but income from Government securities is qualified income for the 95 percent income test, but not for the 75 percent income test. Interim investments may also create problems of holding property primarily for sale. The adoption of a short initial taxable year and, therefore, an accounting period other than the calendar year has provided a convenient solution to these start-up problems. It is difficult to see why every new REIT should be required to pay a tax on its income in its first taxable year.

A REIT may also want to use a fiscal year other than a calendar year in order to facilitate accounting for certain types of income, for example, contingent rental income.

In addition, it is unclear how significantly noncalendar year accounting periods delay distributions to shareholders.

With respect to existing trusts, the amendment proposed by section 1604(i) may, in some instances, prevent the use of a new accounting period as a means to minimize the impact of disqualification.

Section 1605—Excise tax

Section 1605 would impose a nondeductible 3-percent excise tax if a REIT distributes during the year less than 75 percent of its REIT taxable income for that year. This presents several practical problems which should be considered in making the policy decisions reflected in section 1605.

1. Currently many loan agreements and indentures, between REIT's and their lending institutions, both short and long term, prohibit distributions until after the close of the taxable year. Thus, if section 1605 were adopted, REIT's would be faced with the choice of violating their agreements, attempting to renegotiate them, or paying the excise tax, none of which is attractive in the current economic climate.

Accordingly, there should at least be some exception made for cases in which the REIT is prohibited from paying current dividends. See Revenue Act of 1936, section 26(c), which made a similar exception during a time of similar economic difficulties.

2. Quarterly financial statements and thereby quarterly distributions are based on unaudited internally prepared reports. Thus, they may either overstate or understate actual REIT taxable income. In addition, REIT taxable income is determined on an annual basis, rather than a quarterly basis, so that events at the end of a year may well affect the amount of income required to be distributed. Moreover, distribution patterns followed by most REIT's making quarterly distributions (or, aspiring to, once the economic conditions improve) demonstrate both that there is little deferral of distributions in fact, and yet most would be adversely affected by the proposed legislation. For a calendar year REIT, a normal distribution pattern would be as follows:

Quarter	Dividend distributed	Dividend payment date	Amount distributed
Year 1:			
Jan. 1–Mar. 31		None	None.
Apr. 1–June 30	1st quarter	May 1	90–100 percent of "book income" for previous quarter.
July 1–Sept. 30	2d quarter	Aug. 1	Do.
Oct. 1–Dec. 31	3d quarter	Nov. 1	Do.
Year 2:			
Jan. 1–Mar. 31	4th quarter, year 1	Feb. 1	Do.
Apr. 1–June 30	1st quarter, year 2, plus year 1.	May 1	90–100 percent of "book income" for previous quarter, plus year 1 book-tax difference.
July 1–Sept. 30	2d quarter, year 2	Aug. 1	90–100 percent of "book income" for previous quarter.
Oct. 1–Dec. 31	3d quarter, year 2	Nov. 1	Do.

As can be seen, though payment of some income is deferred beyond the end of year 1, the bulk of the deferred amount is paid shortly after year end (when the fourth quarter results are determined), and the remainder, not too long thereafter (when book-tax differences are reconciled). Moreover, after the first year, shareholders will report nearly an entire year's income (i.e., all but the difference between the sum of the 4th quarter of year 1, plus the book-tax difference of year 1 and the like amount for year 2). The amount of deferral would thus appear to be minimal, and the proposed tax unnecessary.

If, notwithstanding the foregoing, it is decided to impose the excise tax, the tax should be drafted so as to give the REIT a reasonable time after the close of the year to make the required distribution, such as 2½ months, as allowed personal holding companies.

3. Many mortgage REIT's use the accrual method of accounting and make construction loans which provide for deferrals of actual payment of accrued interest. Current distributions to shareholders have the result of distributing accrued but unpaid income. Such distributions are possible only if the REIT increases its borrowings, which is very costly under today's economic conditions and may not even be possible.

If current distributions are to be required, it would also seem appropriate to provide for a carryover of distributions in excess of current earnings as in the case of personal holding companies. See sections 561(a)(3) and 564.

SECTION 1606—EFFECTIVE DATE

The effective date provision provides that: (1) deficiency dividend procedures would be available only in the case of determinations occurring after date of enactment; and (2) all other rules would be applicable to taxable years beginning after the date of enactment.

As to deficiency dividend treatment (including any penalty tax resulting therefrom) there would appear to be no reason not to make the bill effective as to deficiency dividends paid (rather than determinations made) after the date of enactment. To encourage prompt settlement of tax disputes, the procedure should be available as to any determination made after the date of introduction provided the deficiency dividend is paid within 120 days of enactment or 120 days of the determination whichever is later.[12] Since the provision aids only those trusts who had "reasonable grounds" to believe they qualified, making this relief available would not reward the willful, reckless, or ignorant.

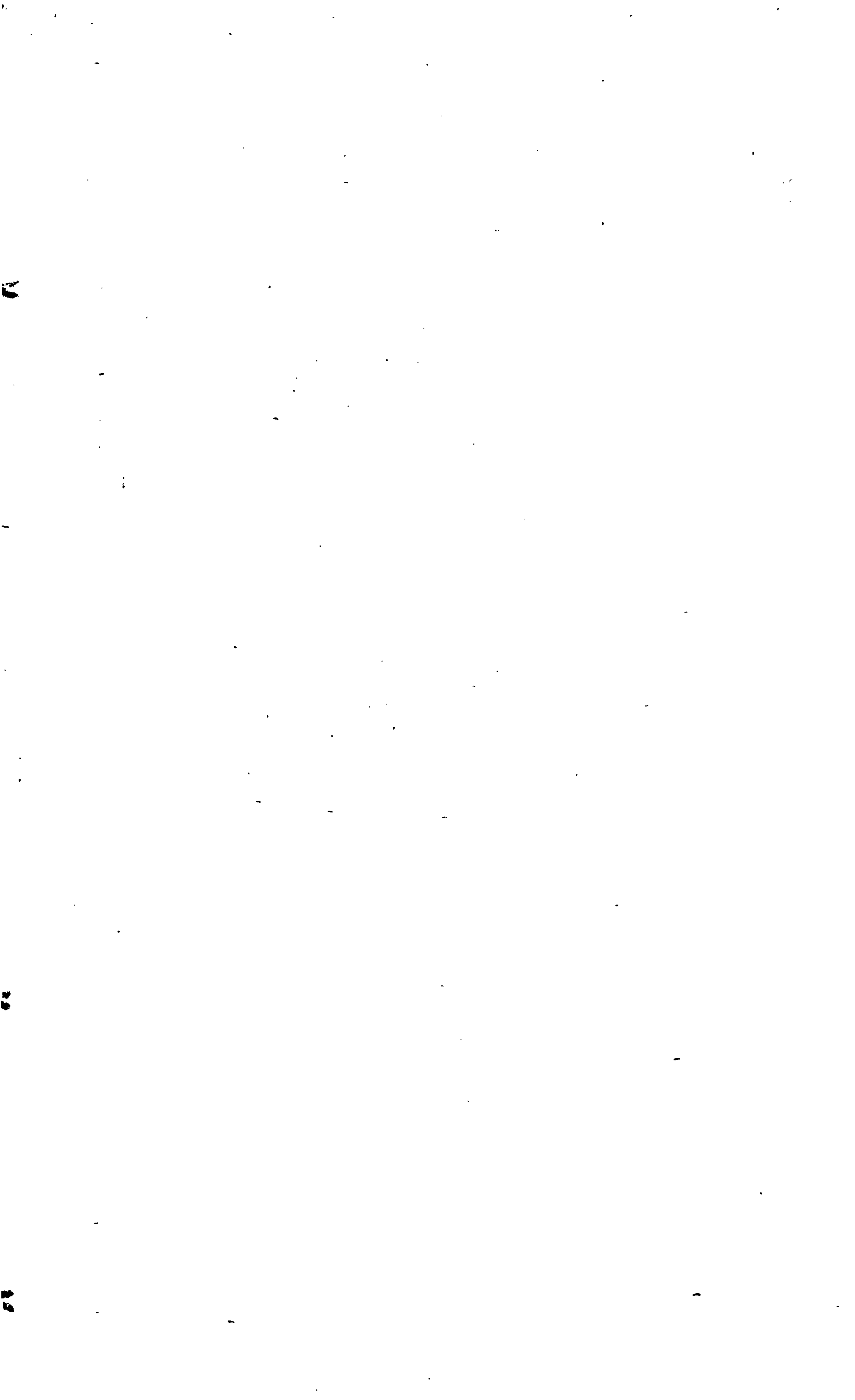
As to the provision regarding the 1-percent "safety value" on sale of section 1221(1) property, your committee suggests that consideration be given to making this relief available with respect to fiscal years ending after the date of enactment, provided that the REIT claiming such treatment elects to have all the provisions of the bill made applicable.

As to the increase in the 90-percent rule to 95 percent, the rule properly should not be imposed until after the close of the taxable years of existing trusts unless a REIT, in order to avail itself of the relief granted, elected to have all the provisions of the bill apply for its first taxable year ending after date of enactment as set forth above.

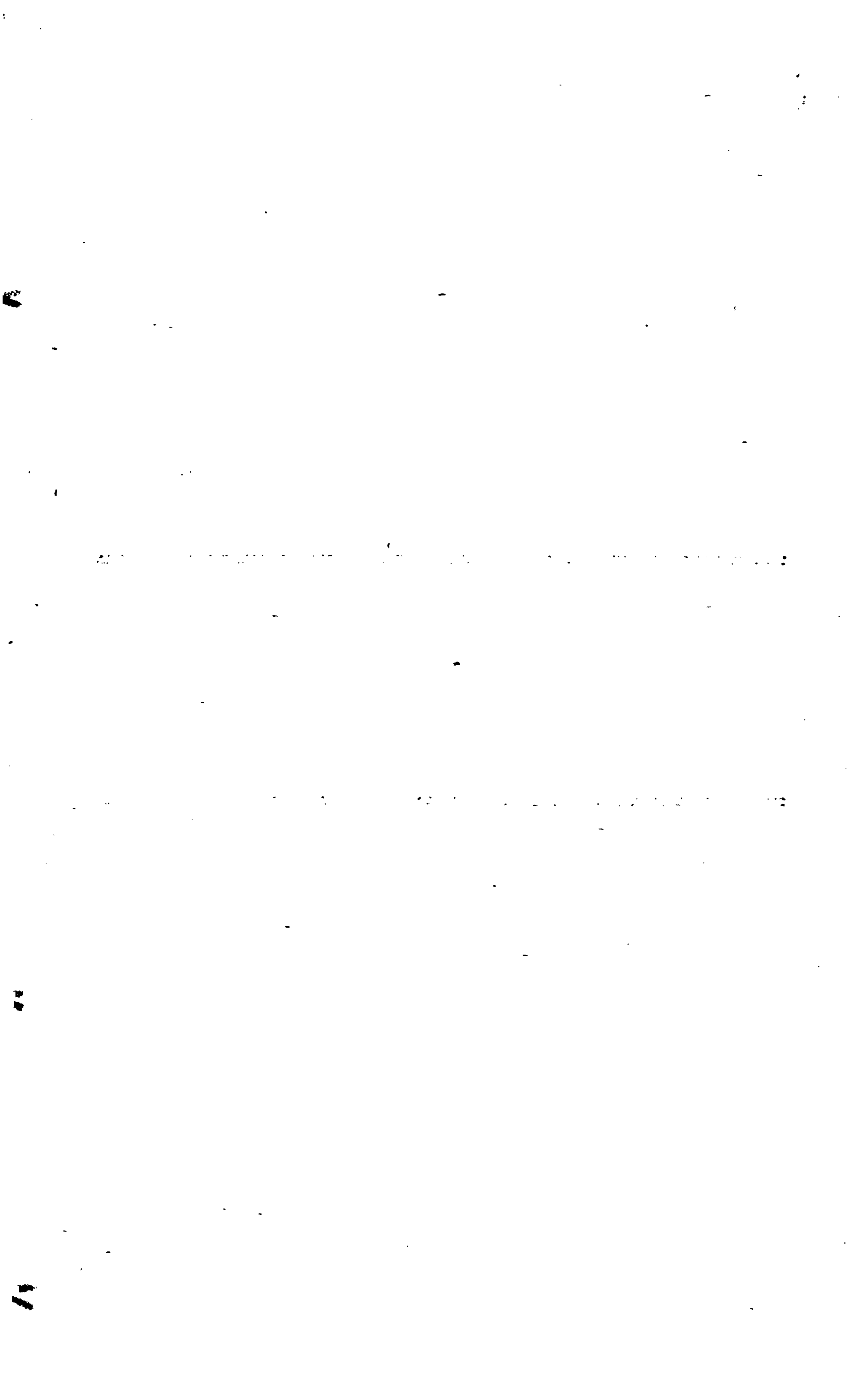
Your committee feels that the relief nature of this bill suggests that its provisions apply at the earliest opportunity.

---

[12] The bill provides that a claim for deficiency dividend treatment must be filed within 120 days of the determination.



Extension of Tax Cuts



STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

I. THE ECONOMICS OF TAX RELIEF

The problem of 1974 was inflation. To deal with it, the administration unfortunately selected, from among the alternatives available, policy actions that were designed to reduce inflation by generating a recession and pumping up unemployment. However, the combination of double-digit inflation and a progressive income tax rate structure substantially weakened consumer purchasing power and intensified the developing recession, apparently beyond what was intended. Higher money incomes pushed taxpayers permanently into higher tax brackets, even while real incomes were falling. The Federal income tax, in an economy burdened with both inflation and unemployment, had a destabilizing rather than a stabilizing effect.

In March 1975, the Tax Reduction Act was passed. The $22.8 billion reduction in taxes was intended to provide a quick but temporary stimulus for a recession economy in which the unemployment rate was 8.7 percent and rising.

As we enter 1976's second quarter, the economy is experiencing a vigorous recovery, due in large part to the 1975 shift to more expansive monetary and fiscal policies, including the tax cuts of the Tax Reduction Act and the extension of those cuts under the 1975 Revenue Adjustment Act. However, to assure a sustained recovery, the Congress must take action prior to July 1 to extend the tax cut still further.

The lost output and unemployment costs associated with a stretching out of the economic recovery process are enormous. From the start of the recession to the end of 1975, the loss in GNP from underemployed capacity totaled nearly $400 billion. Even with a sustained recovery, we can still expect to lose another $600–$900 billion (depending upon how fast the recovery proceeds) by the time our idle capacity is fully employed.

It must also be remembered that a continuation of high rates of unemployment has serious consequences for the Federal budget and the social security system—both of which are sensitive to unemployment. For every 1-percent increase in the rate of unemployment, the Federal deficit increases by $15 to $18 billion. At full employment, the Federal budget deficit for fiscal 1976 would have been about $800 million; instead, with unemployment averaging 8.48 percent in 1975, the deficit is expected to be $74 billion. With respect to social security, a recent study has concluded that if the unemployment rate in 1975 had averaged 5 percent instead of 8.48 percent, the system would have generated a $2 to $3 billion surplus. Instead, for the first time in history,

benefit expenditures are expected to exceed contribution revenue for the system by nearly $3 billion.

Certainly, the elderly have a significant stake in the maintenance of reasonably stable economic growth rates and the avoidance of the roller-coaster economic experience of recent times. Given the present state of the economy, our associations believe that a continuation of moderately expansionary fiscal and monetary policy would help to reduce unemployment without appreciably increasing inflation. On the other hand, we believe that the more restrictive fiscal policy implications of the administration's 1977 budget requests would aggravate unemployment with little impact on inflation. Any inflationary surge in the near future will be more the result of what happens with respect to energy and food rather than the result of moderate changes in fiscal and monetary policy. We recognize that expansionary policies in a time of full or nearly full employment would tend to generate inflation without affecting unemployment rates significantly. However, in view of the severity of the unemployment and lost output consequences of the recession, we expect that it will be a long time before the immediate prospect of such a situation dictates a shift to a restrictive fiscal policy.

II INFLATION AND THE TAX REDUCTION ACT: THE TAX BURDEN SHIFTS UPWARD

All the features that determine the progressivity of the income tax are fixed in dollar terms (the rate brackets, personal exemptions, standard deduction, etc.). As prices and money incomes rise in inflationary periods, taxpayers move into higher tax brackets and find their dollar tax liabilities increasing more rapidly than money income. They may end up paying more taxes in real terms, even though pretax real income may not have increased or may actually have declined. This is exactly what has happened. Federal personal income tax payments increased from 8.6 percent of GNP in early 1973 to 9.4 percent of GNP by early 1975.

As the following table indicates, percentage decreases in real income for low, medium, and high income family units resulting from the combined effects of inflation and the tax structure were very nearly the same, declining from 1.2 percent to 1.4 percent for low and medium units and for high income units that itemize deductions. However, because the Tax Reduction Act did not return the same amount to households that they lost as a result of the inflationary increased tax liabilities, but instead favored low and middle income households, the combined impact of 1974's inflation plus the tax relief of the Tax Reduction Act resulted in a redistribution upwards of the tax burden among income groups. If one of the principal objectives of tax reform is this same shifting of the burden of the Federal income tax toward higher income households on ability-to-pay principles, the combination of inflation and the Tax Reduction Act achieved some degree of tax reform. This result is desirable from the point of view of the aged, who, to the extent that they are taxpayers, tend to be lower income taxpayers.

EFFECTS OF INFLATION AND TAX CUT ON AFTER-TAX INCOME OF LOW-, MEDIUM-, AND HIGH-INCOME, 4-PERSON HOUSEHOLDS, OCTOBER 1973-74

Item	Annual income			
			High-income household	
	Low-income household	Medium-income household	Claiming standard deduction	Itemizing deduction
Income before tax:				
1973	$8,181	$12,626	$18,201	$18,201
1974	$9,320	$14,466	$20,883	$20,883
Percent change, 1973-74	13.9	14.6	14.7	14.7
Exemptions plus deductions:				
1973	$4,300	$4,894	$5,000	$6,094
1974	$4,398	$5,000	$5,000	$6,550
Percent change, 1973-74	2.3	2.2	0	7.5
Taxable income:				
1973	$3,881	$7,732	$13,201	$12,107
1974	$4,922	$9,466	$15,888	$14,333
Percent change, 1973-74	26.8	22.4	20.3	18.4
Taxes:				
1973	$591	$1,319	$2,550	$2,277
1974	$785	$1,692	$3,221	$2,833
Percent change, 1973-74	32.8	28.3	26.3	24.4
After-tax income:				
1973	$7,590	$11,307	$15,651	$15,924
1974	$8,535	$12,774	$17,662	$18,050
Percent change, 1973-74	12.4	13.0	12.8	13.4
Real after-tax income (1973 dollars): 1974 tax laws:				
1973	$7,590	$11,307	$15,651	$15,924
1974	$7,492	$11,149	$15,394	$15,732
Percent change, 1973-74	−1.3	−1.4	−1.6	−1.2
Real after-tax income (1973 dollars): tax cut proposed by administration:				
1973	$7,590	$11,307	$15,651	$15,924
1974	$7,575	$11,326	$15,732	$16,029
Percent change, 1973-74	−0.2	0.2	.5	.7
Real after-tax income (1973 dollars): Tax Reduction Act of 1975:				
1973	$7,590	$11,307	$15,651	$15,924
1974	$7,769	$11,462	$15,796	$16,002
Percent change, 1973-74	2.4	1.4	.9	.5

Sources: Before-tax income in the 1st row is from "Inflation and the Consumer in 1974," a staff study prepared for the use of the Subcommittee on Consumer Affairs of the Joint Economic Committee, 93d Cong., 2d sess. (Dec. 10, 1975; processed). Other data are derived from the provisions of the Internal Revenue Code for 1973-74; the Tax Reduction Act of 1975; and "Fact Sheet: The President's State of the Union Message," released by Office of the White House Press Secretary, Jan. 15, 1975.

III. THE AGED TAXPAYER

The IRS income tax return statistics for 1971 demonstrated that the aged taxpayer, compared to the nonaged taxpayer, is unique and that his problems in attempting to comply with the reporting, self-assessment, and payment requirements of the Federal income tax law are also unique. The 8.7 million persons in the aged taxpayer category at that time constituted about 41 percent of the aged and about 4.3 percent of the total population. They were then and still remain a minority, both with respect to their own age group and with respect to the total population.

The fact that the aged had only 8.2 percent of the total adjusted gross income available to them in 1971 explains the reason why the percentage of taxable returns for that year was disproportionately small in comparison with their 10.8 percent segment of the population and why their percentage of low-income returns was disproportionately high. Indeed, of the 6.76 million returns filed by them, 51.7 percent

reported adjusted gross income of under $5,000 and 79 percent reported adjusted gross income of under $10,000.

It should be clear that the aged taxpayer is both a minority and a lower income taxpayer. With less disposable income than a nonaged taxpayer, he must conserve what dollar of income he does have through more scrupulous consumption habits. He cannot afford to be prodigal; he cannot afford to have imposed upon him extraordinary expenditures which further reduce his limited resources. Unfortunately, the older taxpayer has found it increasingly necessary to purchase outside tax return preparation assistance. The cost of such assistance is just such an extraordinary expenditure.

Upon reaching age 65, the aged taxpayer is confronted by an entirely new set of Federal income tax provisions which combine to make the reporting of his income and the computing of his tax liability a frustrating or, in the context of his other problems, an impossible task. At age 65, the significance of wages and salary, which are relatively easy to report and take into account for tax purposes, declines, and other forms of income, such as investment income and taxable pensions and annuities, which are far more difficult to report and assess, become the dominant components of adjusted gross income. The task of simply reporting and computing tax liability with respect to these forms of income is a complicated and tedious procedure often requiring use of multiple supporting schedules and forms in addition to the standard form 1040.

The use of any simplified form designed for the taxpaying population as a whole, such as the 1040–A, is precluded in the case of an aged taxpayer who attempts to avail himself of tax preferences such as the retirement income credit. With a labyrinth of calculations, procedures and schedules confronting him, it should be little wonder that the aged taxpayer's reporting of income is often erroneous and that his use of provisions intended for his benefit is often effectively barred.

Much of the aged taxpayer's problem arises, of course, from the inherent complexity of the Internal Revenue Code. It is unfortunate that an attempt by the Congress to provide preferential tax treatment for specific groups of taxpayers often results in the introduction of calculations of such complexity that those for whom preferential treatment is intended fail to take advantage of it.

A good example of this, in the case of an aged taxpayer, is the retirement income credit. While designed to relieve part of the tax burden of retired persons living on taxable forms of retirement income to help equalize their tax treatment with that of persons receiving tax-exempt social security, any benefit from the credit is conditioned upon the aged taxpayers' confronting and successfully completing an intricate series of calculations that are purely mechanical.

Moreover, not only must the aged taxpayer contend with the retirement income credit and other special income reporting and tax liability computation requirements, but he must do so under physical, mental and academic limitations which may be substantial and which are not generally shared by the nonaged population. Physical and mental impairments, such as declining visual and hearing acuity, decreasing physical ability and mental alertness are all incidents of the aging

process and are factors that must be taken into account when considering tax preparation problems.

Considering the combined impact of these circumstances, it should not be surprising to discover that substantial numbers of aged taxpayers (80 percent according to the 1970 IRS survey) are forced to seek outside assistance in order to comply with the requirements of the law. To the extent that they must pay for such outside assistance, they are subjected to an expenditure burden which they, as members of a lower income group, can ill afford. Moreover, commercial assistance, in the case of aged taxpayers, is likely to be relatively more expensive than it would otherwise be, simply because their forms of income are more difficult to report and assess for tax purposes.

IV. THE EXTENSIONS OF THE TAX REDUCTION ACT'S RELIEF PROVISIONS FOR INDIVIDUAL TAXPAYERS AND ADDITIONAL TAX REFORM AND TAX PREPARATION ASSISTANCE PROPOSALS

In order to avoid the economic consequences that would result from a shift to a more restrictive policy if the Tax Reduction Act's relief provisions are allowed to expire as of June 30, our associations urge that the increases in the low-income allowance and the percent-standard deduction (together with the accompanying changes in the tax return filing requirements) be extended, at least through the end of 1976.

With respect to the credit for personal exemptions, (IRC sec. 42) our associations urge that the credit be extended and that in computing the total credit available, the taxpayer be allowed a credit equal to $35 times the total number of exemptions which he is entitled to claim under IRC section 151 (including those for age and blindness).

Our associations believe that the earned income credit (IRC sec. 43) should be made permanent and should not be limited merely to workers whose household includes a dependent child. It should also be available to individual workers and families without children. The general decline in the proportion of Federal revenue raised by progressive income taxes and the increasing portion that over time, the Federal revenue system as a whole has become less progressive. In 1960, individual and corporate income taxes accounted for 67.2 percent of Federal revenue; social insurance taxes accounted for only 15.9 percent. In 1976, income taxes should account for 51.7 percent; social insurance taxes should account for 30.8 percent.

Since the earned income credit (which is rebatable) in effect integrates the Federal income and social insurance tax structures and provides relief from the latter social insurance taxes for lower income wage earners, our associations consider this provision a desirable application of the ability-to-pay principle. However, we do not believe that the availability of this credit should be limited solely to workers with dependent children. This is no reason to believe that low income, childless individuals and couples (including the aged who work to supplement their incomes) are any more capable of paying payroll taxes than those with children.

With respect to additional tax reduction measures, our associations urge consideration of the following recommendations. First, the retirement income credit of IRC section 37 should be restruc-

tured, updated, simplified, and cost indexed. When originally enacted, the purpose of the credit was to provide for retirees living on non-social-security forms of retirement income roughly equal to tax treatment with social security recipients whose benefits are excludable from gross income. However, since the credit has not been updated since 1964 and since social security benefit levels have increased dramatically over the period 1964–76, the disparity in Federal income tax treatment between these two groups of retirees is considerable. An individual retiring in 1975 at age 65 could have received a maximum old age insurance benefit award of $341.70 a month or $4,100 a year—all of which is tax free. Yet, with respect to a retiree living on taxable forms of income, only $1,524 of that income could be taken into account in computing his retirement income credit.

Our associations therefore urge that the IRC section 37 credit be changed to an age credit pursuant to which an individual aged 65 and over would be allowed to take into account for purposes of computing the credit, all adjusted gross income (not just retirement income) up to a maximum $4,100 in the case of a single individual and up to $6,150 in the case of a married couple filing jointly. Of course, the credit should continue to be available to individuals under age 65 who receive public retirement pension income and such persons should be subject to the same limitations as the 65 and over group in computing their credit amount.

To limit the availability of the credit primarily to non-social-security recipients, the expanded credit base should continue to be reduced by social security and railroad retirement income.

By allowing an aged individual to take into account income up to the credit base without regards to source, the earned income offset of the present IRC section 37(d)(2) would be eliminated. The credit's discrimination against earned income would be ended. Its computation would be somewhat simplified.

The earned income eligibility feature of the present IRC section 37(b) should also be eliminated.

Finally, the credit base amount should be increased automatically each year by the same percentage by which social security benefits are increased during the year under the present automatic escalator. This would assure that once a reasonable degree of tax equity is restored between elderly social security and non-social-security pension recipients, that equity would be preserved over time.

In view of the changes our associations are advocating with respect to retirement income credit, we consider the provisions of section 503 of the House-passed version of the Tax Reform Act of 1975 (H.R. 10612) to be inadequate. We much prefer Senator Fong's bill, S. 2402 (which has been offered as amendment 1578 to H.R. 10612).

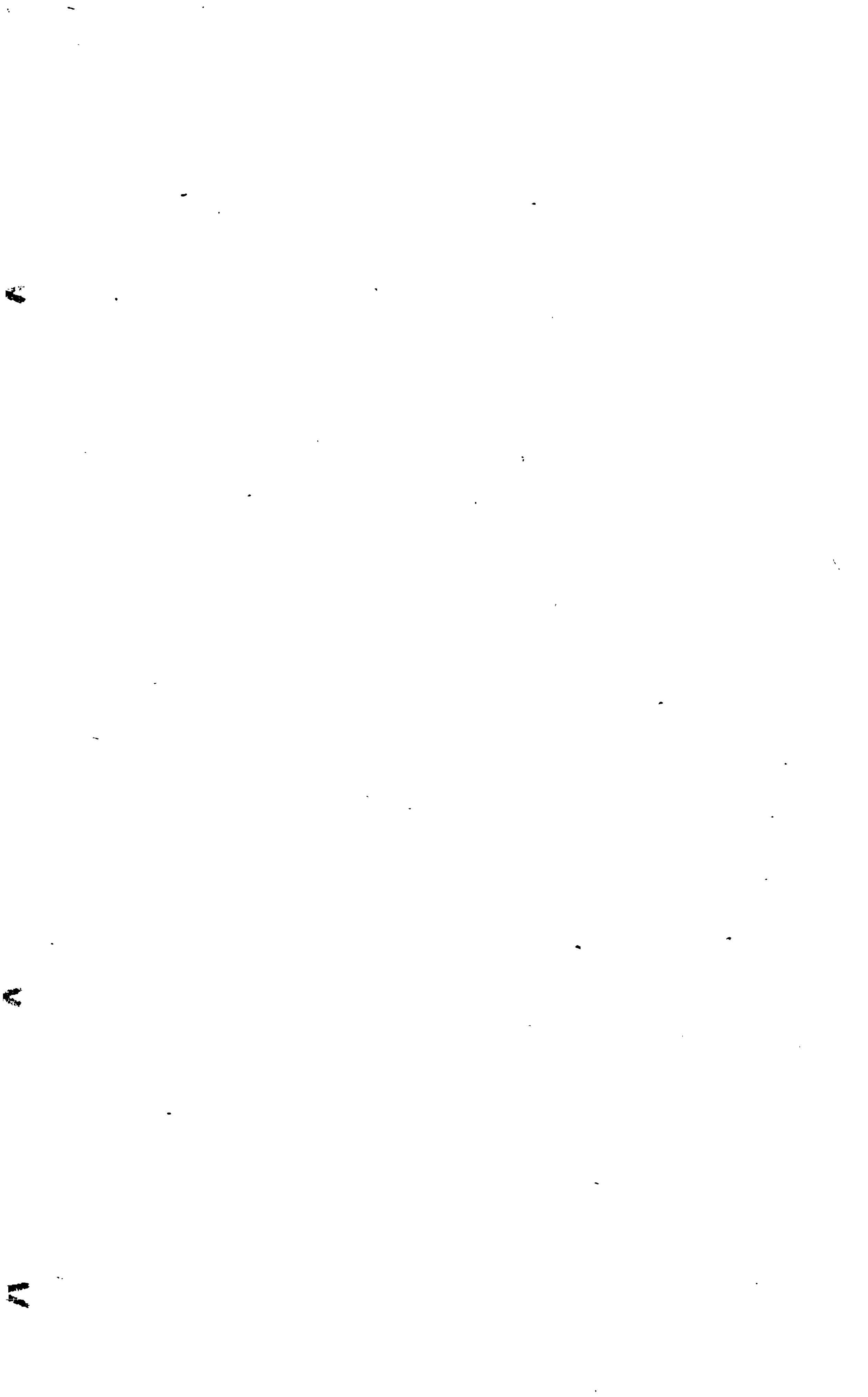
Second, in view of the impact of inflation on the fair market value of personal residences and in view of the number of aged individuals living on relatively fixed incomes who find it necessary to sell their homes because of rising maintenance costs and property taxes (which again are a function of inflation) the present $20,000 adjusted sales price maximum which determines the amount of gain on the sale of a residence which an aged individual may exclude from gross income under IRC section 121 should be increased to not less than $40,000.

Third, with respect to the sick pay exclusion of IRC section 105 (d), we believe it should continue to be available to an eligible individual until "normal" or mandatory retirement age is reached. If any income phaseout feature is superimposed to vary the amount of the exclusion in inverse relation to income level, the maximum benefit of the exclusion should be reduced only for earned income and should be applied only with respect to future disability retirees.

Fourth, in view of the increasing burden that the rising cost of health care imposes upon the aged and the continuing lack of progress with respect to an expansion of health care protection either through medicare or national health insurance, our associations recommend that the present medical expense deduction (IRC section 213) that is available to taxpayers who itemize their deduction in computing taxable income be made a deduction from gross income in computing adjusted gross income. The 1-percent floor with respect to medicine and drugs (IRC section 213(b)) should be eliminated and the 3-percent floor (IRC section 213(a)) should be eliminated in the case of elderly.

Fifth, to assist older taxpayers in using tax preferences intended for their benefit and in complying with the reporting, self-assessment, and payment requirements of the tax laws: (1) older taxpayers should be alerted to these preferences through clear notification on Federal income tax forms and through other means of communication; (2) the Department of the Treasury should continue its efforts to develop means by which payors of pensions and annuities can more readily inform the payee of the taxable proportion of gross annual payments; (3) a "senior short form" should be developed for use of low- and moderate-income older taxpayers who do not itemize deductions in the computation of their Federal income tax liability; and (4) older taxpayers with AGI of $10,000 or less should be exempted from estimated reporting of unearned income.

Finally, to assist those older taxpayers who find it necessary to seek outside tax return preparation assistance, a tax credit of up to $50 should be allowed as a substitute for the present deduction of IRC section 212. Since the existing deduction is only available to taxpayers who itemize their deductions in computing their tax liability and since most older taxpayers tend to use the standard deduction, the IRC section 212 deduction is of limited use to them even though they tend to need tax return preparation assistance more than other taxpayer groups.



Minimum Tax

Statement of American Industrial Clay and Georgia Kaolin Divisions of Yara Engineering Corp., Engelhard Minerals & Chemicals Co., Freeport Kaolin Division of Freeport Minerals Co., J. M. Huber Corp. and Thiele Kaolin Co.

SUMMARY

The "minimum tax for tax preferences," imposed by section 56 of the Internal Revenue Code as enacted by the Tax Reform Act of 1969, evolved from various proposals aimed at meeting criticism of the tax system for permitting wealthy individuals to pay little or no Federal income tax. As first conceived, therefore, such tax was intended to apply only to individuals. There were, at the time, widely publicized reports of individuals who had abused existing tax "preferences," often by combining them in unintended manners and thereby substantially and in some extreme cases completely, avoiding the impact of the progressive individual income tax system. Application of the tax to corporations was considered to be a substantially more complicated question which required careful study of the potential impact on those industries which would be primarily affected.

During the legislative process, the so-called "minimum" tax was transformed into what is actually an additional, rather than minimum, tax, and it was extended to corporations, apparently because of a need for additional revenue, without the careful consideration which theretofore had been considered necessary.

The application of the minimum tax to corporations has had the effect of substantially reducing the percentage depletion allowance granted to various mineral producers. American Industrial Clay and Georgia Kaolin Divisions of Yara Engineering Corp., Engelhard Minerals & Chemicals Corp., Freeport Kaolin Division of Freeport Minerals Co., J. M. Huber Corp., and Thiele Kaolin Co. are producers of china clay, a mineral presently granted a 14-percent rate of percentage depletion. Engelhard Minerals & Chemicals Corp., Freeport Minerals Co., and J. M. Huber Corp. also produce other minerals granted percentage depletion.

For the reasons set forth below, the decision to apply the tax to corporations was erroneous, regardless of the merits of the tax as applied to individuals, and the minimum tax, at least so far as it relates to corporations, should promptly be repealed or substantially modified.

HISTORICAL DEVELOPMENT OF THE MINIMUM TAX

On January 17, 1969, Treasury Secretary Barr issued to the Joint Economic Committee his famous warning of a possible taxpayers' revolt, citing as a reason therefor the cases of 155 individuals with adjusted gross income of more than $200,000 in 1967 (21 of whom had

incomes in excess of $1,000,000) who paid no Federal income taxes.[1] Mr. Barr's statement injected substantial impetus into the movement for reform of the Federal income tax law which permitted these individuals completely to escape its application.

On February 5, 1969, the Ways and Means Committee and the Finance Committee jointly published the "Tax Reform Studies and Proposals" which the Treasury Department under President Johnson had completed shortly before President Nixon took office. The accompanying statement of Treasury Secretary Fowler indicated that the proposals had been developed over a period of more than 2 years.[2] Among these proposals were one for the imposition of a minimum individual income tax and another for the allocation of personal deductions between tax-exempt and taxable income.

The minimum individual income tax was to be a tax at rates varying between 7 and 35 percent on a minimum tax base which included adjusted gross income plus exempt interest on State and local bonds, the excluded portion of net long-term capital gains, the amount of percentage depletion in excess of cost, and the appreciation in the value of property contributed to charity to the extent taken as a deduction, less the greater of allowable deductions or a minimum $10,000 deduction and personal exemptions. The necessity for this minimum tax on individuals was described as follows:

> Present law accords preferential tax treatment to certain types of income through their total or partial exclusion from the income tax base. Some individuals have structured their income to receive so much of one—and often a combination of several—of these items of excluded income that they are not making a fair tax contribution to the Government in relation to the amount of their true income.
>
> This situation has seriously impaired the progressivity of our tax system.[3]

The first set of Treasury proposals expressly declined to recommend application of the minimum tax to corporations:

> Like the allocation of deductions proposal, the minimum tax would not apply to corporations. The corporations whose income would include the four tax-exempt items to any significant degree are found mainly in only a few industries. The question of whether the tax structure for these specific industries should be altered depends upon an analysis of their particular economic and competitive positions. On the other hand, with respect to individuals, the impact of the minimum tax is not so localized. Moreover, the minimum tax is directly associated with the progressive nature of the indiviual income tax.[4]

The tax reform proposals of the Nixon Administration were presented by Treasury Department officials to the Ways and Means Committee on April 22, 1969.[5] These proposals included a provision for the allocation of personal deductions similar to the one contained in the preceding proposals, but substituted a provision for a limit on tax preferences (LTP) for the minimum individual income tax. The effect of the LTP was to disallow the amount of any individual's tax preferences which exceeded one-half of his total income in any year. Total

---

[1] "Hearings on the 1969 Economic Report of the President Before the Joint Economic Committee," 91st Cong., 1st sess., pt. 1, at 6 (1969).

[2] "Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance," 91st Cong., 1st sess., Tax Reform Studies and Proposals of the U.S. Treasury Department 3 (committee print, 1969).

[3] Id., at 132.

[4] Id., at 135.

[5] House Committee on Ways and Means, 91st Cong., 1st sess., tax reform proposals (committee print, 1969).

income was composed of adjusted gross income plus the appreciation in the value of property contributed to charity to the extent taken as a deduction, intangible drilling expenses, and the amount of percentage depletion in excess of cost, the amount of certain excessive farm losses, and the amount of accelerated depreciation on real estate in excess of that allowable under the straight-line method. Allowable preferences would never be reduced below $10,000, and there was to be a 5-year carryover of disallowed preferences.

In recommending adoption of the LTP and the allocation of deductions provisions for individuals, Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, expressly declined to recommend their application to corporations:

> We are not now recommending that LTP and allocation be applied to corporations. A major difference is that in the corporate area the characteristic problem is not an unintended combination of tax preferences but simply intensive use usually of a particular preference which the Congress deliberately legislated as an incentive measure for certain kinds of business. Whether this should be changed necessarily involves a basic reconsideration of the specific preference and the economic effects of its removal or limitation in that industry. This is a project that we are engaged in as part of our present tax reform studies. At the present time, for example, LTP and allocation would have quixotic effect on corporations incurring intangible drilling costs. It might have more serious effects on companies with a single business than on conglomerate-type companies. LTP and allocation serve their purpose well in the case of individuals using preferences in combination to excess, but their application to corporations requires further careful consideration.[6]

Thus, two different sets of Treasury Department officials, each of whom carefully considered the application of the recommended provisions to corporations, expressly declined to recommend that application. Each group noted quite clearly that the core problem was one of individuals abusing the so-called tax preference items or incentive items, usually by combining several of these preference items in such a fashion that they were able to impair the progressivity of the individual income tax system and avoid contributing their fair share to the Federal Government. Each group expressly recognized that the question whether their recommended provisions should be applied to corporations was fundamentally different from the question of their application to individuals, since ordinary business corporations were not in a position to structure their income and combine preference items in the way that individuals could. The few corporations that would be significantly affected by the minimum tax were generally engaged in businesses which called for the intensive use of a particular preference item which Congress had deliberately legislated as an incentive measure for the development of that business because it was in the national interest to promote development of the business. Both groups agreed that the question whether the tax structures of these particular industries should be changed depended upon a careful analysis of the industries and the effects such changes would have on them. Therefore, the question of application of the tax on tax preferences to corporations was one which required further careful consideration.

The distinction which these Treasury Department officials made was based on the fact that ordinary business corporations obtain tax pref-

[6] Id., at 27.

erences primarily because they make active investments for good business reasons in areas where a particular preference applies, whereas individuals primarily make passive investments, often in several areas where preferences apply, and usually for tax reasons rather than for good business reasons. Thus, Mr. Cohen made it very clear during questioning by the chairman of the Ways and Means Committee that the focus of the attack was not upon the various preference items, but rather upon the abuse of those items by individuals:

The CHAIRMAN. What implication is there to be drawn from your proposal to include in your tax base half of the amount of the excess of percentage depletion over cost depletion and intangible drilling costs? Does that mean that you have concluded that the amounts themselves are 50 percent too high?

Mr. COHEN. No, Mr. Chairman, the theory of this is that we are not prepared to make judgment at this juncture about the operation of the provisions and the incentives in any particular industry, be it real estate or oil. But we are saying that the difficulties that have occurred under existing law stem from the excessive use of these special provisions and incentives by any individual.

Our proposal does not attempt to pass judgment that the preferences are 50 percent good and 50 percent bad. It attempts to curb the extent to which they can be used by any individual to eliminate his contribution to the Federal Government. It would not, therefore, change at the moment any rules regarding depreciation on real estate, but it would limit the ability of a person to invest and invest and invest in real estate and use accelerated depreciation piled on top of accelerated depreciation to the point that he makes no contribution to the Government.[7]

The version of the Tax Reform Act of 1969 passed by the House contained essentially the LTP and the allocation of deductions provisions which had been recommended by the Nixon administration, applying them only to individuals. The list of preference items was changed, however, by dropping intangible drilling expenses and the amount of percentage depletion in excess of cost, and adding exempt interest on State and local bonds and the excluded portion of net long-term capital gains.

In presenting the recommendations of the Nixon administration to the Finance Committee, the Treasury Department recommended several changes in the list of preference items, but it did not recommend application of the LTP and allocation of deductions provisions to corporations.[8]

On October 24, 1969, the Finance Committee announced in a press release that it had decided in executive session to substitute a 5-percent minimum tax (which was really an additional tax) on preference income in excess of $30,000 in place of the LTP and allocation of deductions provisions.[9] In spite of the repeated failure of the Treasury Department over an extended period of time to recommend application of the previous minimum tax and the LTP to corporations, the Finance Committee decided to apply its new minimum tax to corporations as well as to individuals. The decision to extend application of the minimum tax to corporations apparently was based upon a desire to increase revenue. Thus, the chairman of the Finance Committee stated in support of the new tax that it was far simpler than the House pro-

[7] Hearings on H.R. 13270 before the House Committee on Ways and Means, 91st Cong., 1st sess., pt. 14, at 5525 (1969).

[8] Senate Committee on Finance, 91st Cong., 1st sess., Tax Reform Act of 1969, H.R. 13270, Technical Memorandum of Treasury Position 38–50 (committee print, 1969).

[9] Senate Committee on Finance, 91st Cong., 1st sess., Tax Reform Act of 1969, Compilation of Decisions Reached in Executive Session 43–45 (committee print, 1969).

visions, and that it also produced more revenue, largely because of its extension to corporations.[10] Regardless of the validity of the claim that the minimum tax was simpler than the LTP and allocation of deductions, the minimum tax did in fact introduce enormous new complexities into an already sufficiently complex Internal Revenue Code.

The report of the Finance Committee which accompanied its version of the Tax Reform Act purported to explain why the minimum tax could apply to corporations whereas the LTP and allocation of deductions provisions could not:

> Moreover, the House provisions for a limit on tax preferences and allocation of deductions would apply only to individuals and not to corporations. In large measure, this is because these provisions do not lend themselves to the taxation of preferences enjoyed by corporations. For example, a corporation with sufficient tax preferences to be affected by these provisions could arrange to escape from their impact by merging with other corporations with relatively small amounts of tax preference income.
>
> The minimum tax provided by the committee avoids these problems since it merely involves applying the 5 percent rate to tax preference income in excess of the specified exemption. It also differs from the House provisions in that it does not treat differently two individuals with the same amounts of tax preference income merely because they have different amounts of taxable income. In addition, the minimum tax is readily applicable to corporation tax preferences since, unlike the House provisions, it is not feasible for corporations to avoid this tax through mergers.[11]

The only reason which the Finance Committee specified for the proposition that its minimum tax was readily applicable to corporations while the House's LTP and allocation of deductions were not, that is, elimination of the possibility of avoidance through merger, was itself eliminated by an amendment to the minimum tax provision on the floor of the Senate. The amendment essentially increased the rate of the minimum tax from 5 to 10 percent, and provided that in addition to the $30,000 exclusion, the amount of ordinary income tax paid should be deducted from the base of the tax. This amendment thereby eliminated the validity of the claim that the minimum tax does not treat differently two taxpayers with the same amounts of tax preference income solely because they have different amounts of taxable income and thus reopened the avenue of avoidance through merger.

The version of the minimum tax which was finally enacted [12] imposes a 10 percent tax on the amount of tax preference items which exceed $30,000 plus the ordinary income tax liability of the taxpayer reduced by certain credits. Nine items were originally treated as tax preference items: excess investment interest,[13] accelerated depreciation on real property, accelerated depreciation on personal property subject to a net lease, amortization of railroad rolling stock, stock options, reserves for losses on bad debts of financial institutions, percentage depletion in excess of cost, and capital gains. A 10th preference item, amortization of on-the-job training and child care facilities, was added in 1971.[14] The statute provides for deferral of minimum tax liability in a year in which the taxpayer incurs a net operating loss any portion

[10] Id., at 43.
[11] S. Rept. 91–552, 91st Cong., 1st sess. 113 (1969).
[12] Sec. 301 of the Tax Reform Act of 1969.
[13] Excess investment interests is an item of tax preference only for taxable years beginning before Jan. 1, 1972. Proposed Reg. § 1.57–2(a).
[14] Sec. 303 of the Revenue Act of 1971.

of which can be carried over to a succeeding taxable year. A 1970 amendment permits the carryforwrd of the amount of any ordinary tax liability not used in the current year to offset tax preference items for a period of 7 years.[15]

Recently, several bills have been introduced which would amend the "minimum tax so as to increase the tax burden on preference items."[16] Although these various bills are not identical, they are designed to accomplish similar goals. In general they would:

(1) eliminate entirely the present deduction from the minimum tax base for the amount of income tax paid (thereby eliminating any vestige of justification for calling the tax a "minimum" tax);

(2) reduce the $30,000 minimum tax exemption to $12,000;[17] and

(3) change the rate of the minimum tax from 10 percent to 20 percent.[18]

APPLICATION OF THE MINIMUM TAX TO CORPORATIONS

Examination of the 10 items which are treated as tax preferences for purposes of the minimum tax points up that many of them do not apply to ordinary business corporations and that most of those which do apply are not as significant for corporate taxpayers as they are for individual taxpayers, that is, the tax benefits they produce are much greater in the case of individuals than in the case of corporations.

Thus, three of the preference items which are of substantial benefit to individuals are inapplicable to ordinary business corporations. These are excess investment interest, accelerated depreciation on personal property subject to a net lease, and stock options. Another preference item, reserves for losses on bad debts of financial institutions, applies only to financial institutions such as banks, mutual savings banks, and building and loan associations.

Four other preference items, accelerated depreciation on real property, amortization of certified pollution control facilities, amortization of railroad rolling stock, and amortization of on-the-job training and child care facilities, are only preferential in that they permit deductions which normally would be taken in later years to be taken in earlier years. Since for all practical purposes the corporate tax rate is a flat rate once the $25,000 surtax exemption is exceeded, the timing of deductions is not nearly as important for corporate taxpayers as it is for individual taxpayers whose rates are truly progressive. Individual taxpayers, by manipulating the timing of deductions and creating large deductions in high income years can actually reduce their ultimate income tax liability. This ability to impair the progressivity of the individual income tax rate structure, which was one of the chief reasons for the development of the tax on preference items, simply does not apply in the case of corporations, the tax rate of which is almost completely nonprogressive. For the vast majority of corporations, the timing of deductions does not produce ultimate tax savings. For corporations, the real benefit of accelerating deductions is a cash-flow benefit, not a benefit which reduces the amount of taxes paid to the Federal

[15] Sec. 501 of the Excise, Estate, and Gift Tax Adjustment Act of 1970.
[16] H.R. 1932, H.R. 8841, and S. 294.
[17] S. 294 would reduce the exemption to $10,000.
[18] S. 294 would leave the rate at 10 percent.

Government. Furthermore, corporations which make the expenditures producing these deductions are merely responding to a congressional policy of encouraging them to do so.

While corporations do have net long-term capital gains, the preferential tax treatment which that type of income is accorded is much more significant in the case of individuals than in the case of corporations. In the first place, the difference between the effective capital gains tax rates and the ordinary income tax rates is more extreme with respect to individuals than with respect to corporations. In addition, most business corporations are engaged solely or primarily in the active conduct of a trade or business which generally produces ordinary income rather than capital gains.

The remaining preference item, percentage depletion, does have a substantial impact on corporate taxpayers, particularly relatively small, nondiversified mining corporations. The percentage depletion deduction, which was already limited to 50 percent of the taxable income from the mineral property, was given separate, careful reconsideration during the course of the enactment of the Tax Reform Act. In cases where Congress found it appropriate to reduce the rate of depletion, it did so.[19] Yet the present 10-percent minimum tax has the effect in many cases of further reducing the depletion deduction, presumably beyond what Congress intended, and adoption of some of the amendments currently being proposed could effectively cut the present nominal depletion rates by more than 40 percent.

Specifically, in the case of the china clay producers submitting this statement, the minimum tax has had the effect of reducing the benefit of the incentive intended by Congress in granting the percentage depletion allowance to china clay. The principal producing area for this mineral in the United States lies in a belt of rural counties in Georgia and South Carolina. The china clay industry is small when compared to most other mining industries, but it is extremely important to the economy of the rural area of Georgia and South Carolina where it is located. The percentage depletion allowance has contributed significantly to the growth of this industry and of the economy of the area in which it operates, and to the industry's ability to compete with foreign producers of the mineral, thereby reducing imports and increasing exports of china clay and favorably affecting our balance of payments. The reduction in the applicable percentage depletion resulting from the minimum tax (as well as from the reduction in rate from 15 percent to 14 percent also enacted in 1969) adversely affects the continued ability of the industry to grow and to compete with foreign producers.

In addition, the minimum tax can create situations which give rise to questions of fundamental fairness. Consider a corporation with a $1 million net operating loss carryover from 1967, none of which is attributable to any tax preference item. If that corporation has $1 million of taxable income before depletion in 1972, and a current depletion deduction of $500,000, it will have to use the current tax preference item to reduce taxable income (before application of the net operating loss carryover) to $500,000, even though that means that it

[19] Sec. 501 of the Tax Reform Act of 1969.

will lose $500,000 of its net operating loss forever. In addition, it will have to pay a $47,000 minimum tax even though the tax-preference item deduction has produced no real tax benefit. It seems manifestly unfair and contrary to the intended purpose of the minimum tax to impose a tax upon a preference item which has produced no tax benefit.

RECOMMENDATIONS

For the following reasons, the minimum tax should be repealed at least insofar as it applied to corporations. The legislative history of the minimum tax indicates clearly that the original versions of the tax on tax preferences, which had been carefully developed by Treasury officials, were not intended to apply to corporations, but only to individuals. Perhaps the most significant distinction between individuals and ordinary business corporations for minimum tax purposes is the difference in their roles as investors. Individuals are in a position to make unintended use of combinations of preferences through passive investments primarily for tax reasons, thereby impairing the progressivity of the individual income tax and avoiding their obligation to contribute to the Federal Government. This ability of individuals to combine preferences and avoid paying any income tax, which was one of the primary reasons for enactment of a tax on tax preferences, is simply not available as a practical matter to ordinary business corporations. The ordinary business corporations which are affected most seriously by the minimum tax generally make intensive use of a particular preference item in an intended manner through active investments for good business reasons.

In addition, an analysis of the items which have been classified as tax preference items for minimum tax purposes points up that many of them are not applicable to ordinary business corporations, and that many others do not produce the tax advantages for corporations which they produce for individuals. Also, examination of the impact of the minimum tax on corporations demonstrates it can unfairly cause a tax to be imposed where the corporation realizes no benefit from the tax preference item.

It is understandable that Congress, under extreme time pressure and faced with the need to raise a certain amount of revenue, would make decisions without giving the careful consideration it ideally would like to give to the probably consequences of those decisions, relying on its ability to change those decisions at a later date when the consequences become more apparent. It is submitted that the decision to apply the minimum tax to corporations was such a decision, and that the decision now should be changed. In the event that the revenue loss which such repeal would produce is considered to be excessive, then the repeal could be accompanied by other measures which would produce the same overall revenue from corporations but on a more equitable basis.

If complete repeal as to corporations is not considered desirable or practicable, then, alternatively, one or more of the following modifications are suggested:

1. The amount of percentage depletion in excess of cost could be removed from the list of tax preference items. This proposal would eliminate the potentially harsh impact of the minimum tax on mining companies.

Since percentage depletion is specifically intended to encourage the development of our natural resources, including it as a tax preference item obviously operates to reduce indirectly the effectiveness of the intended incentive.

Furthermore, the whole purpose of the minimum tax is to insure that all taxpayers make some significant contribution to the support of the Government by preventing the use of certain devices which can eliminate or shelter income. Some of the tax preference items (for instance, those which provide for accelerated depreciation) can be used to shelter income from any source, and thereby reduce to eliminate tax on income having no relation whatsoever to the activity or income giving rise to the preference. On the other hand, since percentage depletion is limited to 50 percent of the "taxable income from the property," which means the "gross income from the property" less all allowable deductions attributable to the property other than percentage depletion, obviously it can never be used to eliminate all of the income from the property, much less to shelter income from any other source. Percentage depletion simply does not possess the flexible tax avoidance potential of other preference items.[20]

2. The tax could be made a true minimum tax, rather than an additional tax, by providing that a corporation's tax will be the income tax, or the minimum tax, whichever is greater, but not both. This proposal would remove most of the inequities but still assure some substantial tax payment by corporations granted tax preferences.

3. The amount of minimum tax paid could be carried forward for a reasonable period (perhaps 7 years) as a credit against future ordinary income tax (or ordinary income tax paid could be carried back for a reasonable period). This would provide relief to those taxpayers who have substantial minimum tax liabilities in early years similar to the relief presently granted to taxpayers whose ordinary income tax payments in early years may be carried forward to offset significant minimum tax liabilities which arise in later years.

Present law permits taxpayers whose ordinary income tax payments in any year exceed the amount of their tax preference income minus $30,000 to carry the amount of that excess forward for a period of up to 7 years to offset future tax preference income. This provides sensible and fair relief to those taxpayers who have substantial income tax liabilities and small amounts of preference income in early years, but substantial amounts of preference income and small income tax liabilities in later years. There is no conceivable reason why similar relief should not be provided to taxpayers who experience the same kind of bunching of these items, but in a reverse pattern.

Permitting, in addition to the present 7-year carry-forward of ordinary income tax paid, the carryforward for some reasonable period of minimum tax paid as a credit against future income tax liability, in years in which there is no minimum tax liability, will eliminate the remaining discriminatory consequences resulting from year-to-year

[20] At the very least, the amount of percentage depletion in excess of cost should be included as a tax preference item only where the person claiming the deduction is not directly engaged in the drilling or mining operation which created the deduction. In this way the minimum tax would not penalize those who are making active investments which create depletion deductions for good business reasons and for the purposes specifically intended by Congress in enacting the depletion deduction provisions, but it instead would be limited to those passive investors who may be motivated principally by tax considerations.

fluctuations of income tax liability and tax preference income. Such a correction should be made effective as of the original effective date of the minimum tax. Of course, this would be of no assistance to a company which is subject to the minimum tax each year.

4. The income tax liability before, rather than after, reduction by credits could be subtracted from the items of tax preference in order to obtain the tax base. Although the relief granted by this proposal is not very substantial and although it does not remove many of the present inequities, it creates more equitable results when foreign income is involved and tends to restore the incentives intended by Congress in adopting the job development investment credit and the work incentive program credit.

TAXATION WITH REPRESENTATION: TESTIMONY BY JOSEPH H. CROWN ESQ., NEW YORK CITY

THE MINIMUM TAX

BIOGRAPHICAL NOTE

Joseph H. Crown (A.B., Columbia College; J.D., Brooklyn Law School) is a New York attorney. He is tax counsel to Tenzer, Greenblatt, Fallow & Kaplan in New York City.

Mr. Crown served as tax counsel to the Accounting-Tax Firm of Eisner & Lubin from 1947 to 1973. Prior thereto he was tax counsel to the Guardian Life Insurance Company from 1934 to 1946. He has authored articles for the New York University Institute on Federal Taxation, Tax Law Review and recently "Basic Income Tax Rules Governing Payments Vis-a-Vis Separation and Divorce" published in Handbook Series No. 63 of the Practicing Law Institute where he has frequently lectured.

SUMMARY OF STATEMENT

The minimum tax is a weak attempt to deal with the problem that many high income taxpayers pay little or no tax. The best solution would be to abolish the tax preferences that allow high income individuals to escape taxation. Short of this, there are other ways to increase the effectiveness of the minimum tax.

First, expand the number of tax preferences which are subject to the minimum tax. Items that should be subject to the tax are tax-exempt interest from state and local bonds, itemized deductions in excess of 50 percent of AGI, and excess intangible drilling costs.

Other needed changes include: reducing or eliminating the $30,000 exemption for tax preference income subject to tax, eliminating the deduction for regular taxes paid; and instituting a progressive rate structure rather than the flat 10 percent rate currently in effect.

DISCLAIMER

The views expressed in this statement are solely the responsibility of the author. They should not be construed as representing the views of any of the organizations or firms with which he is or has been associated.

ADDRESS AND TELEPHONE DATA

Further information regarding the views expressed in this statement can be obtained by writing to Mr. Crown at 100 Park Avenue, New York, N.Y. 10017. Alternatively, he can be reached by telephone during business hours at (212) 953-1839.

REFORMATION OF MINIMUM TAX FOR INDIVIDUALS

The minimum tax now on the statute books was sparked by Secretary of the Treasury Joseph Barr's testimony before the Joint Economic Committee that in 1967 there were 155 individual tax returns with adjusted gross income of over $200,000 on which no Federal income tax was paid, including 21 non-taxable returns with adjusted gross income of over $1 million. This testimony surfaced on January 17, 1969, the last day of business of the Johnson Administration. Shortly thereafter, the new Secretary of the Treasury, David Kennedy, transmitted to Congress a set of tax reform proposals made by the Treasury staff during the Johnson Administration. These became popularly known as the "1968 Treasury proposals". Later, in April 1969, the Treasury of the Nixon Administration submitted new tax reform proposals ("1969 Treasury proposals"). The minimum tax and its companion piece—the allocation of deductions—played a prominent role in both the 1968 and 1969 Treasury proposals. These served as the matrix for the Tax Reform Act of 1969. It was that Act which first incorporated the minimum tax. That legislation (Sec. 56 of the Internal Code of 1954) was intended to tackle the problem of high-income, non-taxable individuals.

Existing Law

Section 56 of the Internal Revenue Code imposes a minimum income tax on particular items of tax preferences. This minimum tax is equal to 10 percent of the total preferences of an individual (or estate, trust, or corporation) in excess of the specific exemption of $30,000 plus the taxpayer's regular income tax.

The tax preference items fall into six categories:

(1) Capital gains (for individuals: one-half of net long-term capital gains); for corporations: in general, (18/48ths of net long-term capital gains);

(2) Accelerated depreciation on real property (and on personal property subject to a net lease) in excess of straight-line depreciation;

(3) Amortization of certain facilities (railroad rolling stock, pollution control, on-the-job training and child-care facilities (over depreciation otherwise allowable);

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) Qualified stock options (the excess of the fair market value at time of exercise over the option price); and

(6) Bad debt reserves of financial institutions.

In addition to granting a deduction for the taxpayer's regular income tax, there is provision for carryovers of excess regular income tax. This provides that in a year in which the taxpayer has regular income tax liability which exceeds his tax-preference income above a $30,000 exemption level, the excess tax liability may be carried forward for seven years and used to offset tax-preference income otherwise subject to the minimum tax in those later years.

Ineffectiveness of the Existing Minimum Tax

The minimum tax attempts to correct the inequity of allowing some types of income to escape tax and to recapture, however partially, the loss of revenue resulting from tax preferences. It was the recogni-

tion of the phenomenom of high-income, non-taxable individuals which first sparked interest in the minimum tax in 1969. Yet, even in that limited sector, the existing limited tax has failed to eliminate that phenomenom. Thus, in 1969 there were 745 individual income tax returns with adjusted gross income ("AGI") of over $100,000 on which no Federal income tax was paid. It is important to note that these statistics significantly understate the extent of tax avoidance by high-income individuals. These statistics do not take into account those individuals with high economic incomes who avail themselves of tax preferences (i.e., capital gains exclusion, the exclusion of interest on state and local bonds and diverse tax shelters) to such an extent that they reduce AGI to a point where they would not be counted in these statistics.

As a result of the minimum tax embodied in the 1969 Tax Reform Act, the number of such non-taxable returns fell from 745 in 1969 to 400 in 1970, and to 300 in 1971. However, in 1972 the number of non-taxable returns with AFI over $100,000 climbed to 425 (not to mention 6 non-taxable returns with AGI over $1 million); and in 1973 it climbed even higher, to 622, including 7 millionaires. Apart from its other limitations, the fact that so high a number of high-income, non-taxable returns have been allowed to exist is dramatic evidence that the minimum tax is, indeed, ineffective.

Basic Criticism of Minimum Tax

The minimum tax recognizes the basic point that high-income individuals are escaping their fair share of the tax burden by reason of the preferential treatment of certain items. The minimum tax makes a modest attempt to subject these items of tax preference to a modicum of taxation. The democratic principle of ability to pay would mandate the total elimination of such preferential treatment. And this is particularly so since these items affect non-earned income; to wit, property income or investment income, which surely would not be accorded more preferential treatment than earned income. However, Congress has not yet summoned the courage to exorcise such preferential treatment, but has moved, Darwinianlike, in gradual fashion to evolve a more equitable mode of taxation.

However, in evolving the minimum tax, Congress has failed to adhere to cardinal criteria of progressive taxation; (1) The principle of graduation—fundamental to a fair income tax system—has been ignored; and (2) certain economic income has been permitted to escape completely; and (3) unwarranted exemptions and deductions have been permitted which unfairly erode the base subject to the minimum tax impost. Little wonder then that the minimum tax has produced only minimal revenue and has come in for much criticism.

Increasing the Effectiveness of the Minimum Tax

The effectiveness of the existing minimum tax can be substantially enhanced by the adoption of the following measures:

A. By expanding the minimum-tax base;

B. By eliminating or reducing the specific exemption;

C. By eliminating or reducing the deduction for regular taxes paid and the related carryover provisions; and

D. Raising the rate of the minimum tax and/or graduating the rate.

A. Expanding the Minimum-Tax Base

It is imperative that Congress reconsider the tax preferences that are subject to the minimum tax, since the minimum tax applies to only 9 of the approximately 60 tax preferences in the tax expenditure budget. Actually, in the case of individuals, the present minimum tax is largely a tax on one preference item—the excluded part of long-term capital gains. Data compiled on tax preferences reported on individual tax returns for the year 1972 show that capital gains dominate the tax preferences for individuals, amounting to almost seven-eighths of the total. Out of the total of $7,935 million in tax preferences reported on individual tax returns for 1972, $6,933 million reflected the excluded part of long-term capital gains. The preference vis-a-vis stock options amounted to $378 million, and the preference vis-a-vis accelerated depreciation on real property amounted to $357 million.

We list below the major items we recommend be added to the items of tax preference subject to the minimum tax.

1. Tax-exempt interest from State and local bonds.—Interest from state and local bonds now escapes federal income taxation completely. We believe the real solution to this problem calls for the elective option to states and municipalities to issue taxable bonds coupled with a Federal subsidy. However, no sound reason exists for the existing exemption from federal taxation of interest from state and local bonds. Such interest should be added to the list of tax preference items. To ease the impact, we suggest that Congress adopt a five-year transition period (modeled on the provision contained in the House version of the Tax Reform Act of 1969).

2. Adding a preference item for itemized deductions in excess of 50 percent of adjusted gross income.—The principal way in which an individual can have high adjusted gross income (AGI) and little or no regular income is to have large itemized deductions. The minimum tax has not directly dealt with itemized deductions (except excess investment interest for a brief transitional period). One technique for dealing with this problem is to provide for an allocation of deductions. The theory behind a provision for allocation of itemized deductions is that, generally, these are personal expenses that can be paid out of tax-free income as well as out of taxed income. This applies to such deductions as non-business interest, taxes charitable contributions, medical expenses and casualty losses.

Such an approach could be implemented by disallowing a fraction of itemized deductions equal to (A) preference income divided by (B) the sum of (i) preference income and (ii) adjusted gross income. However, this problem can also be dealt with within the structure of the minimum tax. Thus, all itemized deductions in excess of 50 percent of adjusted gross income can be considered an item of tax preference. It is significant that under the House version of the Tax Reform Act of 1975, a preference item was added for itemized deductions in excess of 70 percent of adjusted gross income. We believe that our proposal would deal more realistically with the problem posed.

The proposal for expanding the list of preferences to include itemized deductions in excess of 50 percent of adjusted gross income should be viewed as a minimal change. Treating this item as a preference item would merely subject the amount to the minimum tax.

Far more effective would be to impose an overall limit on itemized deductions as a fraction of adjusted gross income (such as 50 percent or 75 percent). Such a technique would be similar to the existing limitations on the charitable contribution deduction; and, as with charitable contributions, there could be an unlimited carry-over of disallowed itemized deductions. Under this technique the disallowed itemized deductions would be subjected to tax at the top rates. It has been estimated that the revenue gain from a 75 percent limit on itemized deductions (with a $10,000 floor) would be $178 million, and the revenue gain from defining all itemized deductions over 50 percent of AGI as an item of tax preference in the existing minimum tax would be $211 million. Depending on its precise form, a proposal for allocations of deductions could raise as much as $500 million.

3. Adding a preference item for intangible drilling costs in excess of those that would be deductible if the intangible drilling costs were capitalized and deducted over the life of the Well.

To the extent that deductions are to be permitted for intangible drilling expenditures, it is appropriate that this item be added to the list of tax preference items. It is notable that the House version of the Tax Reform Act of 1969 and the Tax Reform Act of 1975 did include this item in the list of preferences.

Note: The items thus proposed to be included in the list of preferences should only be included in the minimum tax to the extent that they are not deferred under the limitation of artificial loss (LAL) provisions which may be enacted by the Congress.

B. Minimization of exemptions

The statute now provides for a specific exemption of $30,000 in computing the amount of income subject to minimum tax (as well as granting a deduction for regular taxes paid). The House version of the Tax Reform Act of 1975 made a desirable reform: It reduced the exemption to $20,000 and phased it out dollar-for-dollar as preference income rose above $20,000 so that the exemption vanished when the amount of preference income reached $40,000. We submit there is no warrant for any exemption which serves only to negate the basic purpose of a minimum tax. If this approach be deemed too drastic, then we recommend that the exemption be limited to $10,000 and phased out so that it vanishes when the amount of preference income reaches $20,000.

C. Elimination of deduction for regular taxes paid

The minimum tax is not only not progressive but in a real sense is regressive since, for a given amount of preference income, the minimum tax falls as regular income—and regular tax—rises. This regressivity stems from the deduction allowed for regular taxes paid in computing the amount of preference income subject to tax. Hence, this regressivity should be exorcised by eliminating the deduction for regular taxes paid. This would at least make the minimum tax constant as regualr income rises, rather than having the minimum tax fall as under existing law. In the 1975 Revenue Act, the Ways and Means Committee took the initial step of eliminating half of the regular taxes as a deduction. The House went the full course by eliminating entirely the deduction for regular taxes paid. We commend the ap-

proach adopted by the House and recommend the elimination of the deduction for regular taxes paid (in computing the amount subject to the minimum tax).

D. Graduating the rate of the minimum tax

A fundamental criticism of the existing minimum tax is that it is not sufficiently progressive. In basic terms, a progressive tax is one in which tax liability rises more than proportionately as income rises. The implementation of this principle would require that the minimum tax rise more than proportionately as preference income rises (given the amount of regular income). However, the minimum tax offends this principle of progressivity since the existing minimum tax is merely proportional (disregarding the $30,000 exemption) since it has a flat 10 percent rate; (and as previously noted, the existing minimum tax is indeed regressive since for a given amount of preference income, the minimum tax falls as regular income (and regular tax) rises). Therefore, we recommend that the minimum tax be made more progressive by graduating the rate with respect to the level of preference income.

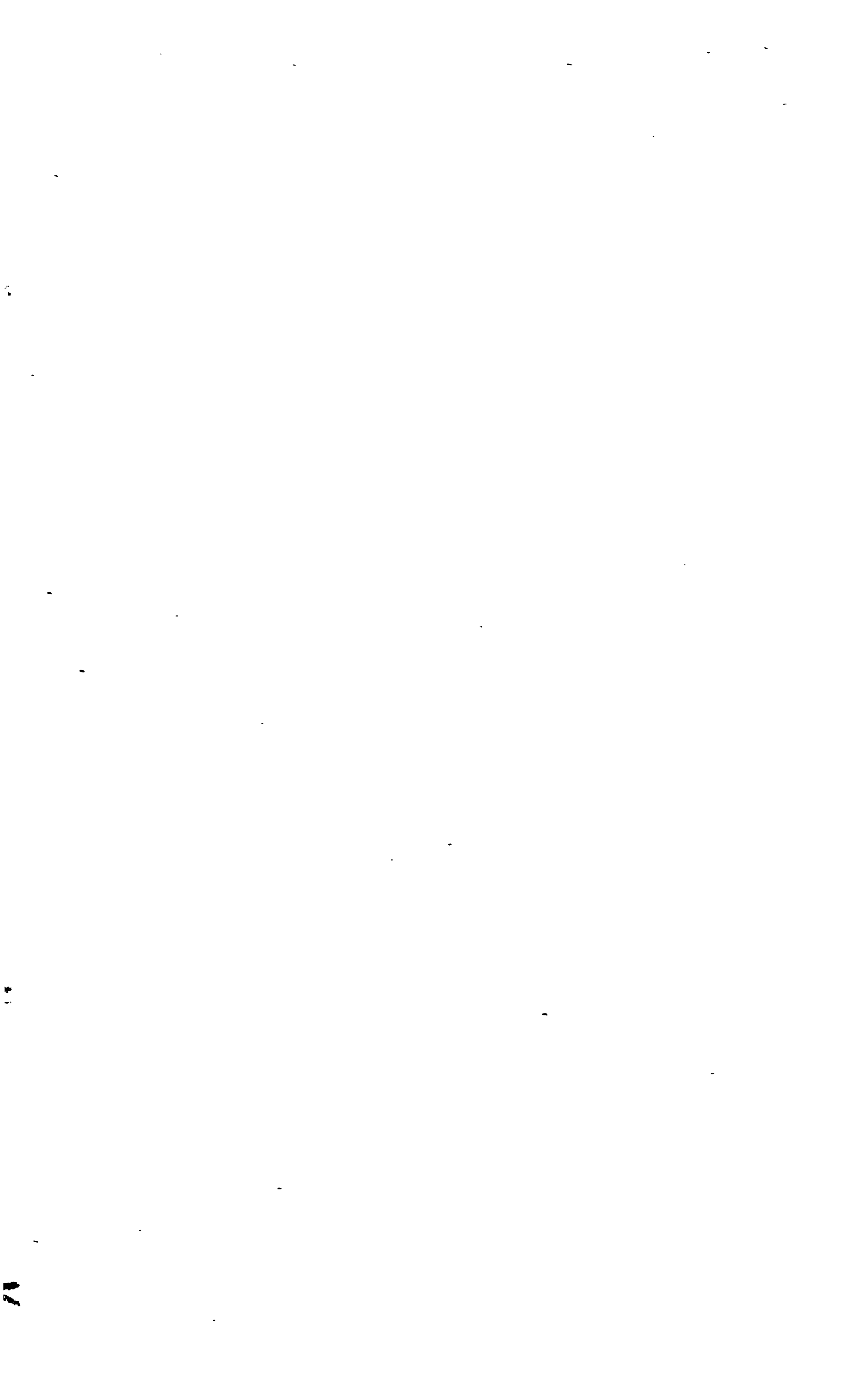
We recognize that problems arise when preferences that represent deferrals of tax liability are included in the minimum tax. When income on which tax is deferred is included in the minimum tax, it it taxed once in the minimum tax and later under the regular income tax. Thus should the minimum tax rate approach 35 percent, the result could lead to confiscatory taxation, taxing individuals' income once at 35 percent and later at 70 percent.

One solution to his problem stemming from graduating the minimum tax-rate with respect to the level of preference income, would be to have a top ceiling of 30 percent.[1] Thus the Congress could adopt a progressive rate schedule (for the minimum tax) ranging from 10 percent to 30 percent. A starting rate of 14 percent as here suggested, is the starting rate for the regular tax; and hence should be the starting rate for items of preference which can escape the regular income tax rate of 70 percent.

---

[1] If the minimum tax rate were to rise above 30 percent (rising, say, to one-half of the regular tax rate), the problem could be resolved by allowing basis adjustments; that is, the basis of assets that generate preference income on which tax is deferred could be increased by one-half of the amount of the preference income from that asset. This would, in effect, allow the taxpayer to recapture his minimum tax when he pays his regular tax on the item of tax preference.

Individual Retirement Accounts



APRIL 5, 1976.

Senator ROBERT PACKWOOD,
Dirksen Building,
Washington, D.C.

DEAR SENATOR PACKWOOD: Thank you for giving me a few minutes of your time at the Dorchester conference to discuss H.R. 10612, The Tax Reform Act of 1975. I think that title XV of H.R. 10612 is a good start toward needed expansion of individual retirement laws, but feel there are other changes that should be considered along with and/or in lieu of title XV. I would hope that this brief statement would be considered as part of the official record of the Senate Finance Committee.

I am a specialist in Keogh and individual retirement plans, and have personally researched governmental retirement plans in Oregon for over 2½ years. I have over 10 years of experience in the retirement field, including: public relations account executive for the California Association of Homes for the Aging for 2 years; administrative assistant to the administrator of 2 multimillion-dollar life care retirement homes in California for 2½ years; interviewed 33 retirement home administrators in reference to the history of life care facilities and their growth; was asked to accept an appointment to the California Council on Aging for the State of California.

Currently, I am director of special accounts and financial services for Benj. Franklin Federal Savings and Loan Association in Portland, Oreg., and am a member of the board of advisors for Mt. St. Joseph's Retirement Home. However, I am not representing Benj. Franklin, Mt. St. Joseph's, or any group or industry in this statement. These are my personal views and recommendations.

From my background, I have been able to see the "ins" and "outs" of retirement living on the expensive and poor levels. I have seen it from the public relations viewpoint, an administration viewpoint, a resident viewpoint, a financial manager viewpoint, and a retirement plan administrator's viewpoint. It is because of this overall view that I offer this statement to the Senate Finance Committee of the 94th Congress.

PROPOSED CHANGES IN H.R. 10612

1. Amend title II, by addition of section 212

Thousands of teachers and individuals, many of whom are retired, are locked into low-paying annuities and custodial accounts used in salary reduction programs. Last year, legislation was passed allowing custodial accounts for regulated investment company stock as an option for salary reduction 403(b) annuities and custodial accounts.

Over the past 10 years, savings and loan associations have shown a higher net return on investment than transportation, utility, and industrial stocks. In only 10 months in 10 years have the Dow Jones industrial stocks been above the initial investment. U.S. Treasury bonds have never been above the initial investment amount in the same 10-year period. (See page 21, "A Theory of Economic Recovery: 'Retention and Redistribution,'" by Douglas Lee Johnston.)

Because of these economic facts, it seems logical and necessary to offer persons in 403(b) annuities and custodial accounts a needed portability and option which will allow them a higher investment return to help achieve their financial retirement goals without risk. I believe savings and loans offer a viable option.

It is with this in mind that I offer the following amendment to section 403(b) of the Federal Code, by adding it as section 212 under title II of H.R. 10612:

SEC. 212. Custodial accounts for savings and loan associations.

(a) General rule—

(1) Effective in taxable years after December 31, 1976, section 403(b) (relating to taxability of beneficiary under annuity purchased by sec. 501(c)(3) organization or public school) is amended by adding at the end thereof the following new paragraphs:

(8) *Custodial accounts for savings and loan associations*

(A) *Amounts paid treated as contributions.*—For purposes of this title, amounts paid by an employer described in paragraph (1)(A) to a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as amounts contributed by him for an annuity contract for his employees if the amounts are paid to provide a retirement benefit for that employee and are to be deposited in savings accounts and certificates of deposit to be held in that custodial account.

(B) *Account treated as plan.*—For purposes of this title, a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as an organization described in section 401(a) solely for purposes of subchapter F and subtitle F with respect to amounts received by it (and income from accrued interest thereof).

(C) *Savings and loan association.*—For purposes of this title, the term "savings and loan" means a domestic building and loan association within the meaning of section 581.

(9) *Transfers retain tax free exclusion*

(A) *Portability.*—For purposes of this title, any custodial account or annuity satisfying the requirements of section 401(f)(2) may be transferred in part or in lump sum between trustees as defined in section 401(f)(2) without taxable consequence.

(B) *Disbursement.*—For purposes of this title, "disbursement" is receipt by the employee or his heirs or beneficiaries, and is a taxable event in the year of receipt. A disbursement is not a "transfer" as indicated in section 403(b)(9)(A).

2. Amend title II, by addition of section 213, or amend title XV, by addition of section 1500 to H.R. 10612.

The concept of a tax-deferred rollover account under the ERISA Pension Reform Act of 1974 was a landmark step in helping individuals to financially prepare themselves for future retirement without undue tax consequence. However, due to the structuring of the definition of a lump sum distribution in the law, a potential problem has arisen.

A lump sum distribution is defined in section 402(e)(4)(A). Then, there are five other definitions before you come to a definition for "Minimum Period of Service," which is section 402(e)(4)(H). This latter subsection indicates that ". . . unless . . . a participant (is)

in the plan for 5 or more taxable years before the taxable year in which such amounts are distributed . . ." the amount distributed will not be considered as a lump sum distribution.

Section 402(e) (4) (H) has been overlooked by attorneys, legislators, administrators, trustees, and IRS officials throughout the United States in defining a lump sum distribution. As a result, many taxpayers are going to not only be taxed on the amount distributed in good faith, but will be charged a 6 percent excise tax for prohibited transactions. This interpretation was not pointed out until the instructions for the individual retirement account returns came out in March, 1976.

Because of the 5-year provision, participants who have been participants in a retirement plan for less than 5 years cannot keep their funds tax-deferred even if the plan terminates. Two examples: a 61-year-old person who must retire at 65; a person of any age whose employment or plan is terminated prior to 5 years of employment. Millions of people are in these categories, because America is a mobile nation with up to 50 percent of the nation moving every year! Also, there is a current trend for more and more plans to be terminated in preference to the individual retirement account concept. I have heard that more plans were terminated in 1975 than were newly created, which if true, would be a first.

Section 402(e) (4) (H) alone and by itself is enough to make title XV of H.R. 10612, in its entirety, completely ineffective and irrelevant. It is because of these facts that I offer the following amendment to section 402(e) of the Federal Code, by the addition of section 213 under title II, or by the addition of section 1500 under title XV of H.R. 10612:

SECTION 213 (or section 1500, as appropriate under one of the two above titles) Definitions and special rules.

(a) Effective for taxable years after December 31, 1974, section 402(e)(4) (relating to definition of lump sum distributions for individual retirement accounts) is hereby amended by—

(1) striking out subsection (H); and

(2) redesignating (I) as (H), (J) as (I), and (K) as (J).

3. Amend title XV, by deletion of section 1502, and proposed section 220 as revised, and the inclusion of a new section 1502.

The idea of giving additional itemized deductions for individuals in retirement plans could be a very positive step forward in helping to stimulate the economy and in helping to slow inflation, but the use of the currently proposed section 1502 and section 220 in H.R. 10612 is not practical for the most effective implementation. There is a simpler way to do it.

By using my following proposed amendments to section 219 instead of creating section 1502 and section 220 (revised), you would:

1. Allow individuals to contribute to an IRA and qualified plans, and deduct from Federal income tax the difference between the employer contribution and 15 percent, whichever is lesser.

2. Eliminate the need for section 1502 and section 220 (revised) to be enacted.

3. Eliminate the need to create new tax forms, rules, procedures, plans, interpretations, and rulings.

4. Reduce administrative plan costs, and increase net returns on plans.

5. Allow Government employees the ability to defer taxes on their contributions, just like anyone else. (This is a major issue which should not be overlooked, because these Government plans are necessary to the turnaround of the whole economy. Many of the employees in these plans would like to have IRA accounts, but they are locked into poor return governmental plans as a mandatory stipulation of employment, and cannot receive employer contributions in some cases until 30 or 40 years of service. My proposed amendments 4 and 5 will make the need for this inclusion even more evident.)

6. Eliminate the September 2, 1974, cutoff date or limited use provision as found in proposed section 220. There should be no cutoff date of any kind. It should begin with any plan as of the effective date of the amendment with the acceptance of plans created after the amendment date. It should not limit the new law to plans ". . . in existence on September 2, 1974."

7. Eliminate problem of not being able to have an IRA and a limited employees retirement account at the same time, as documented in section 220(b) (6), "Double deduction disallowed," under H.R. 10612.

It is with the above reasons that I offer the following amendment to section 219 of the Federal Code, by deleting section 1502 and section 220 (revised) under title XV of H.R. 10612, and adding a new section 1502 to read:

SECTION 1502. Limitations and restrictions, individual retirement accounts

(b) Limitations and restrictions—

(1) *In General*—Section 219 is hereby amended by deleting section 219(b) (1) and (2) (A) (i) (ii) (iii) (iv) (B), and adding:

(b) *Limitations and restrictions.*—

(1) *Maximum deduction.*—The amount allowable as a deduction under subsection (a) to an individual for any taxable year shall not exceed an amount equal to—

(A) the lesser of 15 percent or the compensation includable in his gross income for such taxable year, or $1500, reduced by

(B) the qualifying employer contributions for such taxable year.

Renumber 219(b) (3) as 219(b) (2);
Renumber 219(b) (4) as 219(b) (3);
Renumber 219(b) (5) as 219(b) (4).

Amend 219(c) definitions and special rules by adding:

(3) *Qualified individual deduction.*—For purposes of this section, individual contributions to qualified individual retirement plans, qualified employee retirement plans, and 403(b) annuities, constitute qualified deductions subject to maximum deductions under section 219(b) (1).

4. Amend title XIX, by deletions of (56) (B) and (C), (57), and (58) and the additions of a new (57) and a new (58), under H.R. 10612.

Due to the amendments to section 219 instead of the new proposed section 1502 and section 220 (revised) of H.R. 10612, (56) (B) (C), (57), and (58) are not needed. In lieu of (57) and (58) as proposed, I would suggest two general amendments under these numbers to help solve the mounting governmental retirement plan vesting and funding problems.

ERISA laws were very explicit regarding stepped up vesting requirements for private retirement plans, but it did nothing to help the millions of public employees, teachers, firemen, policemen, sheriffs,

county, city, and small district employees who are locked into losing governmental plans with millions and billions of dollars of unfunded liabilities.

Many of these governmental plans do not vest the employer contribution in the employee until 65 years of age. This means a person could work for 20 years or more and never receive a penny of the employer's contribution, if it was necessary to draw on the employees own contributions prior to 65 years of age.

Required regulations for funding governmental retirement plans should be a must, because in Oregon there are three funds alone which could have unfunded liabilities in the next 10 years of over $400 million There are billions of dollars in governmental retirement plans that are not being funded correctly, and will be lost to the employees, or will be charged back to the tax payers if something isn't done right away.

I refer you to my report, "A Theory of Economic Recovery: 'Retention and Redistribution'," for a more detailed summary of the problems in this area. If any legislation were to be passed in 1976, it should be required vesting and funding laws for Government retirement plans.

Since, there is a tendency for governmental defined benefit plans to be the most common plan causing unfunded liabilities, I have proposed vesting and funding standards only in this area. In this way, those plans needing the most help would be helped out of trouble with Federal guidelines to be met. Then, if appropriate, other legislation could be offered later to cover all, or other Government plans as seen fit. Unfunded liabilities is what I call unseen deficit spending, and it must be stopped as soon as possible to effect any meaningful turn around of the economy.

It is with this knowledge that I offer the following amendment to section 411(e) and 412(h)(3) of the Federal Code, by addition of new numbers (57) and (58) until title XIX of H.R. 10612 to read:

(57) *Amendment of section 411.*—Delete section 411(e)(1)(A) and add,

(A) a government plan (within the meaning of section 414(d) with the exception of government defined benefit plans.

* * * * * * *

(58) *Amendment of section 412.*—Delete section 412(h)(3) and add,

(3) a government plan (within the meaning of section 414(d) with the exception of government defined benefit plans.

* * * * * * *

To all members of the Senate Finance Committee, I extend my personal appreciation for the opportunity you have given me to state my views, and recommendations. In the preparation of these materials alone, I have become increasingly aware of the tough legislative job you perform.

Thank you for your time in trying to help America become even better. If I may be of any assistance, or if you feel it would be of help to you for me to be in Washington, D.C. during the Senate Finance Committee hearings, or the Senate-House conference, please let me know.

Sincerely,

Douglas L. Johnston,
Portland, Oreg.

STATEMENT OF MAJ. GEN. J. MILNOR ROBERTS, EXECUTIVE DIRECTOR OF THE RESERVE OFFICERS ASSOCIATION OF THE UNITED STATES CONCERNING S. 2006, INDIVIDUAL RETIREMENT ACCOUNTS

Mr. Chairman and members of the committee; on behalf of the 102,000 members of the Reserve Officers Association of the United States, we welcome this opportunity to express our views on S.2006 relating to individual retirement accounts (IRA).

As you are all aware, the Employees Retirement Income Security Act (ERISA) of 1974 introduced the individual retirement account (IRA) to permit individuals who are not covered by an employer sponsored retirement program to defer up to 15 percent of their annual income into a specially designated tax-deductible account.

In drafting the IRA legislation, a restriction was established that precluded participation in the program by members of the Reserve and National Guard who were not on active duty, yet who do participate in scheduled drills toward eligibility for retirement under title III. The prohibition included in ERISA 1974 speaks to retirement programs in general but failed to recognize the special conditions and limitations involved in 10 U.S.C. chapter 67 under which there is absolutely no vesting until the reservist has completed a minimum of 20 qualifying years of service and has reached 60 years of age.

Since acceptable participation is dependent upon several variable factors, such as availability of a drilling slot and sufficient scheduled drills, conflict with his primary occupation and geographical location, many reservists are precluded from achieving good retirement years and eventually leave the Reserve program before completing sufficient years to qualify for retirement. Thus, relatively few individuals who enter the Reserve actually end up being eligible for military retirement.

Those reservists who accrue sufficient credit to be eligible for retired pay at age 60, and do not have any other bona fide retirement program are penalized by the restriction because his dependents receive no benefits from his service if he dies before reaching the age of 60. Potential Reserve retirement under 67 U.S.C. 1331–1337 is, therefore, not a reasonable bar to participation in IRA and in fact discriminates against individuals who place our Nation's security above personal gain and the security of his own family beneficiaries.

We have been advised in numerous discussions with Members of Congress that it was not their intent to preclude reservists from participation in the IRA program. They recognize that reservists are volunteers and should not be penalized for their patriotism and dedication to duty. We feel that the exclusion of reservists from IRA programs is an oversight that should be rectified immediately and, therefore, we strongly urge you to favorably consider prompt passage of S.2006 to correct this injustice.

WRITTEN TESTIMONY OF THE CALIFORNIA SAVINGS & LOAN LEAGUE

The California Savings & Loan League is pleased to present to the Committee on Finance its proposals for certain tax revisions

relating to individual retirement accounts. These proposals will focus on (i) problems encountered in the rollover of distributions from qualified employee benefit plans into individual retirement accounts, and (ii) the effectiveness of the individual retirement account in encouraging retirement savings by those who do not participate in qualified employee benefit plans.

The California Savings & Loan League is a trade association of substantially all savings and loan associations operating in California, both State and federally chartered, with affiliate member associations in Arizona, Nevada, Oregon, Montana, Idaho, Utah, and Hawaii. These savings and loan associations hold a substantial number of individual retirement accounts ("IRA's"). By the end of 1975, the nearly 150 savings and loan associations in California held a total of over 81,000 IRA's under the California Savings & Loan League master individual retirement account plan, with a large volume of new accounts continuing to be opened. We expect that the number of individual retirement accounts under the plan will double during calendar year 1976.

A. THE CONCEPT AND FUNCTION OF THE INDIVIDUAL RETIREMENT ACCOUNT

The individual retirement account, as it emerged in the final version of the Employee Retirement Income Security Act of 1974—ERISA—fulfills a dual role. First, it is a means by which employees who are not enrolled in a qualified employee benefit plan can set aside a portion of their income for retirement and defer paying Federal taxes on such income—and on the earnings on such income—until retirement, thereby creating an incentive for retirement saving. Previously, the deferral of Federal taxes on retirement income was only available to persons participating in qualified employee benefit plans. Second, the IRA is a means of providing portability of retirement benefits. The portability and, indirectly, the preservation of retirement benefits was one of the primary objectives of ERISA.

Originally, a Government portability fund or clearinghouse was proposed to receive and hold retirement savings for any employee who terminated his employment. However, the conference committee which produced the substitute bill eventually enacted as ERISA assigned the portability function to the private sector in the form of the conduit or "rollover" IRA.[1]

The California Savings and Loan League wholly supports the assignment of this function to the private financial community. However, the California Savings and Loan League believes that to allow the portability function to be carried out efficiently by the private sector, the ability of employees to preserve their retirement savings and to retain the favorable tax treatment afforded these savings should be limited only to the extent necessary to prevent such employees from obtaining unintended tax benefits, and to assure that the retirement savings so preserved are subsequently available to the employee during his retirement.

[1] See statement of the Honorable Harrison Williams, Jr., upon introducing the conference report on H.R. 2, Aug. 22, 1974; 120 Congressional Record S15737; 1974 United States Code congressional and administrative news 5177, 5182.

The California Savings and Loan League believes that a number of limitations on the establishment of rollover IRA's currently embodied in sections 402 and 408 of the Internal Revenue Code unduly restrict the legitimate use of IRA's. These limitations inhibit the portability of retirement savings, yet have no clear policy justification. The California Savings and Loan League supports enactment of legislation pending to remove certain of these limitations, as discussed in section B, below, and further would propose and support additional measures, discussed in section C, below, to assure that the private sector is able to efficiently fulfill the role assigned to it by the Congress with regard to individual retirement accounts.

B. PENDING LEGISLATION

Under present law, an individual may not make tax deductible contributions to an IRA if for any part of the taxable year he was an active participant in a qualified plan under section 401(a) of the Internal Revenue Code, a qualified annuity plan under section 403(a), a qualified bond purchase plan under section 405(a), or a governmental plan.[2] The proposed IRA regulations state that a person is an active participant in the plan if—

1. Benefits are accrued on his behalf;
2. The employer is obligated to contribute on his behalf; or
3. The employer would have been obligated to contribute on his behalf if any contributions had been made.[3]

The phrase "active participant" as used in section 219 does not distinguish between individuals who are accruing only small benefits that will be of little or no use upon retirement. Any degree of active participation in a qualified plan will disqualify him from participating in an IRA. On the other hand, if the individual were not a participant in his employer's retirement plan or if his employer were not required to make contributions on his behalf, the individual would be entitled to establish an IRA and contribute as much as 15 percent of his compensation or $1,500, whichever is less.

To remedy this discrepancy, section 1502 of the proposed Tax Reform Act of 1976—H.R. 10612—would allow an "active participant" in a qualified employee benefit plan to establish a supplemental retirement account. Such a supplemental account may be an individual retirement account, an individual retirement annuity or retirement bond, or a new type of account denominated a "limited employee retirement account." The act extends the retirement savings deduction to amounts contributed to a supplement retirement account to the extent that the amount contributed does not exceed (i) the lesser of $1,500 or 15 percent of an individual's income, minus (ii) amounts contributed on the individual's behalf by an employer to a qualified plan of which the individual is a member "qualifying employer contributions".[4] The effect of the proposed amendments is to allow every

---

[2] Internal Revenue Code, sec. 219(b)(2).
[3] Temporary Treas. Regs. § 1.219-1(c)(ii)(A).
[4] Technically, this is accomplished by adding to the Internal Revenue Code a new section 220, which allows active participants in qualified plans to deduct amounts contributed to supplemental retirement accounts, within the dollar limits set out in the text. These dollar limits and certain other limitations on contributions to supplemental retirement accounts are set out in proposed section 220(b).

employee to defer tax on a certain minimum portion of his income each year which is contributed to a retirement fund, regardless of his membership in a qualified plan or the amount of employer contribution to such a plan.

The California Savings and Loan League endorses the concept of supplemental retirement accounts and, with the exception next noted, encourages prompt passage of section 1502 of H.R. 10612 so that all taxpayers may begin this year to build retirement savings. However, the California Savings and Loan League has reservations regarding the efficacy of limited employee retirement accounts, and believes that the use and effect of these accounts should be clarified prior to enactment of this legislation.

A limited employee retirement account, as described in proposed section 408A of the Internal Revenue Code, would be maintained within and as a part of an existing employee benefit plan qualified under section 401(a) of the Internal Revenue Code. Employer contributions to this account would constitute compensation to the employee, but could be deducted by the employee to the extent that these employer contributions and the employee's own contributions did not exceed the yearly dollar limit discussed in the text above. While an employee who is entitled to establish a supplemental retirement account indeed may wish to have the account maintained within the employer's plan, there are substantial reasons why he may not. An employee may not wish to be tied to the investment policies and consequent earnings of the employer's plan. He may seek greater earnings available in an individual retirement account. If he contemplates terminating employment, he may wish to maintain his supplemental account independent from the employer, to eliminate the problem of transfer of the account when he does terminate his employment.

The current position of the Internal Revenue Service is that multiple individual retirement accounts are prohibited; that is, an employee may maintain only one IRA (other than rollover IRA's).[6] Should this position be extended to include limited employee retirement accounts established under proposed section 408 A, employees may be precluded from establishing individual retirement accounts to hold their retirement savings. Proposed section 408 A does not provide that an employee must consent to establishment of a limited retirement account. Should an employer establish limited retirement accounts for all plan participants, or should an employee initially request such an account and later determine that its maintenance is disadvantageous to him, the IRS prohibition against multiple retirement accounts would preclude him from then establishing an IRA independent of the employer's plan. Accordingly, the California Savings and Loan League believes that proposed section 408 A must be clarified to allow an employee to establish an individual retirement account independent of a qualified employee benefit plan, regardless of whether a limited employee retirement account has been established. Employees who are eligible to establish supplemental retirement accounts under these proposed amendments should be al-

---

[6] The Internal Revenue Service position on multiple individual retirement accounts is discussed more fully in paragraph C(3) in the text below.

lowed to choose to invest their funds in the most favorable investment vehicle available, and not be tied to the investment performance of the employer plan in which they may be enrolled.

A second provision in H.R. 10612 which requires comment relates to the treatment of excess contributions to individual retirement accounts, and penalty taxes on such excess contributions. Section 1502 (c)(13) of H.R. 10612 amends section 4973(b) of the Internal Revenue Code. The amendment would exempt from the 6-percent excise tax of section 4973 those excess contributions to an IRA, withdrawn under the conditions set out in section 408(d)(4), which result from employer contributions to qualified employee benefit plans. This in effect would allow a taxpayer to adjust his contributions to a supplemental retirement account after the close of his taxable year but before the date for filing his return, and avoid the 6-percent tax on excess contributions to a qualified plan. Employers, of course, can make such contributions subsequent to the close of a taxable year, while an employee's retirement account contribution must be made prior to the close of his taxable year.

The California Savings and Loan League sees this amendment as a necessary and desirable adjustment necessitated by the supplemental retirement account concept. However, the amendment fails to correct a basic inequity that currently exists under the Internal Revenue Code. Section 408(d)(4) provides that an individual's contribution to an IRA for a taxable year may be adjusted after the close of that year, but before the individual's Federal income tax return for the year is due, by withdrawal of any excess contribution. Excess contributions are those which exceed the amount deductible under section 219 of the Internal Revenue Code.

Amounts so withdrawn (under the conditions set out in section 408 (d)(4)) are excluded from the individual's gross income for the year often cannot determine his compensation until after the close of his tax year, yet can only make his IRA contribution during that year. Section 408(d)(4) is intended to prevent a double income tax on the amount of the excess contribution. First, the excess contribution is included in the individual's gross income in the year contributed; by definition it is not deductible in that year since it exceeds the amount of deductible contributions under section 219. Next, absent section 408(d)(4), the excess contribution would again be included in gross income when withdrawn from individual retirement account, by virtue of section 408(d)(1). Under certain circumstances, section 408 (d)(4) relieves an IRA participant from this second income tax.

Notwithstanding the recognition in section 408(d) of the problems inherent in calculating a maximum IRA contribution prior to the end of the tax year, and the relief provided in section 408(d)(4), the Internal Revenue Code in two places imposes a penalty on an excess contribution regardless of whether it is withdrawn in a section 408 (d)(4) adjustment. First, section 4973 imposes a 6-percent tax on all excess contributions, regardless of whether or not they are withdrawn. (The Internal Revenue Service will not assess this tax on withdrawn excess contributions for tax years ending before March 4, 1976. Technical Information Release 1446, March 4, 1976.) The amendment of section 4973 proposed in section 1502(c)(13) of H.R. 10612

does not attempt to remedy this problem. Second, the provisions of section 408(f) impose a 10-percent penalty tax on amounts distributed from an IRA prior to the time the participant reaches age 59½, if such amounts are includible in gross income. Section 408(d)(4) provides that when an excess contribution is withdrawn under that paragraph, any income on such excess must also be withdrawn, and further that this income must be included in the participant's gross income. Because the income on the excess contribution is distributed from the IRA and included in gross income, the 10-percent penalty tax would appear to apply to such income.

There is no justification for imposing these two penalty taxes. The penalties are designed to discourage accumulation of excess IRA funds and the use of such funds other than for retirement. Yet penalties attach to the very procedure the Internal Revenue Code specifies must be used to adjust an IRA balance so that the IRA contribution limits set by Congress will not be exceeded. The ability to adjust IRA contributions after the close of a tax year, as provided in section 408(d)(4), is a necessary device. The California Savings and Loan League urges the removal of all penalty taxes on amounts withdrawn from an IRA in accordance with the procedure set forth in section 408(d)(4) of the Internal Revenue Code.

The supplemental retirement account concept presents a final question which warrants consideration by the committee. Section 1502 of H.R. 10612 defines a "qualifying employer contribution" in terms of the amount contributed to a benefit plan by an employer. It does not consider whether an employee has any vested interest in the contribution. Under the vesting schedules permitted by section 411 of the Internal Revenue Code, there may be substantial periods of time (up to 10 years) during which an employee would have no vested interest in benefits accrued under a qualified employee benefit plan, but during which time he nonetheless would be prohibited from contributing to an individual retirement account or other supplemental account because he is accruing benefits. Benefits accrued but not vested of course are lost when an employee terminates his employment. To cite an example of the consequences of these facts, an individual who terminates employment after 9 years service with an employer, and who has accrued benefits but has no vested benefits under the employer's plan (see section 411(a)(2)(A) of the Internal Revenue Code) will have acquired no retirement savings at the end of that time. The California Savings and Loan League suggests that tying the permitted supplemental IRA contributions to benefits vested rather than benefits accrued in a qualified plan will insure that every employee will be able to set aside retirement savings up to the yearly maximum level (15 percent of income or $1,500) set by Congress.

C. INTERNAL REVENUE CODE RESTRICTIONS ON ROLLOVER INDIVIDUAL RETIREMENT ACCOUNTS

A number of limitations on the tax-deferred rollover of distributions from qualified employee benefit plans into IRA's are set out in sections 402 and 408 of the Internal Revenue Code. The California Savings and Loan League believes that the following requirements are un-

desirable, have no substantial policy justification, and therefore should be modified or eliminated by additional amendment of the Internal Revenue Code.

1. The Internal Revenue Code now provides that, to qualify for the rollover of a distribution from a qualified plan into an IRA, the property rolled over must consist of the same property (other than cash) distributed from the qualified plan.[6] This restriction effectively prevents savings and loan associations, insurance companies and in most cases commercial banks from accepting rollovers where the property distributed consists, in whole or in part, of noncash property. Federal regulations prohibit savings and loan associations from accepting stocks, bonds, other securities, annuities, or indeed any property other than cash. Likewise, most insurance companies and commercial banks either cannot or will not accept contributions of property other than cash.

The limitations in the Internal Revenue Code thus effectively prevent savings and loan associations and other major IRA vehicles from establishing IRA's for employees who have received distributions consisting of property other than cash. Under most qualified retirement plans, a plan member has no control over the form or composition of a distribution to him.[7] The effects of this limitation on the employee who has received a noncash distribution are adverse. First, the market in which he can locate a suitable individual retirement account is substantially reduced, if not eliminated in practical terms, because those IRA vehicles that accept only cash will not be available to him. Second, if he is able to find a trustee who will accept his property, it is likely that the trustee fees and costs will greatly exceed those he would otherwise find among IRA's sponsored by savings and loan associations, banks and insurance companies.[8]

This is a result not only of the smaller market and possibly reduced competition for his account, but also of the increased responsibilities and costs inherent in the administration of a fund consisting of noncash assets. Such a trustee is required to review the investments regularly, decide whether investment changes are required and execute any investment decisions that are made. Because of the rapidly developing law regarding cofiduciary liability, trustees are less and less willing to accept and rely upon investment directions from participants. Understandably, then, they are also less and less willing to accept a rollover of property other than cash. Where such property is accepted, the trustee is generaly high enough to warrant the substantially increased costs and risks. Naturally, the lower the value of the property distributed the less willing the trustee will be to serve (without a

[6] Internal Revenue Code, sec. 402(a)(5)(C). Additionally, all the property distributed must be rolled over. This is discussed in the text below.

[7] This problem is particularly severe when a distribution occurs upon plan termination. Tax deferred rollovers are now permitted upon plan termination by H.R. 12725, signed by the President on Apr. 15, 1976. The likelihood of receiving a distribution in kind on a plan termination naturally is greater than under a normal distribution upon termination of service because such a distribution eliminates selling expenses and does not present the problem of liquidating assets in what may later be found to have been unfavorable market conditions.

[8] A recent study by the Congressional Research Service of the Library of Congress, parts of which were entered into the Congressional Record by the Honorable Charles A. Vanik in February 1976, shows that savings and loan associations typically charge little or no fee for establishing and maintaining IRA's. 122 Congressional Record, No. 12, Feb. 3, 1976; 122 Congressional Record, No. 21, Feb. 18, 1976. The California Savings and Loan League Master Plan, whch is trusteed by Union Bank, currently charges a yearly trustee fee of $7.50 per account regardless of account size.

sizeable minimum fee), thus affecting lower level employees greater than the highly paid executives. For these reasons the private sector has not developed an effective IRA vehicle for accepting noncash distributions from qualified plans.

There is no substantial policy reason that the Internal Revenue Code should require that the identical property distributed be rolled over into the IRA. This rule is of no benefit to the employee, and it is inimical to the concept of portability. It is the experience of the savings and loan associations participating in the California Savings and Loan League Master IRA Plan that customers who cannot roll their qualified plan distributions into a savings and loan IRA, because they have received some property other than cash, generally are unable to us the IRA altogether. Consequently, their distributions are taxed currently and a substantial portion of their retirement savings is lost forever. In some cases, the tax on the distribution will require a sale of some of the property distributed. In most cases, receipt of the distribution and the payment of taxes on it defeat whatever incentive there otherwise would be to preserve the property for retirement.

Finally, subject to certain limitations, the Internal Revenue Code permits an individual to contribute property and cash held in a rollover IRA to another qualified plain maintained by a subsequent employer. In view of the problems that have developed over finding an IRA trustee who will accept property in kind, one must anticipate that other qualified plans will be equally reluctant to accept responsibility for whatever property a participant may wish to roll over. Regardless of the procedure used, under present law only a fiduciary under a qualified plan or IRA is able to convert property to cash in order to facilitate a rollover. The costs, responsibilities, and potential liabilities associated with such a duty are clear impediment to the rollover concept. Yet even if he wants to, the individual cannot accept the responsibility and sell the property himself. The responsibility must be assumed by a stranger, who either need not accept the risk or can be expected to charge a fee commensurate with the risk.

The resolution of this problem could take either of two forms. First, the Internal Revenue Code could permit the rollover into an IRA of any property and the proceeds of sale of any property distributed in kind from a qualified plan.[9] This would open to the individual all of the vehicles for the establishment of a rollover IRA, with the concomitant lowering of costs and ease of establishment of the account. Tracing the distribution would not be a problem, because the responsibility for maintaining adequate records could be placed on the taxpayer (as is customary) and the rollover would still have to occur within 60 days of the qualified plan distribution. Moreover, because distributions from an IRA are treated as ordinary income, it would not be necessary to trace capital gains or losses, or to tax any capital gains at the time of sale. The second possible solution would be to permit the rollover of part of a distribution, in particular, that portion of the distribution consisting of cash. This is discussed more fully below.

---

[9] The desirability of permitting rollover into an IRA of the cash equivalent of a distribution received in kind is recognized in a somewhat differen context in H.R. 12725, signed by the President on Apr. 15, 1976. The bill contains a transitional rule whereby cash proceeds from the sale of noncash property received upon a plan termination, which occurs prior to enactment of H.R. 10612, may be rolled over under section. 402(a)(5) of the code and that no gain or loss on the sale need be recognized.

2. Section 402(a)(5) of the Internal Revenue Code requires that in order for a distribution to qualify for a rollover into an IRA, the distribution must "constitute a lump sum distribution within the meaning of subsection (e)(4)(A) (determined without reference to subsection (e)(4)(B))." In general, subsection (e)(4)(A) defines a lump sum distribution to mean a distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient:

(i) On account of the employee's death;

(ii) After the employee attains 59½ years;

(iii) On account of the employee's separation from service; or

(iv) After the employee has become disabled. Subsection (e)(4)(B) requires that a recipient file a special election in order to qualify for lump sum distribution treatment. Due to the exclusion in section 402(a)(5), quoted above, that a lump sum distribution for rollover purposes is determined without reference to subsection (e)(4)(B), this election need not be filed in order to qualify for a rollover. However, subsection (a)(5) does not specifically exclude the application of subparagraphs (C) through (K) of subsection (e)(4) to the extent that those subparagraphs affect the definition of lump sum distribution. Specifically, subparagraph (H), entitled "Minimum Period of Service," provides as follows:

> (H) *Minimum Period of Service.*—For purposes of this subsection (but not for purposes of subsection (a)(2) or section 403(a)(2)(A), no amount distributed to an employee from or under a plan may be treated as a lump sum distributed under subparagraph (A) unless he has been a participant in the plan for 5 or more taxable years before the taxable year in which such amounts are distributed.

It was originally thought that the language "for purposes of the subsection" referred to subsection (e) of section 402, entitled "Tax on Lump Sum Distributions," and that the 5-year participation rule applied only in determining whether a recipient of an otherwise qualifying lump sum distribution would be entitled to the special 10-year averaging provisions of subsection (e).

The Internal Revenue Service has taken the position, however, that subparagraph (H) qualifies the definition of lump sum distribution under subparagraph (A) for all purposes, including for purposes of the rollover provisions of subsection (a). Consequently, the Internal Revenue Service has indicated that it will not allow a tax deferred rollover from a qualified plan to an IRA or other qualified recipient investment unless the employee was a participant in the qualified plan for 5 or more taxable years before the taxable year in which the distribution occurred. There appears to be no policy justification for this requirement. An employee who has built an equity in benefits accrued under a qualified plan in a period of less than 5 years should not be required to forfeit the tax deferral afforded those benefits upon termination of employment. Once again, by denying the rollover privileges to an otherwise qualified employee the Internal Revenue Service is forcing the immediate taxation of the employee's retirement fund and substantially increasing the likelihood that the fund will not be available upon the employee's actual retirement.

This limitation on rollovers, in addition to the limitation discussed in paragraph 4, below, results from the indiscriminate application of

the lump sum distribution rules to rollovers. Yet, the lump sum distribution rules, and section 402 of the Internal Revenue Code generally, are primarily intended to cover the taxation of distributions from qualified plans, not the portability of retirement benefits. While the wholesale adoption of the lump sum distribution rules may have simplified the drafting of the rollover provisions. those rules should not be allowed to seriously restrict the portability of retirement benefits unless there is a substantial policy reason.

No such policy reason supports the 5-year participation rule. In fact, the policy would appear to go in the other direction. The Internal Revenue Service's position on this issue could easily render the rollover provisions practically useless for migratory employees, the group that was supposed to have benefited most from the rollover concept. As the law is now being interpreted, the retirement benefits of most migratory employees (which arguably should increase because of the new 1-year eligibility rules applicable to most qualified plans) will not qualify for portability and consequently will not be preserved for retirement.

Moreover, when a lump sum distribution is rolled over into an IRA, the tax benefits to which the distributee otherwise would have been entitled (namely, the capital gains treatment of a portion of the distribution [10] and the special 10-year averaging rules for the ordinary income portion of the distribution [11]) are lost, because section 408(d)(1) of the Internal Revenue Code requires that all distributions from an IRA shall be taxed as ordinary income. Consequently, there is little or no incentive to use the rollover privilege for unintended tax benefits and little or no reason (other than simplicity) to rigidly apply the lump sum distribution rules to rollovers. The advantage of simplicity is more than offset by the loss in portability of retirement funds, the guiding purpose of the rollover concept.

3. The Internal Revenue Code further provides that, to qualify for a rollover of a distribution from a qualified plan into an IRA, the property rolled over must consist of all the property distributed from the qualified plan. In addition, the Internal Revenue Service has interpreted the law to require that the rollover be made into a single IRA. For the reasons set out above, these limitations prevent large segments of the financial community from accepting rollovers, in particular in those situations where the property distributed includes non-cash items.

The Internal Revenue Service's position against multiple IRA's, each receiving a portion of a distribution, prevents an employee who has received some portion of a distribution in kind and the remainder in cash from availing himself of the more conservative and generally less expensive IRA's offered by institutions that accept only cash. The employee can, of course, attempt a rollover into two IRA's (assuming the IRA trustees will accept such a rollover and the accompanying risk of being held responsible for any disqualification that results) and directly challenge the Service's position. Normally, however, the risks of such a course of conduct exceed any possible benefit.

The limitation that all of the property distributed from the qualified plan must be rolled over into the IRA causes a hardship on terminated employees who have been "cashed out" of an employee benefit plan.

---

[10] Internal Revenue Code, sec. 402(a)(2).
[11] Internal Revenue Code, sec. 402(e)(1).

The event which caused the distribution—such as the employee's being layed off, fired, voluntarily leaving his employment, or his termination of employment due to disability—may create a bona fide need for cash on his part. Medical expenses, family support during a period of unemployment and similar circumstances may require that the terminated employee draw on a portion of the retirement savings distributed to him to meet his immediate cash needs. Yet, if he needs only a portion of these savings, the requirement that 100% of the distribution be rolled over causes such an employee to lose the tax deferral afforded his retirement fund, even the portion not used. A more reasonable policy would be to allow the terminated employee to roll over all or any part of the distribution into a tax-deferred IRA, to encourage the preservation of as much of his retirement savings as possible. Of course, any amount not rolled over would be subject to current taxation.

4. The Internal Revenue Code further provides that, to qualify for a rollover, the amount distributed from the qualified plan must consist of the entire balance of the employee's interest under the plan, and the distribution must be made within 1 taxable year of the recipient.[12] The comment of the California Savings and Loan League on this requirement is essentially a technical one. Distributions from a qualified plan, particularly under the distribution events required for a rollover,[13] may be made at any time during the plan year. Occasionally, they are made in more than one installment; for example, a participant's interest in a plan's fixed income account may be distributed in cash as soon as possible, while his interest in the plan's equity account may be distributed much later to allow for a sale of stocks under acceptable market conditions or to prepare for a distribution in kind. Also, the plan may be on a fiscal year, so that the timing of distributions is based upon a taxable year that does not coincide with the employee's taxable year (normally, the calendar year). Under those circumstances, it is quite possible that the employee will receive his distribution over 2 taxable years, even though both installments are received within a relatively short period of time. Errors in calculation and subsequent adjustments of accounts also can precipitate a second distribution after the end of the employee's taxable year.

Again, use of the lump-sum distribution rules has caused a conflict of purposes. For purposes of the taxation of distributions from qualified plans, it is important that the distribution occur within 1 taxable year. On the other hand, where no tax will be payable on the distribution, such as in a rollover situation, it may be important to accomplish the distribution promptly but it is not important that it bear any relationship to the employee's taxable year.

The California Savings and Loan League believes that the policy which this provision is designed to promote with respect to IRA's—namely, that distributions and rollover be completed within a reasonably short period of time—would be better served by substituting a fixed period of time, such as 12 months, for the present 1-taxable-year requirement.

---

[12] Internal Revenue Code, section 402(a)(5)(A).
[13] Internal Revenue Code, sections 402(a)(5)(A) and 402(e)(4)(A).

THE MANUFACTURERS LIFE INSURANCE CO.,
Toronto, Canada, April 20, 1976.

Mr. MICHAEL STERN,
U.S. Senate, Washington, D.C.

DEAR MR. STERN: I wish to make the following submission to the hearings held by the Committee on Finance in respect to tax reform bill, H.R. 10612.

The conference committee report that was issued at the time that the Employee Retirement Income Security Act (ERISA) became law in 1974, included the following statement:

"The committee bill also contains a provision to permit self-employed individuals to set aside up to $750 a year out of earned income as a deductible contribution, even though it exceeds the otherwise applicable percentage limitation (15 percent of earned income). This provision will enable certain organizations of the self-employed, such as the Jockeys' Guild, to set up retirement plans for their members without having to confront complex recordkeeping and administrative problems, and will also allow any self-employed individual who wishes to do so to save for his retirement, even though his earned income in a particular year is relatively low."

To carry out this concept, section 404(e) (4) was added to the code by ERISA. It reads as follows:

"(4) Limitations cannot be lower than $750 or 100 percent of earned income.—The limitations under paragraphs (1) and (2) (A) for any employee shall not be less than the lesser of—

(A) $750, or

(B) 100 percent of the earned income derived by such employee from the trades or businesses taken into account for purposes of paragraph (1) or (2) (A) as the case may be."

I submit that the two quotations state quite clearly that a self-employed person may contribute to a Keogh H.R. 10 plan any amount up to the lesser of $750 or his earned income.

Proposed regulations issued by the Treasury Department and the Internal Revenue Service on April 21, 1975 (and not yet finalized), describe in section 1.404(e)-1A(b) (3) (i) (C) the deduction permissible in the same manner as described in section 404(e) (4) above. Then, in spite of the contents of the two quotations above, that section of the proposed regulations adds the following limitation:

"However, see section 415 for rules applicable to years beginning after December 31, 1975. For example, if a defined contribution plan using a trust permitted an employer contribution to be made for any participant in the plan for a year beginning after December 31, 1975, in excess of the amount described in section 415(c) (1) (B) the trust established under such plan would not constitute a qualified trust under section 401(a), notwithstanding the provisions of section 404(e) (4). The special rule in the second sentence of paragraph (3) (A) of section 404(a) is not applicable in determining the amounts deductible on behalf of self-employed individuals."

It is to be noted that section 404(e) (4) contains no statement to the effect that the limit in section 415(c) (1) (B) overrides the limits in section 404(e) (4).

Also, it is to be noted that the statement in the conference committee report contains no reference to the limit in section 415(c)(1)(B).

Because it is believed by myself and many other persons that Congress had no intention of having the limit in section 415(c)(1)(B) override the limit in section 404(e)(4), it is suggested that a technical amendment be added to tax reform bill H.R. 10612, as follows:

"The limitation of 25 percent of the participant's compensation provided in section 415(c)(1)(B) shall not apply to any contribution made under the terms of this subsection."

I shall appreciate the Committee on Finance giving consideration to this suggestion.

Sincerely,

NORMAN H. TARVER.

THE MANUFACTURERS LIFE INSURANCE CO.,
Toronto, Canada, April 20, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. STERN: I was very pleased to learn today that the House and the Senate have passed bill H.R. 12725 and that it has already been signed into law as Public Law 94-267.

This action has some bearing on the suggestions that I included in the brief that I submitted on April 12, 1976, to the hearings on tax reform bill H.R. 10612. I am assuming that section 1501 of H.R. 10612 is now superfluous and would normally be deleted. However, what I would like to propose is that instead of simply deleting section 1501, only the present contents of it be deleted and then that the Finance Committee consider inserting in section 1501 the following:

(a) The proposed wording for a new section 402(a)(6) as shown on page 14 of the brief and as discussed on page 1, in respect to a lump sum distribution in event of a participant's death.

(b) Wording in respect to permitting "property" to be converted into "money" and permitting the resulting money to be rolled over, as discussed on page 2 of the brief.

(c) Wording to remove the 5-year minimum period restriction, as discussed on page 2 of the brief.

I would appreciate your adding this letter to the letter and brief submitted on April 12.

Sincerely,

NORMAN H. TARVER.

THE MANUFACTURERS LIFE INSURANCE CO.,
Toronto, Canada, May 7, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. STERN: Congress is to be commended for the passage of Public Law 94-267, which extends to a lump-sum distribution made to a participant in the event of a termination of a qualified plan, the privilege of rolling over such distribution to an individual retirement account or annuity (an IRA) or to another qualified plan.

The change resulting from Public Law 94–267 thus means that a lump-sum distribution received as a result of a plan termination may be treated in any one of three ways, as follows:

(1) It may be treated as ordinary current income;

(2) It may be rolled over into an IRA or another qualified plan;

(3) It, together with other current income, may be accorded the 5-year income averaging privilege under section 1301.

A lump-sum distribution received as a result of employment termination, however, in addition to the three treatments described above that are available to a lump-sum distribution received as a result of a plan termination, may be taxed on the 10-year averaging method provided in section 402(e)(1).

There appears to be no reason why there should be this difference between the treatment of the two types of lump-sum distributions. Therefore, it is suggested that the 10-year averaging method provided in section 402(e)(1) should be made available for a lump-sum distribution resulting from a plan termination. With this in mind, it is suggested that tax reform bill H.R. 10612 be amended to include a technical amendment that will add "a plan termination" to the list of events listed in section 402(e)(4)(A).

Sincerely,

NORMAN H. TARVER.

STATEMENT OF NORMAN TARVER, SUPERINTENDENT, PENSION LEGISLATION RESEARCH, MANUFACTURERS LIFE INSURANCE CO.

This brief comments on and makes suggestions in respect to the following items:

SEC. 1501—TAX-FREE ROLLOVERS

(1) Rollovers on Plan Termination.
(2) Lump-Sum Death Benefits.
(3) Property Other Than Money.
(4) Five Year Minimum Service Period.

SEC. 1502—IRA'S FOR ACTIVE PARTICIPANTS

(1) Basic Philosophy.
(2) An Alternative to Offsetting Employer Contributions.
(3) Government Plans.
(4) 403(b) Plans.
(5) Members of Reserve Components of the Armed Forces.

SEC. 1502—LERA'S FOR ACTIVE PARTICIPANTS

(1) Basic Philosophy.
(2) Extend LERA's to All Plans.
(3) Alternative to Offsetting Employer Contributions.
(4) Code Section 415.
(5) Accrued Benefits.

OTHER IRA PROPOSALS

(1) Increased Deduction Limits.
(2) Carryback Provision.
(3) Excess Contributions and Penalty Tax.
(4) Spousal IRA.

ENCLOSURES

(1) Proposed Wording for Code Section 402(a)(6).
(2) Proposed Wording for Proposed Code Section 220(b)(1).
(3) Proposed Wording for Proposed Code Section 220(c)(1).
(4) TABLE (A)—Maximum Contribution Limit (15%/$1,500).
(5) TABLE (B)—Maximum Contribution Limit (15%/$2,000).

Bill H.R. 10612—Tax Reform Act of 1975

Title XV—Individual Retirement Account Amendments

SEC. 1501—TAX-FREE ROLLOVERS

Rollovers on plan termination

Amending Code Sections 402(a)(5) and 403(a)(4) to permit a rollover of a lump sum distribution to an IRA on termination of a qualified pension or profit sharing plan is highly desirable. Congress is to be commended for giving consideration to this amendment.

In many cases, employment termination and plan termination are in essence the results of the same circumstances. Sometimes employment termination occurs before plan termination. Sometimes the events occur in reverse order. To allow a rollover for employment termination but not for a plan termination, means that the latter is being discriminated against.

Bill H.R. 4721 submitted to the 94th Congress by Representatives William A. Steiger, John N. Erlenborn, Joseph E. Karth and Robert W. Kasten, Jr., would also provide for rollover on plan termination.

Bill H.R. 12725 recently submitted by Representatives Al Ullman, Herman T. Schneebeli, Barber B. Conable, Jr., Joseph E. Karth and William A. Steiger would extend the tax-free privilege to lump-sum distributions resulting from partial plan terminations. Section 1501 of Bill H.R. 10612 would permit tax-free rollovers for only lump-sum distributions on complete plan terminations. Such extension is very desirable.

Lump-sum death benefit

It is suggested that consideration be given to amending the Code to permit a rollover to an IRA by a beneficiary receiving a lump-sum death benefit resulting from the death of a participant in a qualified retirement plan.

The philosophy on which rollovers to IRA's are based is that it is socially desirable to provide a means whereby a participant receiving a large lump-sum distribution is able to retain it intact on a tax-deferred basis until he or she needs the money for retirement. A rollover provides the means for preserving pension benefits.

It is suggested that it is equally desirable socially to permit a beneficiary to preserve a lump-sum death benefit so it can be used for future needs.

It is to be noted that Code Section 402(e)(4)(A), which defines a "lump-sum distribtution", already includes in (A)(i) a reference to a distribution payable to a recipient on account of the death of an employee.

Therefore, it is suggested that two new sections 402(a)(6) and 403(a)(5) be added to the Code. A suggested draft for 402(a)(6) is attached. 403(a)(5) would be similar.

Property other than money

Section 402(a)(4)(A), which defines a "lump-sum distribution", does not distinguish between "money" and "property". In fact, for purposes of 402(e)(4)(A), if property in the form of an annuity contract is distributed, it is treated as a lump-sum distribution or as a part of a lump-sum distribution.

On the other hand, 402(a)(5) and 403(a)(4) do distinguish between "money" and "property". The wording of these two Sections apparently states that, if a participant receives property (as distinct from money), he or she must transfer such property intact into an IRA. It appears that the participant cannot convert the property into money and then transfer the money into an IRA. On this basis, a participant receiving some or all of his or her lump-sum distribution in the form of property (other than money) cannot transfer the distribution into an IRA annuity contract because an insurance company is not normally able to receive property (other than money) as a premium payment.

Quite likely, the reason a participant wants to transfer his or her lump-sum distribution into an IRA is to convert the distribution into a retirement annuity. If the participant is not permitted to convert the "property" into "money", he or she is barred from converting the distribution in a retirement annuity.

Sections 1501(c)(2) and (3) of Bill H.R. 10612 do make reference to the "sale or exchange of property" and to the transfer of "an amount in cash". However, this sale of the property appears to be confined to only a sale that occurs prior to the enactment date of Bill H.R. 10612. Bill H.R. 11331, submitted to the 94th Congress by Representative James F. Hastings would provide for the sale or exchange of property and the transfer of the realized proceeds to an IRA.

Bill H.R. 2009, submitted by Representative Robert A. Roe, would permit "an amount equal to" a qualified lump-sum distribution from a qualified plan to be transferred into another qualified plan. The principle embodied in this Bill is very desirable. However, it does not provide for a transfer into an IRA.

It is suggested that 402(a)(5) and 403(a)(4) be amended to permit any property received as the whole or a part of a lump-sum distribution to be converted into money and to permit the resulting money to be transferred into an IRA or another qualified plan, subject to the regular rules. For this purpose, the wording in Section (b)(3) of Bill H.R. 11331 could be used.

Five-year minimum service period

Section 402(e)(4)(H) states that if an employee has been a participant in a qualified plan for less than 5 years, the ordinary income element in a distribution received by him or her may not be treated as a lump-sum distribution.

Whether or not there is any reason why this restriction is necessary in respect to the 10-year averaging provision in Code Section 402(e)(1), there seems to be no logical reason why an employee receiving a lump-sum distribution on employment termination or plan termination within such 5-year period, should not be able to transfer the lump-sum distribution into an IRA. After a transfer to an IRA, a subsequent distribution from the IRA would not receive any special tax favor other than the ordinary 5-year averaging provision in Code Section 1301, which would have been available for the original distribution.

It is suggested that this restriction be eliminated by adding references to 402(a)(5) and 403(a)(4) to the subsections to which 402(e)(4)(H) does not apply.

TITLE XV—INDIVIDUAL RETIREMENT ACCOUNT AMENDMENTS

SEC. 1502—IRA'S FOR ACTIVE PARTICIPANTS

Basic philosophy

Extending IRA's to active participants is highly desirable. Many employees who are active participants in qualified plans are presently discouraged from setting aside savings for their retirements, even though the retirement pensions they will receive from the qualified plans will prove to be inadequate for them to maintain reasonable status after retirement. There is a real need for supplementary savings, and Congress is to be commended for giving consideration to amending the Code to encourage such savings.

A large proportion of the workers who are not currently participating in pension plans, are employed by small employers that have not established such plans. Many of these small employers are not financially able to fund adequate pensions for their employees. Encouraging employees of small companies to set aside retirement savings on their own should help considerably to encourage their employers to establish at least modest pension plans. For this reason, extending IRA's to active participants should help appreciably to increase pension plan coverage.

However, it is suggested that Congress could do more than is contemplated by Section 1502 to encourage such savings. As described below, requiring the amount of the employer's contribution to a qualified plan to be directly offset against the 15%/$1,500 limit for contributions to an IRA or a LERA would result in many complications which would discourage many active participants from setting aside savings.

An alternative to offsetting employer contributions

Under proposed Section 220(b)(1), the normal 15%/$15,00 limit would be reduced by the amount of the employer's contribution to the

qualified plan. In theory, this reduction is proper. However, the definition of "qualified employer contribution" is proposed Section 220 (c)(3) would result in expensive calculations for an employer, particularly in the case of a qualified defined benefit plan referred to in Section 220(c)(3)(B).

For a plan funding a past service benefit the requirement in proposed Section 220(c)(3)(B)(ii) for amortizing it is different to the requirement in Code Section 412(b)(2)(ii) for amortizing for the Funding Standard Account. This means two expensive calculations; one for the plan benefit and one for the employee's IRA contribution.

Another problem with a direct offset of employer contributions is that the offset would have to be recalculated each time a change in circumstances occurs (e.g., a change in the employee's compensation or pension benefits). A procedure would need to be developed for informing individual employees of the size of the offset. An employer could not do this until its tax year is over, except by estimate. An estimated employer contribution could be wrong, so that the employee's contributions to the IRA could be too small or too large, in which case the employee would be subject to a 6% excise tax penalty on the excess.

Under these circumstances, it is likely that most employers would balk at making the calculations needed for their employee's IRA's. If so, the whole purpose of extending IRA's to active participants would be defeated. The result would be "Indian-Giving"; giving a benefit by legislation but negating it by administration.

Bills H.R. 2848, 8990, 9293 and 11940, submitted by Representatives Thomas F. Railsback, Robert J. Cornell, William A. Steiger and John N. Erlenborn, respectively, would provide for an offset somewhat like that in Bill H.R. 10612. Three other Bills, H.R. 9426, 9427 and 9681, are identical to Representative Cornell's Bill H.R. 8990 and have been cosponsored by at least 35 other Representatives. Under most of the Bills, instead of making an actual calculation of the employer's contribution in every case, for those cases where it is difficult to make the calculation an employer contribution rate of 7% of compensation could be assumed. Although this is an improvement over the provision in proposed Section 220(c)(3)(B)(ii), it nevertheless requires the calculation of a direct offset.

Senator Daniel K. Inouye has submitted Bill S. 2428 which would extend IRA's to active participants and would provide for an offset for employer contribution. However, a method for calculating the offset is not included in the Bill and would be left to be provided by regulation.

It is suggested that the desired objective can be achieved much more easily and on a basis that requires no calculation to be made by an employer or anyone except the employee. In place of the 15%/$1,500 limit and the offset in proposed Section 220(b)(1) (A) and (B), I suggest defining the maximum contribution an active participant can make as a gradually reducing percentage of the employee's compensation as the latter increases in size. Or, alternatively, the maximum contribution could be a gradually reducing number of dollars as the employee's compensation gradually increases in size.

Both of these concepts are demonstrated in TABLE (A), attached. Using either of these concepts would mean that the employee could

easily calculate his or her own maximum contribution limit without having to get any contribution figure from his or her employer. For "compensation", it is suggested that it could be defined as the figure in Box 2 of Form W-2, which the employer has to calculate and furnish to the employee anyway.

If the figure in Box 2 is used as the "compensation" as suggested, the figure would be somewhat smaller than the figure defined in proposed Section 220(a). However, for simplicity's sake, it is nevertheless suggested that the Box 2 figure be used.

If the deduction limit is changed to 15%/$2,000 as has been proposed by the Secretary of the Treasury, TABLE (B), attached, demonstrates how the concept could be used under the larger limit.

If TABLE (A) or TABLE (B) procedure is adopted, proposed Section 220(b)(1) would be changed to include the table selected. A suggested wording for 220(b)(1) is attached. Also, if TABLE (A) or TABLE (B) procedure is adopted, proposed Section 220(b)(7) and 220(c)(3), (4) and (5) could be deleted. A suggested wording for 220(c)(1) is also enclosed to define "compensation".

It is agreed that the use of TABLE (A) or TABLE (B) would not be as finely accurate as the method in proposed Section 220(b)(1), but is fine accuracy really needed? After all, the limits of 15%/$1,500 or 15%/$2,000 are nothing more nor less than arbitrarily selected figures. Why try to add fine accuracy to an arbitrarily selected figure? Moreover, fine accuracy would be expensive to obtain and administer for all concerned (employee, employer, Internal Revenue Service) and confusing to an employee.

I have suggested using the compensation figure shown in Box 2 of Form W-2. I realize that an employee does not receive his Form W-2 until after the end of his taxable year. However, later in this brief, it is suggested that an employee be permitted to make contributions until his tax filing date (see "Carryback Provision").

Government plans

Proposed Section 220(b)(2) would decline to extend IRA's to active participants of "government plans" (as therein defined). Making use of the reducing limits suggested above under TABLE (A) or TABLE (B), should make it feasible to permit active participants in government plans to contribute to IRA's.

For employees with incomes of sufficient size that they can afford to contribute to IRA's, the size of the permitted contributions available under either TABLE (A) or TABLE (B) are such that there would seem to be no logical reason for not granting the privilege to active participants in government plans.

403(b) plans

In essence, a 403(b) plan (so-called tax sheltered annuity) has always been a type of retirement savings much like an IRA. It is true that the contribution limits are calculated by a different formula. It is also true that technically a 403(b) plan is based on employer contributions. It is also true that the original concept was that a 403(b) plan would be a substitute for a qualified pension plan.

However, in practice, 403(b) contributions are almost always employee contributions developed through a salary reduction agree-

ment. By this means, employees are able to secure deductions for their contributions. Moreover, even if the employer is making contributions to a qualified plan, an employee is still able to make contributions to a 403(b) plan and obtain tax deductions for them, although the deduction limit is reduced because of the employer's contributions to a qualified plan. In practice, a 403(b) plan is really a type of IRA, subject to different limits and different requirements.

Proposed Section 220(a), which would be added to the Code by Section 1502 of Bill H.R. 10612, would permit an employee participating in a 403(b) plan to establish an IRA. All of the Bills referred to above would also permit such an employee to establish an IRA.

Because a 403(b) plan is like an IRA, I suggest that IRA's be not extended to active participants in 403(b) plans, which would mean removing the reference to such plans from proposed Section 220(a).

Members of Reserve components of the Armed Forces

Senator Strom Thurmond has submitted Bill S. 2006 to the Senate and Representative James R. Jones has submitted Bill H.R. 11084 to the House. Each of these Bills would extend the privilege of establishing IRA's to members of reserve components of the armed forces, providing such members are otherwise permitted to do so.

It is suggested that Section 1502 be amended so as to provide for the addition to Code Section 219(c) and to proposed Section 220(c) the subsection (3) contained in Bills S. 2006 and H.R. 11084.

Title XV—Individual Retirement Account Amendments

SEC. 1502—LERA'S FOR ACTIVE PARTICIPANTS

Basic philosophy

The philosophy of permitting a qualified pension or profit sharing plan to be expanded to include a provision whereby employees may make contributions to such plans and take deductions for them, is highly desirable.

Many small corporate and non-corporate employers would like to establish retirement plans for their employees. However, due to financial circumstances, they do not feel that they can contribute enough on their own to provide worthwhile pensions, even though, as employers, they are able to take deductions for their contributions. If these employers could establish plans under which both employers and employees could secure deductions for contributions, it is believed that many more small employers would establish retirement plans.

Many Senators and Representatives have expressed the thought that an important objective of ERISA is to expand pension coverage to many more employees.

Extend LERA's to all plans

With these thoughts in mind, the concept of permitting a provision to be added to a qualified plan that would permit employees to join with their employers in accumulating savings for retirement, is very commendable. However, proposed Section 408A, as it would be incorporated in the Code by Section 1502, is disappointing. Section 408A would make LERA's available for only qualified plans in operation on

September 2, 1974; no plan established after that date would be able to include the provision. Not only is this disappointing, but it is also discriminatory without apparent justification for such exclusion.

Also, the provision for LERA's would be of no help whatever to small employers who had not prior to September 2, 1974, established plans for their employees, where it could do a great deal of good.

Therefore, it is suggested that Section 408A(a) be amended by the deletion of the proviso "if the plan was in existence on September 2, 1974".

Alternative to offsetting employer contributions

The comments in regard to proposed Section 220 (b)(1) above and the suggestion for using TABLE (A) or TABLE (B) would apply to contributions to LERA's.

Code section 415

Code Section 415 places limits on benefits and contributions under retirement plans. Ordinarily, the contributions made to IRA's must come within the 15%/$1,500 limit specified in Section 219 without any reference to Section 415. Also, under proposed Section 220, contributions to IRA's by active participants would have to come within the 15%/$1,500 limit, again without reference to Section 415. This treatment of contributions to IRA's is quite logical and proper.

However, under Bill H.R. 10612, Section 1502(c)(16) would amend Section 415(c)(2) so that employee contributions to a LERA would be considered to be contributions to the qualified plan in question. The result is that the LERA contributions would be taken into account in applying the 25%/$25,000 limit in Section 415(c). There seems to be no logical reason for treating LERA contributions any different to IRA contributions.

Therefore, it is suggested that the proposed amendment of Section 415(c)(2) be deleted by deleting proposed Section 1502(c)(16).

Accrued benefits

Proposed Section 408A(h)(1) describes a procedure for separating the benefits accruing from LERA contributions from the benefits accruing from the nondeductible employee contributions to the qualified plan.

LERA contributions will need to be segregated from all other contributions (both employer and employee contributions) at all times. Also, investment earnings on LERA contributions will need to be segregated and credited to the individual LERA contribution accounts. Because the LERA contributions and earnings must at all times be segregated for accounting and reporting purposes (even though they may be commingled with the qualified plan assets for investment purposes), there seems to be no need for including a provision for computing and segregating accrued benefits. Actually, the LERA provision would be operated as a defined contribution plan appended to a qualified plan, regardless of the type of plan that the qualified plan might be.

Therefore, it is suggested that proposed Sections 408A (1) and (2) be deleted from the Bill.

TITLE XV—INDIVIDUAL RETIREMENT ACCOUNT AMENDMENTS

OTHER IRA PROPOSALS

Increased deduction limits

The 15%/$1,500 limit for contributions and deductions was first proposed in December, 1971 by President Richard M. Nixon and, subsequently, it was included in Bills S. 3012 and H.R. 12272 submitted to the 92nd Congress. In due course, that limit was included in the Employee Retirement Income Security Act of 1974.

Because the Consumer Price Index has risen appreciably since 1971, Secretary of the Treasury William E. Simon in October, 1975 when testifying before the House Ways and Means Committee on Bill H.R. 10612, proposed that the dollar limit should be raised to $2,000 and that it should be indexed to C.P.I.

Most IRA's are started by individuals at ages beyond 45, which means that they normally have fewer than 20 years to accumulate savings for retirement. The following table (which is based on an insurance company's immediate annuity rates) will give an indication of the retirement pension that can be expected to be purchased by an annual contribution of $1,500 accumulated at 6% compound interest to retirement at age 65.

Starting age	Accumulated amount at age 65	Annual life annuity commencing age 65 (no minimum guaranteed period)	
		Male	Female
40	$87,234	$9,360	$8,341
45	58,490	6,270	5,588
50	37,010	3,962	3,530
55	20,958	2,236	1,993
60	8,963	947	844

At ages beyond 45, it is obvious from the above table that contributions of $1,500 per year are going to produce inadequate retirement pensions for anyone who can afford to set aside $1,500 per year.

Therefore, it is suggested that the limits of 15%/$1,500 for IRA's and LERA's are too low and they should indeed be raised to 15%/$2,000 if not to some larger limit. For this purpose Code Section 219 (b)(1) and proposed Section 220(b)(1)(A) would need to be amended.

A comparison of the 15%/$1,500 limit for IRA's with the 15%/$7,500 limit for self-employed persons under Keogh plans underlines the need to raise the limit for IRA's. The pension benefits under a Keogh plan could be 500% of those under an IRA!

Bill H.R. 2848 submitted to the 94th Congress by Representative Thomas F. Railsback, would increase the limit for IRA's to 20%/$7,500. Although the idea of an increase as provided in Bill H.R. 2848 is to be commended, it is suggested that an increased limit of 15%/$2,500 or perhaps 15%/$3,000 would be more reasonable.

Carryback provision

ERISA amended Code Section 404(a)(6) so that for all types of qualified pension and profit sharing plans (including Keogh plans)

employer contributions may be made at any time up to the filing date of a tax return and be counted as having been made on the last day of the taxable year for which the tax return is made. The amendment was made primarily to assist self-employed persons to make contributions to Keogh plans, because a self-employed person frequently does not know where he stands financially at the end of his taxable year.

Much the same circumstance applies to an employee contributing to an ERA. Whether the suggestion above regarding the use of TABLE (A) or TABLE (B) is adopted or whether the offset provision in proposed Section 220(b)(1) is adopted, an employee may not know where he or she stands at the end of his or her taxable year in respect to making a contribution to an IRA.

For the sake of simplification, it has been suggested above that the use of TABLE (A) or TABLE (B) be related to the use of the figure in Box 2 of Form W-2 (although this relationship is not essential to the use of TABLE (A), or TABLE (B) as proposed above). Form W-2 would not be received by an employee within his taxable year. Even if TABLE (A) or TABLE (B) is not adopted and, instead, the calulations described in proposed Sections 220(b)(1)(B) and 220(c)(3) are adopted, the figure for the "qualifying employer contributions" are not likely to be received by the employee within his or her taxable year.

Therefore, it is suggested that Section 404(a)(6) be amended to permit IRA contributions to be made at any time up to the tax filing date in the same fashion as contributions to a qualified plan.

Excess contributions and penalty tax

Confusion has developed recently with regard to the meaning of the Code Sections 408(d)(4), 4973(a) and 4973(b) as to what constitutes "excess contributions" and as to when and how the 6 percent excise tax penalty is to be imposed.

Publication 590 published by the IRS in April, 1975, contains this paragraph:

"This *excise tax is not applied if the excess contributions*, and any interest earned on it up to the date of distribution, *is distributed to you.* The interest element will be taxable income to you in the tax year in which you receive it. This distribution must take place no later than the time you are required to file your tax return for the year in question." [Emphasis added.]

TIR-1446 issued by the IRS on March 6, 1976, contains this statement:

"Under the Code, the 6 percent excise tax is imposed on an excess contribution for the year in which it is made, *even though the excess is withdrawn by the due date for the filing of the return.*" [Emphasis added.]

TIR-1446 went on to say that an error had occurred in Publication 590 and that it would be corrected in the next printing.

I suggest that the interpretation of the Code in TIR-1446 is unduly harsh and is not what Congress intended when it passed ERISA. Code Section 408(d)(4) provides for the timely refund of excess contributions prior to the tax filing data (or extension thereof). Code Section

4973(a) provides for the imposition of the 6 percent excise tax on excess contributions and 4973(b) defines "excess contributions". A reasonable interpretation of these three subsections of the Code would be that the excise tax would not be imposed on an excess contribution that has already been refunded.

To reinforce this interpretation, the last sentence of Code Section 4973(b) reads as follows:

"For purposes of this paragraph, any contribution which is disbuted out . . . (an IRA) . . . in a distribution to which Section 408 (d)(4) applies, shall be *treated as an amount not contributed.*" [Emphasis added.]

It appears that Congress intended this sentence to mean that an excess contribution refunded under Code Section 408(d)(4) is not to be considered as an excess contribution and, therefore, not subject to the penalty tax. If the refunded amount is an "amount not contributed", then it obviously cannot be called an excess contribution. In spite of this sentence, TIR–1446 considers the refunded amount to be an amount contributed rather than an amount not contributed.

It is suggested that the wordings of Code Sections 408(d)(4), 4973 (a) and 4973(b) should be reviewed to make sure that they carry out the intentions of Congress.

A "Carryback Provision" has been suggested above under which contributions would be permitted up to an individual's tax filing date. The refund provision in Code Section 408(d)(4) ties in nicely with a carryback provision. An individual would be able to make contributions and obtain refunds of excess contributions up to his tax filing date (or extension thereof). Tidying up Code Sections 4973(a) and 4973(b) so as to make it clear that an excise tax penalty is not levied on excess contributions that have been timely and properly refunded, would be a logical and desirable action.

I would like to suggest a further amendment to Code Section 408 (d)(4). As a matter of convenience, it is suggested that the individual be given the privilege of:

(a) Receiving excess contributions as a cash refund, or

(b) Transferring them as a payment on account of his contribution to his IRA for his next succeeding taxable year.

In the case of (b), the transfer should be made only on written instructions from the individual and deduction for the reapplied excess contributions would be available, providing that the 15%/$1,500 limit is not exceded for the next succeeding taxable year, taking into account additional cash contributions in that year. Under either (a) or (b) above, no excise tax penalty would be imposed on excess contributions timely refunded.

Spousal IRA

Bill S. 2732 was submitted to Congress by Senator William V. Roth, Jr. in December, 1975 and, at the same time, Senator Mike Mansfield stated that he would co-sponsor the Bill. I understand that since December, 1975, Senators Hubert H. Humphrey, Lee Metcalf, Joseph M. Montoya and Herman E. Talmadge have also endorsed the concept of Spousal IRA's. All of these Senators are to be commended for their actions.

Bill S. 2782 would permit an employee to establish an IRA in the name of his or her spouse but take deductions for contributions to it in the employee's tax return. This Spousal IRA would be owned by the spouse, who, in due course, would include distributions from it in the spouse's tax return.

As Senator Roth said in his statement to the Senate, a housewife usually has no earned income and no earnings coverage under Social Security. Therefore, she must depend entirely on her husband's retirement benefits. Senator Roth also pointed out that, besides providing greater retirement protection, his Bill would encourage increased savings for use in the economy of the country. This would make more funds available for mortgages, consumer and business loans and would stimulate construction and other economic activity.

It is suggested that provision for Spousal IRA's be incorporated in the Code by an addition to Bill H.R. 10612. However, it is suggested that the wording of Bill S. 2782 could be improved, as follows:

(1) The amendment that would be made in Section 219(a) would be to add the words "or for the benefit of his spouse". It is suggested that more than this amendment is needed to make it clear that the spouse would be the individual who would own the Spousal IRA. Probably a new section should be added to Section 408 and 409 to define a Spousal IRA and to describe the requirements and conditions pertaining to it.

(2) If the Code is amended to provide for LERA's along the lines contained in Bill H.R. 10612 (with the restriction in respect to plans established after September 2, 1974 deleted) and if IRA's are extended to active participants, there would seem to be no reason why such LERA's or IRA's could not be Spousal IRA's or LERA's. If such is so, then there will likely need to be revisions of proposed Sections 220 and 408A.

(3) If both spouses have earned income and both wish to make contributions to one IRA, it would seem the IRA could be a Spousal IRA in the name of one or the other of the two spouses. This aspect may need some study.

(4) The value that has accumulated in an IRA to which a taxpayer has made contributions probably should not be transferable into a Spousal IRA.

(5) Also, a participant receiving a lump-sum distribution from a qualified plan probably should not be able to transfer it into a Spousal IRA.

(6) When an employee reaches the taxable year in which he is 70½, he cannot make any further contributions to his own IRA or LERA. However, there would seem to be no reason why he could not make contributions in and after that taxable year to a Spousal IRA, at least until the taxable year prior to the year in which the spouse attains age 70½.

PROPOSED WORDING FOR CODE SECTION 402(a)(6)

(6) Rollover amounts.—In the case of an employee's trust described in section 401(a) which is exempt from tax under section 501(a), if—

(A) The balance to the credit of an employee is paid to his beneficiary in the event of his death while a participant in such trust in one or more distributions which constitute a lump-sum distribution within the meaning of subsection (e)(4)(A) (determined without reference to (e)(4)(B)),

(B) The beneficiary transfers all the property he receives in such distribution to an individual retirement account described in section 408(a), an individual retirement annuity described in section 408(b) (other than an endowment contract), or a retirement bond described in section 409, on or before the 60th day after the day on which he received such property, to the extent the fair market value of such property exceeds the amount referred to in subsection (e)(4)(D)(i), and

(C) The amount so transferred consists of the property (other than money) distributed, to the extent that the fair market value of such property does not exceed the amount required to be transferred pursuant to subparagraph (B), then such distributions are not includible in the gross income of the beneficiary for the year in which paid. For purposes of this title, a transfer described in subparagraph (B) shall be treated as a rollover contribution as described in section 408(d)(3).

NOTES

I. The wording for Code Section 403(a)(5) would be similar.

II. If 402(a)(5) is amended as suggested in respect to allowing "property" to be converted to "money", then 403(a)(4) should be correspondingly amended.

PROPOSED WORDING FOR CODE SECTION 220(b)(1)

(b) Limitations and restrictions.—

(1) Maximum deduction.—The amount allowable as a deduction under subsection (a) to an individual for any taxable year shall not exceed an amount equal to the percentage shown in Column (2) in the table below corresponding to the employee's compensation shown in Column (1).

(1) Compensation of employee	(2) Contribution limit as a percentage of compensation
Up to $5,000	15
$5,001 to $6,000	14
$6,001 to $7,000	13
$7,001 to $8,000	12
$8,001 to $9,000	11
$9,001 to $10,000	10
$10,001 to $11,000	9
$11,001 to $12,000	8
$12,001 to $13,000	7
$13,001 to $14,000	6
$14,001 to $16,000	5
$16,001 to $18,000	4
$18,001 to $20,000	3
$20,001 to $22,000	2
$22,001 to $24,000	1
$24,001 and up	0

PROPOSED WORDING FOR CODE SECTION 220(C)(1)

(c) Definitions and special rules.

(1) Compensation.—For purposes of this section, the term "compensation".

(i) In the case of an employee other than an employee within the meaning of section 401(c)(1) means compensation as defined in section 415(c)(3);

(ii) In the case of an employee within the meaning of section 401(c)(1) means earned income as defined in section 401(c)(2).

TABLE (A)—MAXIMUM CONTRIBUTION LIMIT

Employee compensation bracket (box 2 of form W-2)	Contribution limit as a percentage of compensation	Contribution limit as a number of dollars	Offset to take the place of the employer's contribution	
			If percentage basis is used	If dollar basis is used
(1)	(2)	(3)	(A)	(B)
Up to $5,000	15	$750	0	0
$5,001 to $6,000	14	840	1	60
$6,001 to $7,000	13	910	2	140
$7,001 to $8,000	12	960	3	240
$8,001 to $9,000	11	1,020	4	330
$9,001 to $10,000	10	1,080	5	420
$10,001 to $11,000	9	1,020	6	480
$11,001 to $12,000	8	960	7	540
$12,001 to $13,000	7	900	8	600
$13,001 to $14,000	6	840	9	660
$14,001 to $16,000	5	780	10	720
$16,001 to $18,000	4	720	11	780
$18,001 to $20,000	3	600	12	900
$20,001 to $22000	2	440	13	1,060
$22,001 to $24,000	1	240	14	1,260
$24,001 and up	0	0	15	1,500

Notes: This table (A) assumes that the normal contribution limit is 15 percent per $1,500. It is suggested that either col. (2) or col. (3) be included in 220(b)(1) but not both. Cols. (A) and (B) would not be included in the code. They are included here mainly to demonstrate the effects of col. (2) or col. (3). Basically col. (3) is merely the application of the percentage in col. (2) to the top figure in the compensation bracket in col. (1). However, some smoothing has been made for the amounts derived from the percentages from 11 percent down to 5 percent.

TABLE (B)—MAXIMUM CONTRIBUTION LIMIT

Employee compensation bracket (box 2 of form W-2)	Contribution limit as a percentage of compensation	Contribution limit as a number of dollars	Offset to take the place of the employer's contribution	
			If percentage basis is used	If dollar basis is used
(1)	(2)	(3)	(A)	(B)
Up to $5,000	15	$750	0	0
$5,001 to $7,000	14	980	1	70
$7,001 to $9,000	13	1,170	2	180
$9,001 to $11,000	12	1,320	3	330
$11,001 to $13,000	11	1,430	4	520
$13,001 to $15,000	10	1,500	5	500
$15,001 to $17,000	9	1,530	6	470
$17,001 to $19,000	8	1,520	7	480
$19,001 to $21,000	7	1,470	8	530
$21,001 to $23000	6	1,380	9	620
$23,001 to $25000	5	1,250	10	750
$25,001 to $27,000	4	1,080	11	920
$27,001 to $29,000	3	870	12	1,130
$29,001 to $31,000	2	620	13	1,380
$31,001 to $33,000	1	330	14	1,670
$33,000 and up	0	0	15	2,000

Note: This table (B) assumes that the normal contribution limit is 15 percent per $2,000. It is suggested that either col. (2) or col. (3) be included in 220(b)(1) but not both. Cols. (A) and (B) would not be included in the code. They are included here merely to demonstrate the effects of col. (2) or col. (3). Basically col. (3) is merely the application of the percentage in col. (2) to the top figure in the compensation bracket in col. (1).

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N.Y., April 9, 1976.

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

DEAR CHAIRMAN LONG: The National Association of Mutual Savings Banks appreciates the opportunity of commenting on certain proposals contained in the Tax Reform bill passed by the House (H.R. 10612) and presently under consideration by the Senate Finance Committee. I will confine my comments to those proposals affecting Individual Retirement Accounts (IRAs) and the deduction for interest paid on an indebtedness.

The savings bank industry has long been in favor of proposals which would permit individuals not otherwise covered by a qualified retirement plan to establish a tax deductible retirement program on their own behalf. Accordingly, our industry supported those provisions of the Employee Retirement Income Security Act of 1974 (ERISA) permitting the establishment of Individual Retirement Accounts. At the outset it should be noted that the long-term nature of IRA accounts makes them ideally suited for mortgage lending, and therefore should be encouraged at mortgage-oriented thrift institutions. Because of their long-term nature, moreover, they can be an important means of achieving a more even balance between the long-term assets and short-term liabilities of savings banks—a prime objective, over the years, of efforts to strengthen thrift institutions. Thus, IRAs can contribute to an expanded supply of housing credit. Accordingly, our industry strongly supports all meaningful and equitable proposals which would expand the availability of this type of retirement program.

More specifically, our industry supported those provisions relating to individual retirement accounts which provided for tax-free rollovers of amounts distributed to an employee from a qualified plan to an IRA. The stated Congressional purpose—to facilitate portability of pensions—has been well served by individual retirement accounts through these rollover provisions. However, because of a technical oversight in the drafting of the provisions of ERISA, an inequity became apparent to which H.R. 10612 has addressed itself. Under present law where an employer terminates a plan and distributes its assets, an employee who continues to work for the same employer will have an immediate tax on the distribution and is not entitled to rollover the funds tax free to an IRA.

This result obtains because of the technical definition of a lump-sum distribution, under which a distribution to an employee who does not sever his employment is not considered a lump-sum distribution. The proposal before your Committee recognizes that an employee who wishes to reinvest such a distribution in a tax qualified retirement plan or an IRA should be permitted to do so, on the same basis as an employee whose distribution qualifies as a lump-sum distribution.

As the Committee on Ways and Means pointed out in its Report concerning this proposal, this change would have been included in the Employee Retirement Income Security Act of 1974 had it been presented then. Accordingly, the savings bank industry strongly supports the inclusion of this provision to correct this technical over-

sight. This is particularly important in view of reports we have read to the effect that many employers have been terminating existing qualified plans and have instituted Individual Retirement Account programs for their employees because of the administrative convenience afforded by these IRAs.

The savings bank industry also supports that proposal which would permit employees who are participants in qualified retirement plans to make deductible contributions to an IRA or a "Limited Employee Retirement Account" (LERA). This provision, permitting employees under certain circumstance to contribute and deduct amounts paid into an IRA or a Limited Employee Retirement Account, corrects another apparent oversight under ERISA. After the passage of ERISA it became apparent that certain employee, who were active participants in qualifying plans, could not make deductible contributions to an IRA even though the benefits provided by such a plan were less than the employee could have provided for himself under an IRA. Under the language of the ERISA provisions, coverage under a qualified plan, regardless of its extent, precluded the establishment of an IRA. The savings bank industry strongly supports that provision of H.R. 10612 which permits, in general, contributions and deductions to an employee covered by a qualified plan to the extent that his employer's contributions to the qualified plan are less than 15 percent of his compensation or $1500, whichever is less. This proposal would have the obvious effect of placing an employee covered by a qualified plan in at least as favorable a position as an employee who is not covered by a qualified plan.

On the proposal to limit the deduction for nonbusiness interest paid or accrued by an individual on an indebtedness, the savings bank industry is deeply concerned about any limitation on this long-standing deduction, particularly as it relates to mortgage interest paid with respect to a personal residence. While we recognize that the $12,000 proposed limitation on interest deductible under this provision would not affect the deduction available to the great majority of residential mortgagors, we oppose on principle any limitation in this area. The Ways and Means Committee, in its Report discussing the proposal, stated that ". . . certain economic goals, such as home ownership, should be within the reach of as many people as possible and thus the deduction for personal interest should be continued."

We fear that any limitation on the deduction for interest paid on a residential mortgage could—because of inflationary pressures and revenue needs—result in a substantially reduced deduction in the future if the concept of a limitation is embodied in the Internal Revenue Code. Such a limitation could, therefore, be in conflict with the broadly supported goal of home ownership since deductibility of mortgage interest has enabled many lower and middle income taxpayers to own a home. Any erosion of this deduction, therefore, would have an adverse impact on the housing market.

We hope these comments will be helpful to the Senate Finance Committee.

Sincerely.

KENNETH L. BIRCHBY,
Chairman, Committee on Taxation.

Statement of Rachel Lisses, Cerritos, Calif.

PROPOSAL TO AMEND INTERNAL REVENUE CODE OF 1954, SECTION 408

Some time ago Congress held hearings regarding Social Security credit for homemakers. This would be a considerable burden for the Social Security Administration, therefore I would like to propose an alternate retirement plan for homemakers.

Congress has seen fit to implement several retirement programs (i.e. corporate pension plans, self-employed individuals Keogh plan and the IRA plan). However, the individual who has decided to remain in the home and care for the children has been excluded from the above mentioned retirement plans.

A mother at home is an important asset to the family unit, as well as to society. Children need to know that someone will be there to love and care for them—to listen to their problems, give advice and lend a helping hand. The woman that remains at home does much more to improve society than just rearing a family, she contributes her time and energy to various community activities. The many varied scouting and youth groups, PTA and school volunteer programs, etc. would come to a sudden stop without the devoted effort of the American homemaker.

Today in our country there are many elderly women who have worked very hard most of their lives; they are living a very poor existence because they did not or could not plan for their retirement years. The young homemaker of today must begin now to plan for the future. The retirement plan I propose would help women attain a better quality of life in their retirement years. It would also foster individual incentive. This could all be done with no financial burden to the government. Conceivably, it might even lessen the government's financial burden, since these women would not be dependent on welfare payments.

I feel that a homemaker's role should be considered of value, it need not be given a set monetary value except as a starting point for the proposed retirement plan. The Chase Manhattan Bank of New York has determined that it would cost approximately $8,500 a year to hire an individual to care for a family's children and home; with today's inflation this figure is probably far too low, but I feel it is a good starting point.

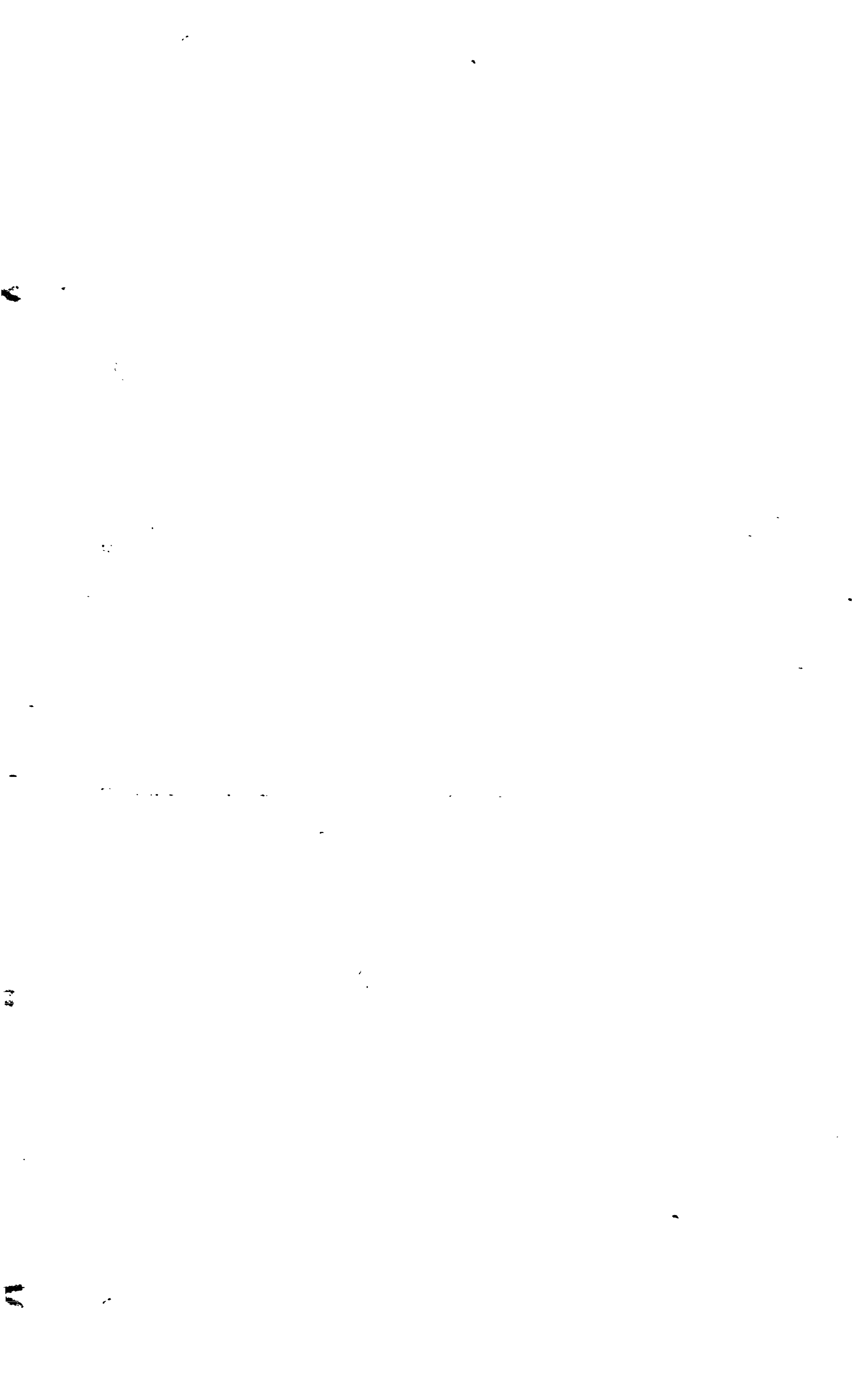
Based upon the reasons mentioned above, I therefore propose that serious consideration be given to the establishment of an IRA plan for homemakers. The plan would take the following form:

1. Any individual who chooses to remain in the home to care for their family should be eligible, provided they do not qualify for the previously mentioned pension plans.
2. Each year these individuals could set aside up to 15 percent of $8,500. For the purpose of establishing an IRA account the $8,500 will be treated as "earned" income—not as taxable income. The amount set aside would be tax deductible and could be saved from the family's income (i.e. husband's wages).
3. The other provisions for this plan can be drawn directly from the IRA plan. (Code Section 408 of the Internal Revenue Code of 1954).

I know that the issue can be raised that larger families and larger homes mean more work for the homemaker. Some may say that it is unfair for a mother of two to get as much benefit as a mother of eight. I agree that a mother of eight must do a great deal more work, however this argument should not make it necessary for another generation of women to live poorly in their old age.

I respectfully submit this proposal for your consideration and support.

Tax Shelters



JOINT STATEMENT OF U.S. SENATORS HIRAM L. FONG AND DANIEL K. INOUYE (BOTH HAWAII) PROPOSING AMENDMENTS TO "SECTION 204. METHOD OF ACCOUNTING FOR CORPORATIONS ENGAGED IN FARMING" OF H.R. 10612, TAX REFORM ACT

Mr. Chairman and members of the committee, we are submitting this joint statement to urge the committee to approve clarifying amendments to H.R. 10612, specifically to section 204 which as passed by the House of Representatives would add new section 447 to Internal Revenue Code, method of accounting for corporation engaged in farming.

As you know, the new code section 447 would require publicly held corporations engaged in farming to use the accrual method of accounting with the capitalization of certain preproductive period expenses. Preproduction expenses are defined in section 101 of the bill which would add new section 468 to the code.

The amendments we propose make clear that corporations (1) which have been using the "annual accrual method" of accounting for farm income for at least 10 years prior to the effective date of the bill and (2) which raise crops maturing not less than 12 months after planting will not be forced to change to the new accrual method of accounting required by section 204 of the House-passed bill. Text of the amendments is attached.

ADVERSE IMPACT OF FARM ACCOUNTING PROVISIONS ON HAWAII'S LEADING AGRICULTURAL INDUSTRIES

We are compelled to offer these amendments because, unless section 204 of the bill is clarified, proposed code section 447 together with proposed code section 468 would impose unnecessary and unreasonably harsh accounting costs and Federal income tax burdens on the first and second leading agricultural industries in Hawaii, cane sugar and pineapple. These two crops rank as Hawaii's third and fourth top income producers, surpassed only by Federal expenditures and tourism.

The resulting impact would strike at the very survival of Hawaii's sugarcane and pineapple industries, which currently provide jobs for about 20,000 regular and seasonal workers with a total payroll of about $150 million.

Sugar and pineapple combined to bring about $500 million in revenue into the economy of the State of Hawaii in 1975 and paid more than $130 million in Federal, State, and local taxes. One pineapple company alone paid $4.4 million in 1975 Federal income taxes on net income from pineapple operations.

Figures are not available for the other two pineapple companies, but by extrapolation based on tons of pineapple produced in Hawaii it is possible to guesstimate nearly $20 million in Federal income taxes were paid by the three pineapple companies in the State. Federal income

69-516—76—pt. 7——18

taxes withheld from the wages of pineapple employees totaled $8,335,-000, with another $2,049,000 withheld for State income taxes.

Hawaii's 15 sugar companies paid about $78.4 million in Federal taxes in 1975 and about $15 million in State and local taxes. Federal income taxes withheld from sugar employees in that year totaled $17,-400,000 and State withholding totaled $5,700,000. Nonlabor expenditures in Hawaii by sugar companies amounted to $111 million, providing business and jobs directly and indirectly for many, many people.

As will be shown later in this statement, both the sugarcane industry and the pineapple industry in Hawaii—despite modernization, mechanization, improved yields per acre, and various self-imposed economies—generally operate at a minimal, often marginal, level. Were it not for a few healthy years, such as the short-lived 1974 boom in sugar prices and the favorable 1974–75 price levels for pineapple, it is doubtful the existing sugar and pineapple companies in Hawaii would be able to stay in business.

With U.S. sugar producers now competing directly with less-efficient but lower labor cost sugar producers elsewhere in the world, with world sugar prices having dropped sharply from the unprecedented heights of 1974, and with fuel, fertilizer, labor, and other costs rising for Hawaii sugar producers, there is the stark possibility that some Hawaiian sugar operations may suffer losses in 1976. With the outlook for sugar prices on the world market remaining unpromising, such marginal plantations could face an extended period of unprofitable operations and would be forced out of business.

We are not crying wolf. Three plantations have ceased operations during the last 5 years.

On top of all this, it is estimated the impact of section 204 of H.R. 10612, if not amended as we propose, would require an initial permanent deferral of about $37,550,000 of growing crop costs, resulting in an increase of about $18 million in aggregate Federal tax liabilities. Add to this the costs of detailed field-by-field accounting required by section 204, and it is easy to foresee that some sugar companies in Hawaii would soon be forced to the wall.

One pineapple company in Hawaii would not face added taxes by section 204, we are advised, but the remaining two would indeed be affected, to the tune of about $7 million combined in additional Federal income taxes. Further, one of the two companies estimates that the tax cost of changing the accounting method would be at least $2 million—more than all of that company's pineapple profits over a recent 10-year period.

Competition for Hawaiian pineapple is stiff, both from low-cost pineapple produced in foreign countries and from other fruits produced in mainland United States. Of nine pineapple companies in Hawaii in 1960, only three remain. In 1960, there were 24,517 persons employed by pineapple companies, compared with only 11,747 in 1975. So again, we are not crying wolf.

Although both sugar and pineapple have done relatively well in their earnings in the past 2 years, both industries are cyclical and both are on a downward curve. Sugar has already suffered severe price declines, and some of the companies are approaching a marginal earnings status. Pineapple, also, appears to have peaked, and its earnings are on the downgrade.

FARM ACCOUNTING PROVISIONS ENDANGER HAWAII'S ECONOMY

Sugar and pineapple are Hawaii's chief exports. This has particular significance in that such exports help to keep the lid on shipping costs for Hawaii. Sugar and pineapple provide backhaul freight for the vessels which bring to Hawaii from mainland United States most of the food, construction supplies, and other essentials needed by 850,000 people of our State. Without such backhaul freight, shipping companies would have to increase their freight rates for goods imported into Hawaii. This in turn would increase the cost of living for the people of Hawaii, who already suffer from living costs about 15 percent higher than those experienced by residents of the Washington, D.C., area. The Honolulu metropolitan area, which includes the city and county of Honolulu, where more than 80 percent of the entire State population live, is the second highest cost area in the Nation, according to a just-released Bureau of Labor Statistics survey of 40 major urban centers.

When sugar and pineapple companies fail in Hawaii, there is no ready and viable alternative industry to replace them. The State of Hawaii has spent millions of dollars over the past several years trying to establish industrial enterprises that could provide jobs for workers made jobless by closing of sugar and pineapple companies and that could provide a new tax base for the State's economy, but with notable lack of success. Should Hawaii lose the sugar and pineapple industries entirely, the impact on Hawaii's fragile economy, now suffering 9.3 percent unemployment, will be disastrous. In Maui County, despite extensive sugar and pineapple operations, the unemployment rate is 13 percent.

HOUSE WAYS AND MEANS COMMITTEE RECOGNIZED ADVERSE IMPACT ON HAWAIIAN SUGAR AND PINEAPPLE

When the potential impact of section 204 on Hawaii's sugar and pineaple industries became known, an effort was made to ameliorate the situation, but it was too late to change the language in the bill itself.

However, in the House Ways and Means Committe report, in explaining the proposed new code sections 447 and 468, the committee stated:

> If a corporaiton has computed its taxable income on an annual accrual method of accounting for a ten-year period to December 31, 1975, and if such corporation raises crops which mature at least in the second year after planting, then for purposes of this section, such corporation will be deemed to be computing its taxable income on an accrual method of accounting and with the capitalization of proproductive period expenses (as enumerated in new sec. 468(c)(1)). (House Report 94-658, 94th Cong., 1st Sess., 1975, page 95.)

As you know, the proposed new code section 447, to be added by section 204 of H.R. 10612, is aimed at corporations presently reporting farm income using the cash method of accounting. The cash method is not used by any of the three Hawaii pineapple companies or by any of the Hawaii sugar companies (except one small family-owned company).

The House Ways and Means Committee, in its report on H.R. 10612, said the cash method frequently does not match income with related

expenses. Further, the committee said, it is inappropriate for large corporations with ready access to the skilled accounting assistance often required to identify specific farm costs to continue to use the cash method of accounting.

Although Hawaii's sugar and pineapple companies have not used the cash method of accounting permitted under Federal law and thus have not used their operations as tax shelters, these companies would be forced to change to the accounting method called for by section 204 of H.R. 10612, at considerable expense.

Successful commercial growing of sugarcane in Hawaii dates back to the 1830's. Pineapple's modern industry in our islands began in 1901. So these are not fly-by-night operations set up to take advantage of any Federal tax shelter. They are well-established industries, and they are pillars of Hawaii's economy.

ACCOUNTING METHOD LONG USED BY HAWAII SUGAR AND PINEAPPLE COMPANIES FULFILLS INTENT OF HOUSE COMMITTEE AND IS APPROVED BY I.R.S.

Hawaii's sugar producers have been on the annual accrual method for the past 25 years or longer, one of the three Hawaii pineapple companies has used the annual accrual method for more than 20 years, and a second pineapple company uses the static value method, which, we are advised, produces similar results.

The annual accrual method is used not only to compute farm net income for Federal tax purposes but is also used for reporting earnings to shareholders and the public. It was adopted with I.R.S. approval and is regarded by the accounting profession as a sound method to reflect an accurate picture of farm operations for cane sugar and pineapple. The Securities and Exchange Commission has accepted the annual accrual method for Hawaii's sugar plantations as conforming with generally accepted accounting principles.

The annual accrual method currently used in Hawaii provides a far more accurate matchup of farm income and expenses than the crop method to which the sugar and pineapple companies would be forced to convert under section 204 of H.R. 10612. In fact, the companies had been using the crop method prior to adopting the annual accrual method.

But as both sugar and pineapple crops require more than 12-months to mature, the crop method proved unsatisfactory.

Allowing the Hawaii sugar and pineapple companies to continue to use the annual accrual method would carry out the intent of the House Ways and Means Committee, which in discussing section 204 plainly indicated it wants income to match related farm expenses. Such continuance would also conform to the IRS practice of accepting the annual accrual system for Hawaii sugar and pineapple as a valid system for Federal income tax purposes. Such continuance would also carry out the intent of the House Ways and Means Committee report language deeming in compliance with proposed Code sections 447 and 468 those corporations that used an "annual accrual method of accounting" for a 10-year period to December 31, 1975, and whose crops mature "at least in the second year after planting." Further, it

will not interfere with the stated objectives of section 447 in the treatment of farm corporations now on the cash method.

At the same time, our proposed amendments would make it impossible for a tax shelter promoter to use a Hawaiian sugar plantation to generate artificial tax losses. A new syndicate or partnership could not meet the amendment's stipulation that it must have used the annual accrual method for 10 years prior to the effective date of the bill. Thus, such a new syndicate or partnership would be required to capitalize all preproductive period expenses of growing crops.

NATURE OF SUGARCANE AND PINEAPPLE CROPS GOVERN ACCOUNTING METHODS

Both Hawaii's sugarcane and pineapple crops are long-term crops. No beet sugar is grown in Hawaii. A field planted in sugarcane generally yields three crops over a 6-year period. The first crop is harvested approximately 2 years after planting, with the next succeeding crop—which grows from the stools of the sugar plants remaining after harvest—requiring 2 years to reach maturity, and the third crop also requiring 2 years.

The normal cycle for pineapple is 4 years. A first crop is harvested 18 to 20 months after planting, with a second crop harvested 12 to 14 months later and occasionally a third crop taken off another 12 to 14 months after that.

Years ago, it was found for these long-term crops that the crop method of accounting, such as proposed in section 204 of H.R. 10612, is unsatisfactory. On the other hand, under the annual accrual method, costs of growing crops are charged to current production, although materials and supplies are not deductible for tax purposes until actually used by the growers.

Thus, the annual accrual method is a significant aid to management in keeping expenses within income, particularly during periods of rising prices. It facilitates budgeting and financing operations, which necessarily are concerned with the flow of cash receipts from product sales and disbursements for crop expenses and capital expenditures, rather than with the allocation of these items to crops which were planted several years ago or which will be harvested several years hence.

The annual accrual method matches costs against revenues at comparable price levels, and therefore it produces a more realistic determination of net income.

In the case of pineapple, some costs, such as those allocable to canned product not sold at yearend would be capitalized as part of the inventory. But treating growing pineapple as inventory, or its equivalent in the form of deferred cost, is like considering eggs as inventory before the chickens have laid them.

It is not today's prices but world prices a year or two ahead that will determine whether costs incurred currently on growing crops will ever be fully recovered.

The annual accrual method is simple to operate, easy to understand, and economical. It results in income statements that are understandable by employees, stockholders, bankers, and the public. It facilitates labor-management negotiations.

AMENDMENT INCLUDES PROVISION RE STATIC VALUE METHOD

The new subsection (b) we propose to section 204 of H.R. 10612 addresses a problem confronting one of Hawaii's three pineapple companies, the Dole Division of Castle & Cooke.

In the early 1950's, when Dole sought to change to the annual accrual method, the Internal Revenue Service denied the request because in 1938, Dole had entered into an agreement with the IRS to remain on a static value method in future years.

That agreement will be automatically superseded if new section 447 becomes law, and Dole will be required to convert to the crop method stipulated in section 447. Such method, as we have already explained, is inappropriate and unsatisfactory for Hawaii's long-term sugarcane and pineapple crops.

Furthermore, we are advised that the results of the static value method do not differ significantly from the annual accrual method. Dole's actual results in 1975 under the static value method differed by one-half of 1 percent from the results which would have been obtained under the annual accrual method.

Our proposed amendment—subsection (b)—would allow a company that has been using a static value method to elect to change to the annual accrual method within 1 year after the effective date of proposed new Code section 447.

We are advised that, as of December 31, 1975, Dole had a deferred crop account of $1,028,888, which it would be permitted to write off over 10 years if allowed to change to the annual accrual method under our amendments to section 204 of the bill. At a 48-percent Federal corporate income tax rate, this would produce a total benefit to Dole of less than half a million dollars over 10 years; to be exact, $493,866.24, or $49,386.62 for each of the 10 years.

On the other hand, if Dole is required to convert to the crop method of accounting for pineapple, as it would if our amendments are not approved, the cost to Dole in terms of tax burden would be a total of $5 million over 10 years.

This substantial tax cost, plus the heavy costs of converting to the crop method of accounting, would have a substantial impact on Dole's ability to obtain adequate economic returns from pineapple. If the marginal and deficit operations experienced by Hawaii's pineapple companies in the 1960's and early 1970's are repeated, this additional burden could lead to further reductions in Dole's Hawaiian pineapple operations and increase unemployment. This would entail a loss in Federal revenue far larger than the anticipated gain under section 204 as it stands.

REASONS WHY SECTION 204 METHOD OF ACCOUNTING SHOULD NOT APPLY TO HAWAII'S SUGAR AND PINEAPPLE PRODUCERS

1. The crop method of accounting required by section 204 is inappropriate because it would not properly match costs and revenues, particularly as both sugarcane and pineapple in Hawaii require more than 1 year to mature.

2. The crop method would produce possibly misleading balance sheet figures. There would be uncertainty that the "preproductive period" expenses would ever be fully recovered.

3. The crop method would unnecessarily impose substantial additional accounting costs, which could be devastating to both sugar and pineapple industries in Hawaii—both of which are normally only marginally profitable, both of which are subject to wide cyclical variations in their profitability, and both of which are currently on the downgrade of their cycle. For one pineapple company, the estimated $2 million-plus tax cost of changing its accounting method is more than all the company's profits from pineapple in a recent 10-year period.

4. Section 204 would result in accelerated tax burdens on the sugar and pineapple companies totaling a minimum of $25 million. Even though H.R. 10612 allows 10 years for payment of these taxes, these are an added cost of doing business in a period when costs are already high and inflation is expected to continue and when Hawaii's sugarcane industry faces fierce competition from both foreign cane, domestic beet, and corn sweetener producers and when Hawaii's pineapple faces fierce competition from both foreign pineapple and domestic fruits of other kinds.

For pineapple companies, facing a downturn in business, the $7 million minimum tax burden would mean the difference between profit and loss. Likewise, marginal sugar companies could find their accelerated tax burden under section 204 the straw that broke the camel's back.

5. Hawaii's economy—where unemployment statewide is running 9.3 percent and in some areas 13 percent—can ill afford the loss entailed if additional sugar and pineapple companies should fail. Three sugar companies failed in the last 5 years, and six of nine pineapple companies failed in the last 15 years. Replacement industry to provide jobs for the sugar and pineapple workers displaced so far by recent closings has been almost nonexistent. Where would the approximately 20,000 sugar and pineapple workers find jobs if Hawaii's third and fourth ranking industries, sugar and pineapple, fail?

6. Last, but certainly not least, the potential damage to Hawaii's sugar and pineapple industries would cost the Federal Treasury far more than continuance of these corporations as economically viable, tax-paying enterprises. It is estimated that, without adoption of our amendments to section 204, Federal taxes on sugar and pineapple operations in Hawaii would increase over the next 10 years by a minimum of $25 million.

Based on the Federal taxes paid by Hawaii's pineapple companies in 1975—an unusually healthy year—and employee income taxes withheld, the loss to the Federal Treasury over 10 years should the three pineapple companies fail would total $300 million.

If Hawaii's sugar companies fail, based on their Federal taxes paid and employee taxes withheld in 1975—a high earnings year—the loss to the Federal Treasury could total $957.9 million over the next 10 years. It is unlikely that all sugar companies would fail at the same time, so this estimate is not a realistic one; however, should any of the companies fail, the cost to the Treasury of the loss in taxes could easily surpass the anticipated revenue gain under section 204.

While no one can foretell precisely the economic impact of section 204 as it stands, it seems clear to us that, without our amendments, the impact on Hawaii's sugar and pineapple industries will be so adverse

that the losses to the Federal Treasury by forced reductions in pineapple and sugar operations will far exceed the relatively small gain anticipated for the Treasury under section 204.

URGE APPROVAL OF OUR PROPOSED AMENDMENT TO SECTION 204

We believe that our amendment for the annual accrual method will continue to provide the Federal Government with tax revenues computed on an equitable and realistic basis on sugar and pineapple operations in Hawaii.

We believe the Federal Treasury will be better off if our amendment is adopted than if the House-passed version is allowed to stand.

We believe our amendment fulfills the intent of the House Ways and Means Committee, stated in its report on H.R. 10612, that farm corporations which have used the annual accrual method for 10 years prior to December 31, 1975, and which raise crops maturing "at least in the second year after planting" will be deemed to be in compliance with the requirement of section 204 for an accrual method of accounting and capitalization of preproductive period expenses enumerated in the bill's proposed new code section 468(c)(1).

We urge the members of the Finance Committee to approve our amendment to H.R. 10612.

[H.R. 10612, 94th Cong., 2d sess.]

AMENDMENTS Intended to be proposed by Mr. Fong (for himself and Mr. Inouye) to H.R. 10612, an Act to reform the tax laws of the United States

On page 54, line 23, insert immediately after the period the following: "If a corporation described in paragraph (1) has computed its taxable income on an annual accrual method of accounting for the ten taxable year period prior to the first taxable year beginning after December 31, 1975, and if such corporation raises crops which mature not less than twelve months after planting, then for purposes of this section, such corporation shall be deemed to be computing its taxable income on an accrual method of accounting and with the capitalization of preproductive period expenses described in section 468(c)(1) for any taxable year after December 31, 1975, for which such corporation continues to employ such annual accrual method of accounting."

On page 58, line 9, strike out the end quotation marks.

On page 58, between lines 9 and 10, insert the following:

"(f) Annual Accrual Method of Accounting Defined.—For purposes of subsection (a), taxable income is computed on an annual accrual method of accounting if revenues, costs, and expenses are computed on an accrual method of accounting and the preproductive expenses (described in section 468(c)(1)) incurred during the taxable year are charged to harvested crops or deducted in determining the taxable income for such year.".

On page 58, strike out line 12, and insert in lieu thereof the following:

(b) Election to Change from Static Value Method to Annual Accrual Method of Accounting.—

(1) If a corporation described in section 447(a)(1) (as added by subsection (a)(1)) has computed its taxable income on an accrual

method of accounting together with a static value method of accounting for preproductive period expenses for the ten taxable year period prior to the first taxable year beginning after December 31, 1975, and if such corporation raises crops which mature not less than twelve months after planting, such corporation may elect, within one year after the date of enactment of this Act and in such manner as the Secretary or his delegate prescribes, to change to the annual accrual method of accounting for taxable years beginning after December 31, 1975. Such change shall be treated as having been made with the consent of the Secretary of the Treasury, and under regulations prescribed by the Secretary or his delegate, the net amount of the adjustments required by section 481(a) to be taken into account by the taxpayer in computing taxable income shall (except as otherwise provided in such regulations) be taken into account in each of the ten taxable years beginning with the year of change.

(2) A corporation which elects to change to the annual accrual method of accounting under this subsection shall, for purposes of section 447 (as added by subsection (a)(1)), be deemed to be a corporation which has computed its taxable income on an annual accrual method of accounting for the 10 taxable year period prior to the first taxable year beginning after December 31, 1975.

(c) Effective Date.—

Statement of the Pineapple Growers Association of Hawaii, Proposing Clarifying Amendments to New Section 447 of the Internal Revenue Code

SUMMARY

Section 204 of H.R. 10612, as passed by the House, would add a new section 447 to the Internal Revenue Code requiring all publicly held corporations engaged in farming to change to the accrual method of accounting with the capitalization of preproductive period expenses.

Most of the publicly held pineapple and sugar growers of Hawaii compute their net income on the annual accrual method of accounting both for tax purposes and in reporting income to shareholders and the public. This method, an accrual method in which preproductive expenses are charged to harvested crops or expensed, conforms with generally accepted principles of accounting and has been consistently applied in Hawaii with the consent of the Internal Revenue Service for over 20 years.

In view of the marginal and cyclical nature of pineapple and sugar operations in Hawaii, the additional tax and accounting costs of changing to a new method of accounting would have a serious impact on those industries and on the Hawaiian economy which they help support.

The Ways and Means Committee agreed that Hawaii's pineapple and sugar growers, having used the accepted annual accrual method for many years, need not and should not be required to change accounting methods under section 447. The facts regarding the annual accrual method were not brought to the Ways and Means Committee's attention in time to amend section 447 in the House bill, but the committee's intent to allow the annual accrual method was made clear in its report. See H.R. Rept. No. 94-658, 94th Cong., 1st sess. (1975) at page 95.

If this committee decides to approve the concept of section 447, the Pineapple Growers Association of Hawaii respectfully requests that the committee amend section 447 to permit continued use of the annual accrual method as intended by the Ways and Means Committee. Clarifying amendments to this effect are contained in the appendix to this statement.

I. INTRODUCTION

The Pineapple Growers Association of Hawaii [1] is filing this statement in support of clarifying amendments to proposed new section 447 of the Internal Revenue Code, which would be added by section 204 of H.R. 10612. The purpose of these amendments is to make clear that corporations which have been using the annual accrual method of accounting for farm income for at least 10 years, and which raise crops which mature not less than 12 months after planting, may remain on that method. The text of the proposed amendments and an explanation of the language used are attached as an appendix to this statement.

Section 447 generally requires corporations (other than "family" corporations) engaged in farming to use the accrual method of accounting with the capitalization of certain preproductive period expenses.[2] The provision is aimed at corporations presently reporting farm income using the cash method of accounting. The Ways and Means Committee's report states that the cash method "frequently does not match income with related expenses" and that farmers were allowed to use it solely because of its "simplicity." The committee thought it inappropriate for large corporations "which have ready access to the skilled accounting assistance often required to identify specific farm costs" to continue to use the cash method of accounting. See H.R. Rept. No. 94–658, 94th Cong., 1st sess. (1975), pp. 93–94.

Most of the major plantation owners in Hawaii are already using an accrual method of accounting, the annual accrual method.[3] For important reasons discussed hereafter, however, the costs of growing crops (including "preproductive period expenses") are charged to harvested crops or expensed under this method in accordance with generally accepted accounting principles. The Internal Revenue Service consented to the use of the annual accrual method in Hawaii when

---

[1] The Pineapple Growers Association of Hawaii consists of the three publicly held companies which grow and can pineapple in Hawaii: Del Monte Corp., the Dole Division of Castle & Cook, Inc., and Maui Land & Pineapple Co., Inc. A description of the operations of the members of the association and their importance to the economy of Hawaii appears later in this statement.

[2] Preproductive period expenses include "any amount which is attributable to crops * * * during the preproductive period of such property and which is allowable as a deduction for the taxable year." See proposed sec. 468(c)(1)(A), added by sec. 101(a) of H.R. 10612. The term "preproductive period" means "(i) in the case of property having a useful life of more than 1 year which will have more than one crop or yield, the period before the disposition of the first such marketable crop or yield, or (ii) in the case of any other property the period before such property is disposed of." See proposed sec. 468(c)(1)(C), added by sec. 101(a) of H.R. 10612.

[3] There are two exceptions. Castle & Cooke, a sugar and pineapple grower, is on an accrual method but uses a static value method of accounting for the cost of growing pineapple under a prior agreement with the Internal Revenue Service. Its static value method, like the annual accrual method, charges most of the costs of growing crops to harvested crops or expense, and the results produced are substantially similar to the annual accrual method. Castle & Cooke would be permitted to change to the annual accrual method under the amendments proposed by the Pineapple Growers Association as explained hereafter at pp. 15–17.

Another grower, Del Monte, is on an accrual method but uses the crop method of accounting for all of its growing crops and would not be affected by the amendments proposed by the association. Del Monte did not make the change to the annual accrual method for its Hawaiian operations in order to maintain uniformity with its other extensive farming operations on the mainland.

that method was adopted by the Hawaiian pineapple and sugar growers almost 25 years ago.

The pineapple and sugar companies of Hawaii will have to include as income millions of dollars of deductions legitimately and properly claimed under their accepted, IRS-approved annual accrual method if they are now required to change to an accrual method "with the capitalization of preproductive expenses" by section 447. The estimated initial tax cost—$25 million—would be a severe blow to companies already facing long cycles of marginal operations. The Hawaiian pineapple industry in particular needs help to end a decline that has seen two-thirds of its growers go out of the pineapple business since 1960, but this measure can only aggravate its problems. The State of Hawaii, with one of the highest unemployment rates in the nation and no ready alternatives for employees who depend on sugar and pineapple for their livelihood, cannot afford further damage to these important props to its economy.

The Ways and Means Committee was not aware of the annual accrual method and its importance to the pineapple and sugar growers of Hawaii when it drafted section 447. The Ways and Means Committee did make clear in its report, however, after being informed of the facts, that it did not understand section 447 as requiring companies to change from the generally accepted annual acrual method. Thus, the committee stated:

> If a corporation has computed its taxable income on an 'annual accrual method of accounting' for a ten-year period to December 31, 1975, and if such corporation raises crops which mature at least in the second year after planting, then for purposes of this section, such corporation will be deemed to be computing its taxable income on an accrual method of acconting and with the capitalization of preproductive period expenses (as enumerated in new sec. 468(c)(1)). H.R. Rep. No. 94-658, 94th Cong. 1st Sess. (1975) p. 95.

For the reasons set forth in detail below, the Pineapple Growers Association of Hawaii believes that this intention of the Ways and Means Committee is a fair and reasonable way of dealing with the special problems of Hawaii's pineapple and sugar growers. We urge that approval of the annual accrual method for growers presently on that method be made explicit in the language of section 447, assuming the committee intends to include section 447 in its "tax reform" package. The association also urges that one of Hawaii's pineapple growers be permitted to change to the annual accrual method from the essentially similar "static value method" if section 447 is enacted into law.

II. EXPLANATION OF THE ANNUAL ACCRUAL METHOD OF ACCOUNTING

A. Description of Hawaiian pineapple operations

The pineapple companies in the Hawaiian Islands grow pineapple on plantations, harvest it, sell a relatively small quantity to local markets and on the United States mainland as fresh fruit, and can the remainder as fruit and juice in a variety of sizes, cuts, and concentrations. Canneries are located in Kahului, Maui, and Honolulu. The canned product is warehoused in Hawaii and in various distribution points on the mainland and is sold to chain stores (retailers) and wholesalers as well as to reprocessors for inclusion in fruit cocktail and blended fruit beverages. A small percentage of the canned prod-

uct is sold in Western Europe, Canada, and other parts of the world.

The normal cycle for pineapple is 4 years. A first (plant) crop is harvested 18 to 20 months after planting.[4] A second (first ratoon) crop is harvested 12 to 14 months later. Sometimes a third (second ratoon) crop is taken off another 12 to 14 months after the second crop, but in most instances the fields lie fallow for the duration of the cycle. Sometimes fields are short cycled—plowed up and planted after the second crop is harvested.

The total acreage devoted to the cultivation of pineapple ordinarily does not vary significantly from year to year, except for major reductions in acreage over the past 16 years because of inadequate economic returns.

The plantations plan their field operations so that approximately the same number of acres of pineapple mature each year and so that ripening peaks during the summer months of June, July, and August. The total amount of plantation expenses do not vary greatly from year to year except for the effects of inflation and unforeseen circumstances such as disease, pests, or unusual weather.

Practically all of the plantations' expenses are of an intangible nature; that is, they comprise items that do not enter identifiably into the product of the plantations. The intangible direct costs of growing crops are clearing, plowing and preparing for new crops, planting new crops, ratooning, weeding, irrigating, and fertilizing. Intangible indirect costs are employee benefits, supervision and administration, repair and maintenance, depreciation, taxes, insurance, and general expenses.

Any farming operation is subject to natural hazards, and the Hawaiian plantations are no exception. All of the plantations are affected by weeds, nematodes, ants, other pests, and variations of the weather, drought, flooding, or wind action. There was a 10 to 15 percent drop in Hawaiian pineapple production in the last few years due primarily to the severe drought during those years.

B. History of and justification for use of the annual accrual method in Hawaii

Prior to the early 1950's, most of the major Hawaiian plantations computed income using a variation of the "crop method" of accounting. This method is similar in many respects to the crop method which would be imposed under new section 447. Revenues and expenses are recognized on an accrual basis; the costs of growing crops are capitalized until the crops are harvested.[5]

In the early 1950's most of the major plantations changed from the crop method to the annual accrual method upon the advice of a national consulting firm and one of the national accounting firms which has offices in Hawaii. The annual accrual method is better suited to conditions in Hawaii and results in a more realistic matching of costs and revenues.

---

[4] Pineapple thus qualifies as a crop "which mature(s) at least in the second year after planting" as stated in the report of the Ways and Means Committee. The draft amendments which appear in the appendix to this statement use the phrase "matures in not less than 12 months," which the association believes fairly and somewhat ambiguously reflects the committee's intent.

[5] Under the crop method used by Hawaiian plantations prior to the 1950's, all indirect plantation costs were charged to production or expensed.

Under the annual accrual method, in contrast to the crop method, the costs of growing crops are not deferred until the particular crop is harvested but are charged to current production. Some of these costs (that portion allocable to canned product not sold at yearend) will nevertheless be capitalized as part of the inventory of canned product at the end of the year. The remaining costs, allocable to pineapple that is sold as canned goods or fresh fruit during the year, is treated as cost of sales and charged to current period expense.

One important reason for the change by sugar and pineapple growers in Hawaii to the annual accrual method is that the crop method required inclusion of a growing crop value in the balance sheet at a figure which could be misleading. It is always uncertian whether all the costs of growing crops deferrable under the full absorption crop method proposed by section 447 will ultimately be recovered.

Pineapple is a perishable commodity and has value as fresh fruit or for canning for a period of only a few days. At any time prior or subsequent to this short time span the pineapple plant and its fruit are useless. Treating growing pineapple as inventory (or its equivalent in the form of a deferred cost) is similar to considering eggs as inventory before the chickens have laid them.

Drought, tropical storms, insect pests, and other natural hazards can significantly affect crop yield. Equally important, the value of the crop is subject to the vicissitudes of world prices for pineapple and competing fruits which are outside the grower's control. Further, it is not today's prices but world prices a year or two hence that will determine whether costs incurred currently in connection with growing crops will be fully recovered.

The annual accrual method has advantages other than eliminating vexing problems of valuing growing crops of pineapple. Because it matches costs against revenues at comparable price levels, it produces a more realistic determination of net income. It is thus a significant aid to management in controlling costs and gives a more realistic view of earnings for appraisal by management and labor during contract negotiations. In this respect the annual accrual method is quite similar to the LIFO method used so extensively today in valuing inventories of nonagricultural products.

The crop method proposed by new section 447 would add substantially to the recordkeeping costs of sugar and pineapple growers in Hawaii without improving upon the annual accrual method. The additional costs of installing, recording, collecting, organizing, reporting, and administering the element-by-element and field-by-field cost system under a crop method could be better spent modernizing production techniques, making Hawaii's sugar and pineapple growers better able to compete on world markets while improving the marginal returns on their operations in Hawaii. American business is already overburdened with paper work; requiring Hawaii's plantation owners to change from an accepted method of accounting to one that simply requires additional recordkeeping without improving the final result is a classic example of wasted effort that should be minimized rather than encouraged by the tax law.

C. The Internal Revenue Service determined that the annual accrual method, a generally accepted method of accounting, clearly reflects income for Hawaii's sugar and pineapple growers

The major plantation owners of Hawaii were required to obtain permission from the Internal Revenue Service when they changed from a crop method to the annual accrual method of accounting. The Commissioner of Internal Revenue has "a broad administrative discretion" in determining whether a new accounting method "clearly reflects the income" of the taxpayer, and the courts rarely overturn his decisions. See *Schram* v. *United States*, 118 F. 2d 541, 543–544 (6th cir. 1941).

The Commissioner consented to Hawaii's pineapple and sugar growers' change in accounting method, demonstrating that the annual accrual method reflects the income of those growers at least as clearly as the crop method which would be imposed by section 447.

The annual accrual method is not used simply for tax purposes. The financial statements of the publicly held sugar and pineapple companies of Hawaii have been prepared on this method for almost 25 years. Their statements have been audited by certified public accountants from national accounting firms. Those firms have consistently rendered unqualified opinions that the companies' statements were prepared in accordance with generally accepted accounting principles. No exception has ever been taken to the annual accrual method. Indeed, the adoption of the annual accrual method by Hawaii's major plantation owners was attributable in part to the suggestion of one of the major national accounting firms.

The annual accrual method conforms with the principles of accrual accounting in all respects, including its treatment of the costs of growing crops. It does not distort income like the cash method of accounting or offer opportunities for delaying recognition of income or accelerating deductions for expenses.

Income is recognized as soon as the right to receive it becomes fixed and is not deferred until receipt as under the cash method.

Immediate deduction of prepaid items, sometimes seen as a tax abuse under the cash method of accounting, does not occur under the annual accrual method. Prepaid expenses such as freight and insurance, often substantial items, are capitalized and charged to periods benefited by the expenditure.

Pineapple growers on the annual accrual method maintain large inventories of items such as fertilizer, chemicals, maintenance parts, and other supplies. These items are not charged to expense or production until issued or used, whereas under the cash method they are expensed when paid.

Pineapple growers operate their own canning facilities and maintain substantial inventories of canned pineapple. Part of the cost of inventories of canned pineapple represents current costs incurred in growing crops which have been charged to production. Under the cash method, these expenditures would be written off to expense in their entirety when paid.

Hawaiian sugar and pineapple growers have used the annual accrual method with the approval of the Internal Revenue Service and the accounting profession for almost a quarter century. There is no

reason to impose a different method at this late date. To the contrary, it would be inequitable to now require them to capitalize and restore to income deductions that were legitimately claimed under an accepted method of accounting and to pay taxes on that income now that they can ill afford the additional expense.[6]

D. The static value method

One of Hawaii's pineapple growers, the Dole Division of Castle & Cooke, Inc., was not permitted to change to the annual accrual method in the early 1950's with other major plantation owners in Hawaii. Permission was denied by the Internal Revenue Service because Dole had entered into an agreement with the Service in 1938 to remain on a static value method in future years. That agreement, of course, will be automatically superseded if new section 447 becomes law.

The amendments to new section 447 proposed by the Pineapple Growers Association of Hawaii would allow a company that has been using a static value method to elect to change to the annual accrual method within 1 year after the effective date of section 447 instead of changing to the crop method otherwise required by section 447. This would enable Dole to change to the same method of accounting—the annual accrual method—already used by all but one of the Hawaii's major sugar and pineapple growers. This is only reasonable and fair because Dole's static value method produces results substantially the same as those of the annual accrual method. Furthermore, Dole would be using the annual accrual method today were it not for the 1938 agreement with the Internal Revenue Service that will be superseded in any event if section 447 becomes law.

A brief explanation of the static value method used by Dole in accounting for its pineapple operations shows that the results of that method do not differ significantly from the annual accrual method.

Under the static value method of accounting for the costs of growing pineapple applied by Dole under its 1938 agreement with the Internal Revenue Service, the direct growing costs per acre at various stages of maturity, determined at 1930's prices rather than current prices, are multiplied by the number of acres under cultivation at the end of the accounting period. The product is treated as the value of growing crops at that date. The difference in the values of growing crops at the beginning and the end of the accounting period is added to or deducted from the total cost of growing crops incurred for the year as determined under the annual accrual method to determine the current year's cost of crops harvested.

To take a simplified example, suppose that the number of acres under cultivation, all at the same stage of maturity, was 16,000 acres at the beginning of the year and 18,000 acres at the end of the year, an increase of 2,000 acres. Further, assume that the average direct cost per acre at 1930's price levels was $60 per acre and that total cost of harvested crops under an annual accrual method would be $18 million. The costs of crops harvested under Dole's static value method could then be computed as follows:

[6] Such restoration would be required as a mandatory "sec. 481 adjustment" in making a change in accounting methods. See sec. 204(b)(2)(C) of H.R. 10612. The impact of this adjustment on the pineapple industry is discussed at pp. 19 to 24 of this statement.

	Acres under cultivation	1930's unit cost	Value
Beginning of period	16,000	$60	$960,000
End of period	18,000	60	1,080,000
Difference	2,000		102,000
Cost incurred for the year under the annual accrual method			18,000,000
Cost of crops harvested under static value method ($18,000,000 minus $120,000)			17,880,000

The total cost of harvested crops under the static value method would be $17,880,000 as compared with an $18 million cost under the annual accrual method. This is a difference of only two-thirds of 1 percent. The small difference in this simplified example is representative of Dole's actual experience. For example, Dole's actual results in 1975 under the static value method differed by only one-half of 1 percent from the results which would have been obtained under the annual accrual method.

E. Summary

The annual accrual method, unlike the cash method at which section 447 is directed, cannot be contested on grounds of not matching income with related expenses. It has been approved by the Internal Revenue Service as clearly reflecting income, has been accepted by the accounting profession, and has been used consistently by most of the publicly held sugar and pineapple growers in Hawaii for almost 25 years. It is to be sharply distinguished from the cash method, under which income is not taxed until actually received, prepaid expenses are immediately deducted when paid, and no inventories of finished product are maintained.

The sugar and pineapple companies of Hawaii should not be required to change to a method basically similar to the crop method of accounting which they abandoned in the early 1950's, with the consent of the Internal Revenue Service, because the crop method was inappropriate to their conditions. There is no tax shelter or other abuse inherent in the annual accrual method used by these publicly held incorporations. Accordingly, the Senate Finance Committee should implement the intention so clearly expressed by the Ways and Means Committee by allowing companies which have been using the annual accrual method of computing farm income to remain on that method for tax and public accounting purposes.

III. PINEAPPLE OPERATIONS IN HAWAII ARE MARGINAL FOR LONG PERIODS AND COULD BE THREATENED IF GROWERS ARE FORCED TO INCUR THE ADDITIONAL ACCOUNTING AND TAX COSTS OF CHANGING TO THE CROP METHOD OF ACCOUNTING PROPOSED BY NEW SECTION 447

Pineapple is one of the mainstays of Hawaii's undiversified economy. It is the State's fourth largest source of revenue (after Federal Government expenditures, tourism, and sugar), accounting for $141 million in 1975. The industry payroll was $44 million in 1975, paid to more than 5,000 regularly employed workers and 6,000 seasonal

workers employed during the peak summer months. Pineapple and sugar are Hawaii's two principal cash crops and only significant exports, providing the income needed to buy the mainland's products. These crops also provide the shipping industry with its only important backhaul freight, thus reducing the cost of food, medicine, construction materials, and other supplies which must be shipped into Hawaii from the mainland.

In the past 15 to 20 years, growers have found it increasingly difficult to obtain adequate economic returns from pineapple operations in Hawaii. Long periods of marginal and deficit operations, only occasionally broken by brief periods of prosperity, have driven many companies out of the pineapple business. Two-thirds of the nine pineapple companies in Hawaii in 1960 are no longer in the pineapple business. Employment in pineapple operations has declined from 24,517 in 1960 to 11,747 today.

Section 447, if applied to the remaining pineapple growers of Hawaii, can only accelerate this trend. It is estimated that, to begin with, the affected companies would have to pay $7 million in additional taxes as a "transitional adjustment" if forced to change to the crop method.[8] This amount could mean the difference between profitable and deficit pineapple operations in Hawaii for many years.

The relatively small, short-term revenue gain[9] is not worth the very serious risk that, if section 447 does not recognize and accept the annual accrual method, further substantial reductions in pineapple operations and unemployment may be the result. One need only look at the experience of one of the three remaining pineapple growers in Hawaii, Maui Land & Pineapple, to see why this risk is so real and substantial.

Maui Land & Pineapple would be faced with a $2 million increase in its Federal income tax bill if it is forced to change to the crop method of accounting. During the entire 10-year period, 1963–72, Maui's net earnings from pineapple totaled less than $2 million, a return of barely two-thirds of 1 percent on its owner's invested capital. If the experience of the coming 10-year period is similar to that of 1963–72 (which may be too optimistic), the initial tax impact of section 447 will wipe out all of Maui's pineapple profits for 10 years. Hawaii's pineapple growers cannot long remain in business with no prospect of any economic returns.

Any further reductions in pineapple operations would have severe repercussions in the Hawaiian economy and would ultimately reduce Federal revenues by far more than $7 million. Unemployment in the State of Hawaii is over 9 percent and in pineapple growing areas

[8] Two of the three major pineapple growers in Hawaii would be affected by this provision, Maui Land & Pineapple Co., Inc., and the Dole Division of Castle & Cooke, Inc. However, the Ways and Means Committee's estimate that section 447 will result in an increase in corporate tax liability of $80 million annually should not be substantially affected by the amendments to section 447 proposed therein by the Pineapple Growers Association because, as noted above, the committee has already assumed that Hawaii's pineapple companies on the annual accrual method would not be affected by section 447. There would be a revenue loss of approximately half a million dollars over 10 years as a result of allowing Dole to change from the static value method to the annual accrual method.

[9] In contrast to the $7 million of additional revenue which might be obtained over a 10-year period if section 447 is applied to Hawaiian pineapple operations, the Ways and Means Committee predicted that the "tax reform and tax simplification" measures in H.R. 10612 would raise $1,600,000,000 annually by 1981. See H. Rept. 94–658, 94th Cong., 1st sess. (1975).

such as Maui it is already up to 13 percent. The State has found from past cutbacks in pineapple operations, particularly on the island of Molokai, that the resulting unemployment is especially persistent and troublesome because of the lack of alternative employment opportunities in pineapple growing areas. Keeping in mind that the Hawaiian pineapple companies withheld over $10 million in Federal, State, and local taxes on the wages of pineapple-related employees in 1975 and paid an estimated $24 million in Federal, State, and local taxes on their earnings from pineapple operations, the amount at risk is substantial indeed.

Even without the prospect of additional taxes, the future of the Hawaiian pineapple industry was so much in doubt that hearings on its continued viability were held in October 1973, in Honolulu, by Senators Hiram L. Fong and Daniel K. Inouye, and Representatives Spark M. Matsunaga and Patsy T. Mink. The problems of the industry have been identified as an influx of foreign pineapple imported into the United States (lower-priced because of cheap labor and the availability of low cost foreign shipping)[10] and an oversupply of competing domestic fruits. Solutions have not been so readily apparent.

The Hawaiian pineapple industry received a temporary reprieve in 1974 and 1975. This period has seen higher pineapple prices and a more reasonable return to pineapple growers, principally because cutbacks in acreage combined with drought conditions in the tropics and adverse weather conditions elsewhere reduced the availability of pineapple and competing fruits.

There are signs that these conditions are now ending. Pineapple supply is catching up with demand, and special promotional allowances must now be offered to counter increased competition from competing fruits. The tropical drought has broken and additional pineapple acreage has been planted to partially offset the closing of certain operations in 1973 and acreage shifted to production for fresh fruit sales. Following the cyclical pattern of the past few decades, pineapple earnings appear once again to be on a downward trend.

Great potential harm to the pineapple industry and the State of Hawaii could result if Congress forces a change from the annual accrual method. Over the long term the Federal Government and certainly the State of Hawaii would suffer a net revenue loss if the additional tax and accounting cost burden causes a further contraction in pineapple operations and employment in Hawaii. Equally important, no change is necessary because the annual accrual method already meets the Internal Revenue Code's requirement of clearly reflecting income.

We therefore urge the Senate Finance Committee not to adopt section 447 without first implementing the intention of the Ways and Means Committee by amending section 447 in the manner set forth in the appendix to this statement.

---

[10] Under U.S. law (the Jones Act) domestic shipments of Hawaiian pineapple are denied the use of foreign ships, and foreign-built, but domestically owned ships. Shipping costs on these vessels are substantially higher than on foreign-flag vessels.

Appendix to Statement of Pineapple Growers Association of Hawaii

TEXT OF AMENDMENT TO SECTION 204 OF H.R. 10612

The Pineapple Growers Association of Hawaii supports the adoption of the following amendments to section 204 of H.R. 10612.

1. Section 204(a)(1), adding new section 447 to the Internal Revenue Code, is amended by adding the following new sentence to paragraph (a) of section 447 (at page 54, line 28):

If a corporation has computed its taxable income on an annual accrual method of accounting for a 10-year period prior to [the effective date of section 447], and if such corporation raises crops which mature not less than twelve months after planting, then for purposes of this section, such corporation will be deemed to be computing its taxable income on an accrual method of accounting and with the capitalisation of preproductive period expenses described in section 468 (c)(1).

2. Section 204(a)(1) is further amended by adding the following new subsection 447(f) (at page 58, after line 9):

(f) *Annual accrual method of accounting defined.*—For purposes of subsection (a), taxable income is computed on an annual accural method of accounting if revenues, costs and expenses are computed on an accrual method of accounting and the preproductive period expenses (described in section 468(c)(1)) incurred during the taxable year are charged to harvested crops or deducted in determining the taxable income for such year.

3. Section 204 is further amended by redesignating paragraph (b) thereof as paragraph (c), and by adding the following new paragraph (b) (at page 58, after line 11):

(b) *Election to change from static value method to annual accrual method of accounting.*—

(1) *Election.*—If a corporation has computed its taxable income on an accrual method of accounting together with a static value method of accounting for preproductive period expenses for a ten-year period prior to [the effective date of section 447], and if such corporation raises crops which mature not less than twelve months after planting, such corporation may elect (within one year after the date of enactment of this act in such manner as the Secretary or his delegate prescribes) to change to the annual accrual method of accounting for taxable years beginning after [the effective date of section 447]. Such change shall be treated as having been made with the consent of the Secretary of the Treasury and, under regulations prescribed by the Secretary or his delegate, the net amount of the adjustments required by section 481(a) to be taken into account by the taxpayer in computing taxable income shall (except as otherwise provided in such regulations) be taken into account in each of the 19 taxable years beginning with the year of change.

(2) *Effect of election for purposes of section 447.*—A corporation which elects to change to the annual method of accounting under this subsection shall, for purposes of section 447, be deemed to be a corporation which has computed its taxable income on an annual accrual method of accounting for a 10-year period prior to [effective date of section 447].

EXPLANATION OF AMENDMENTS TO NEW SECTION 447

All but one of the major sugar and pineapple growers in Hawaii use the annual accrual method (or a static value method which produces similar results) in computing the net income from farming. The an-

nual accrual method was adopted in the early 1950's with the approval of the Internal Revenue Service. The companies, all of which are publicly held, also use the annual accrual method in reporting earnings to shareholders and the public.

The Ways and Means Committee, in its report on section 447, stated that the new section would not affect companies raising crops which mature at least in the second year after planting (like Hawaiian sugar and pineapple) that have been using the annual accrual method of accounting for at least 10 years. The amendments make this intent explicit in the language of section 447.

The amendments also deal with the special case of a Hawaiian company that was not permitted to change to the annual accrual method in the 1950's solely because it was using a static value method under an agreement entered into with the Internal Revenue Service in 1938. The static value method produces results which are essentially the same as those under the annual accrual method. It is only reasonable and fair that this company now be given the opportunity of changing to the annual accrual method used by most of the other sugar and pineapple growers in Hawaii since the 1938 agreement which previously prevented a change to this method will be superseded by section 447 in any event.

STATEMENT OF HAWAIIAN SUGAR PLANTERS' ASSOCIATION BEFORE THE COMMITTEE ON FINANCE, UNITED STATES SENATE, ON PROPOSED SECTION 447, INTERNAL REVENUE CODE (SECTION 204 OF H.R. 10612)

The Hawaiian Sugar Planters' Association (HSPA) is a nonprofit agricultural organization of sugar companies and individuals united for the purposes of maintenance, advancement and protection of the sugar industry in Hawaii. Attached to this statement is a list of the member companies of HSPA which together account for about 95 percent the sugarcane grown in Hawaii, or about 10 percent of total U.S. consumption requirements (appendix, page 1).

I. SUMMARY

Proposed section 447 would require corporations (with certain exceptions not applicable here) to use the accrual method of accounting for farming operations and also to capitalize preproductive expenses associated with growing crops. These expenses are listed in proposed section 468(c)(1) (section 101(a) of H.R. 10612) and would include all plantation costs attributable to growing sugarcane prior to the disposition of the first marketable crop. In Hawaii, this preproductive period extends approximately two years.

The proposed change in accounting method is directed at corporate enterprises which are reporting farm income and expenses on the cash method.

Hawaiian sugar producers are not on the cash method. They have been on an "annual accrual method" for 25 years, with the specific approval of the Internal Revenue Service. It has been and still is considered to be a sound method of accounting for the industry.

The change with respect to treatment of preproductive expenses that would be required by application of proposed section 447 in

its present form would have serious financial impact on the entire sugar industry in Hawaii and, therefore, on the economy of the State as a whole.

The unintended consequence to Hawaii of proposed section 447 was not brought to the attention of the Committee on Ways and Means until markup on the bill was completed. When the committee was told of this problem it added to the report on H.R. 10612 the following statement of its intent:

> If a corporation has computed its taxable income on an 'annual accrual method of accounting' for a 10-year period to December 31, 1975, and if such corporation raises crops which mature at least in the second year after planting, then for purposes of this section, such corporation will be deemed to be 'computing its taxable income on an accrual method of accounting and with the capitalization of preproductive period expenses (as enumerated in new sec. 468(c)(1)). [H.R. Report No. 94-658, 94th Congress, 1st session, (1975), p. 95]

In order to further effectuate the stated intention of the Ways and Means Committee in connection with section 447, the Hawaiian Sugar Planters' Association respectfully urges the Committee on Finance to amend section 447 in the manner shown, (appendix, page 2), consistent with the quoted language of the report. The proposed amendment will permit the sugar industry in the State of Hawaii to continue its presently approved method of accounting and will not interfere with the stated objectives of section 447 in the treatment of corporations now on the cash method.

II. SUGAR IN THE STATE ECONOMY AND IMPACT OF PROPOSED CHANGES

(*a*) *The place of sugar in the economy of Hawaii*

The sugar industry is the third largest source of income for the State of Hawaii, after Federal Government expenditures and tourism, which have only in recent years supplanted sugar in the No. 1 position. As it has been for nearly a century, sugar is Hawaii's principal export. In 1975, sugar contributed approximately $368 million to the State's economy. Since most of Hawaii's food and other essential supplies must be imported from the mainland, the shipments of sugar are extremely important to the State's trade balance.

Sugar producers employ approximately 9,000 full-time year-round workers in the State, with a 1975 payroll of approximately $110 million. Nonlabor expenditures by sugar companies in the State totaled about $111 million. Federal and State taxes paid in 1975 were approximately $93,500,000 and Federal and State withholding taxes were over $23 million.

Compared with most other regions of the United States, Hawaii's economy is relatively undiversified, primarily because of its distance from other markets but also because of the relative scarcity of natural resources. Pineapple, the second largest export, contributed approximately $141 million to the State's economy in 1975. (For several years, pineapple growing has been declining in Hawaii because of the impact of lower cost competition from other parts of the Pacific). These four areas, Federal Government, tourism, sugar, and pineapple, represent the major elements of the economy. Damage or economic difficulties in any one of them can have far-reaching consequences throughout the State.

Since the termination of the 40-year-old U.S. Sugar Act at the end of 1974, U.S. sugar producers have been competing directly with less efficient but lower labor-cost sugar producers in various parts of the world. World sugar prices dropped in 1975 from the unprecedented and short-lived heights of late 1974 to a present level at which some Hawaiian sugar operations may not be profitable in 1976. The outlook for sugar prices on the world market is uncertain and currently unpromising. At the same time, fuel, fertilizer, labor, and other costs continue to rise rapidly. Three plantations have closed over the last 5 years. Any extended period of unprofitable operations undoubtedly would cause other marginal plantations to go out of business. With current unemployment in the State already 9.3 percent (compared with a national rate of 8.7 percent), any further closings would seriously aggravate this grave situation. Despite the earnest and cooperative efforts of all the parties involved, no satisfactory alternative employment has been found for many workers from these defunct plantations.

The additional burden which might be imposed by application of new section 447 in its present form would be particularly damaging to the Hawaiian sugar industry and the State's rather fragile economy at this critical time.

(b) *Impact of application of proposed section 447*

Based on available information, the major Hawaiian sugar companies estimate that the financial effect the change proposed by section 447 would have on them would be as follows:

(1) An initial, permanent deferral of approximately $37,550,000 of growing crop costs would be required in the year the change would become effective, thereby causing an increase of about $18 million in aggregate Federal tax liabilities.

(2) Assuming even moderate inflation in the future, additional tax obligations would occur in each succeeding year because expenses actually incurred in the year of harvest or sale would be higher than the costs deferred or capitalized in prior years.

(3) Additional expenses in significant but undetermined amounts would be incurred in changing accounting methods and in maintaining the new systems required for compliance with the proposed code revisions. Much of the additional work would require collection of data on a field-by-field basis which would be both time-consuming and expensive because of the number and diversity of field operations.

III. SUGAR PLANTATION OPERATIONS

The sugar plantations in Hawaii grow sugarcane, harvest it, grind it at their mills and process it into raw sugar and, to a minor extent, into molasses. Storage capacity at the mills for the raw sugar is not substantial so that the plantations do not have a large inventory of raw sugar and molasses at any time during the year. Title to the raw sugar passes to their cooperative marketing organization when loaded aboard ground transportation equipment for movement from the mills to shipping terminals in Hawaii. Substantially all of the raw sugar is then shipped to the mainland where it is refined and marketed.

The total acreage devoted to the cultivation of sugarcane in Hawaii is fairly constant from year to year because there are practical limitations on the amount of land available for farming.

The land under cultivation is divided into fields which, largely because of contour, are not uniform in size or shape. Some contain only a few acres; others contain several hundred acres. Each plantation has a great many fields. A field planted in sugarcane generally yields three crops over a period of about 6 years. The first crop is harvested approximately 2 years after planting. The second crop, which grows from the stools of the sugarcane plants after the first harvest, and therefore is known as a ratoon crop, matures approximately 2 years later. The third crop which develops from the same source after the second harvest, and therefore is likewise a ratoon crop, requires still another 2 years, approximately, to reach maturity.

The plantations plan their field operations so that about the same number of acres of sugarcane mature each year, and, to the extent practicable, in each month during each year. There is an off-season of from several weeks to upwards of 3 months, usually late in the year, during which no harvesting or milling operations take place and during which major mill repairs are made. As a result of the mill shutdown at year end, the plantations have no inventory of raw sugar at the end of their taxable year.

The sugar plantations have substantial capital investments. In addition to the land, mills are necessary for grinding the sugarcane and processing it. Mechanical equipment is extensively used in the fields in all phases of the work.

The principal kinds of plantation expenses related to growing crops—the items with which this statement is concerned—are the following: Clearing, plowing, and preparing for new crops; planting new crops; repairing and replanting ratoons; weeding; irrigating; fertilizing; and indirect expenses.

It is to be noted that because of the relative continuity of plantation operations, all of these expenses recur annually, although the amounts vary from year to year. Under relatively stable economic conditions the fluctuations are not great.

Practically, most plantation expenses are comprised of items that do not enter identifiably into the product of the plantations. Seed is cut from the plantation cane and the cost of purchased seed is very minor. Of the direct expenses, labor (for planting, plowing, weeding, irrigating, and fertilizing) is much the largest element. Of the purchased materials, water, fertilizer, and herbicides are by far the most important items. It is impossible to identify any of these in the growing cane, or in the raw sugar and molasses which constitute the finished products of the plantations.

Because of the nature of most of the expenses, it would be difficult to allocate them exactly among fields and crops. Even some of the direct expenses can be assigned to specific crops only in an arbitrary manner.

In this connection, it is to be noted that in part the plantation expenses serve to maintain the productivity of the land itself, as well as to produce sugarcane and transform it into raw sugar and molasses.

Any farming operation is subject to natural hazards, and the Hawaiian plantations are no exception. All of the plantations are affected

by variations in weather, drought, flooding, or wind action, and a small number have been and may hereafter be affected by lava damage or tidal wave action.

IV. ANNUAL ACCRUAL METHOD OF ACCOUNTING

All major sugar corporations in Hawaii use the "annual accrual method" in determining taxable income. Under this method all plantation expenses, both direct and indirect, are deducted from gross income—i.e., charged against revenues as incurred. It is significant to note that the annual accrual method creates a much different result than the treatment of expenses under the cash method. The annual accrual method requires that materials and supplies are not deductible for tax purposes until they are actually used by the plantation. For example, the cost of fertilizer or herbicides would not be deductible until utilized by the plantation.

Some of the plantations began to use the annual accrual method for accounting and financial statement purposes as to a portion of their expenses—those classified as indirect expenses—prior to 1913; others did so during the 1920's; and still others did so during the 1930's. By 1937 all of the plantations (except one small unit which is on the cash basis) were using that method as to indirect expenses.

Eventually they extended its use to the remainder of their expenses—those classified as direct expenses. The following shows the years in which the plantations began to use the annual accrual method with respect to all of their expenses, both direct and indirect:

1931—4 plantations (but 3 of these did not adopt the annual accrual method for income tax purposes until 1937).

1934—1 plantation.

1951—6 plantations.

1952—14 plantations.

1954—3 plantations (but all of these adopted the annual accrual method for income tax purposes retroactively as of 1952).

The change from the deferred crop method to the annual accrual method for Federal income tax purposes by the three plantations in 1937 was made after receipt of a favorable ruling from the Commissioner of Internal Revenue permitting the change in method. Similarly, the change to the accrual method for Federal income tax purposes of the 6 plantations in 1951 and the 17 plantations in 1952 was made with the consent of the Commissioner of Internal Revenue. The other two plantations used the annual accrual method since their inception.

In the opinion of Haskins & Sells, certified public accountants, the annual accrual method is in conformity with generally accepted accounting principles, clearly reflects annual income as reported in financial statements, and is supported by sound business reasons, taking into consideration certain aspects, peculiarities and hazards inherent in sugar operations. Their opinion, with detailed support, is on record with the Internal Revenue Service in Washington, D.C. The Securities and Exchange Commission has also accepted the annual accrual method for Hawaii's sugar plantations as conforming with generally accepted accounting principles.

The annual accrual method is a significant aid to management in controlling costs, that is, in keeping expenses within income. This is especially so during a period of rising prices such as has characterized the economy for the past several years. For the same reason, it facilitates budgeting and financing operations which necessarily are concerned with the flow of cash receipts from product sales and disbursements for plantation expenses and capital expenditures, rather than with the allocation of these items to crops which were planted several years ago or which will be harvested several years hence. Because it results in income statements that are readily understandable by employees, stockholders, bankers, and the public, it is a great help in negotiations between management and those groups. This is most important in labor relations, which have been extremely difficult for the plantations during recent years. The method is simple to operate, easy to understand and economical. The plantations have been able to eliminate a substantial volume of detailed accounting work as a result of using it.

V. CHANGES PROPOSED BY SECTION 447 AND REASONS THEREFOR

(a) Proposed method of accounting

The bill adds a new section to the code (sec. 447) which requires corporations (with certain exceptions not applicable in this situation) to use the accrual method of accounting for farm operations and also to capitalize their preproductive period expensse of growing crops. The preproductive period expenses required to be capitalized under this provision are the preproductive period expenses enumerated in new section 468(c)(1) which includes all plantation costs attributable to growing sugar. In the case of property having a useful life of more than 1 year, which has more than one crop, such as a sugar plant, the preproductive period extends until the disposition of the first marketable crop or yield—approximately 2 years for Hawaiian sugarcane.

Thus, costs attributable to the cultivation, maintenance, or development of a newly planted sugarcane field in a taxable year before the first year in which a marketable crop is sold are preproductive period expenses and must be capitalized.

(b) Stated general reasons for change

The report of the House Committee on Ways and Means contains the following general reasons for change [numerals in brackets added for reference]:

[1] "Under the cash method of accounting, all items which constitute gross income are reported in the taxable year in which actually or constructively received, and expenses are deducted in the taxable years in which they are actually paid. The primary advantage of the cash method is that it generally requires a minimum recordkeeping; however, it frequently does not match income with related expenses. Consequently, the cash method can be used to create tax losses which defer current tax liabilities on both farm and nonfarm income. Corporations, as well as individuals, can benefit by the time value of such deferral of taxes.

[2] "The opportunity for farmers generally to use the cash method of accounting, without inventories and with current deduction of certain expenses which are properly capitalizable, was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity which, for example, eliminates the need to identify specific costs incurred in raising particular crops or animals.

[3] "In recent years, however, many corporations have entered farming. While some of these corporations involve relatively small business operations owned by a family or a few individuals, other corporations conduct large farm businesses which have ready access to the skilled accounting assistance often required to identify specific farm costs. In addition, sophisticated farm operations have often been carried on by farm syndicates or partnerships consisting of high-income investors and a corporation representing a promoter of a farm 'tax shelter'.

[4] "In view of this, your committee believes it is appropriate to require corporations, and certain partnerships, engaged in farming use an accrual method of accounting with the capitalization of certain preproductive period expenses. Your committee, however, has excepted from this requirement certain small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming." [H.R. Rept. No. 91-658, 94th Cong., 1st sess. (1975), p. 94.]

(*c*) *Inapplicability to sugar industry in Hawaii*

The first two paragraphs of the committee's report are directed at the abuses that can result under the cash method of accounting. These abuses cannot exist in Hawaii because all of the sugar plantations except one (Gay & Robinson, a family-owned plantation) use the accrual method in determining income for financial reporting and income tax purposes.

The third paragraph discusses the abuses created by new corporate farmers as well as farm syndicates or partnerships consisting of high-income investors and a corporation representing a promoter of a farm tax shelter. The Hawaiian sugar plantations commenced operations in the eighteen hundreds. While some plantations have closed since that time and others have been sold between various Hawaiian corporations, all of the Hawaiian plantations have in the past and are now owned by corporations with a long history of farming in the Hawaiian Islands. Not a single plantation is owned by a "new" corporate farmer. Furthermore, not a single sugar plantation in Hawaii has been used as a farm syndicate or partnership to promote a farm tax shelter. The limited amount of land, the substantial cost of maintaining a sugar plantation and the very low profit margin has made sugar in Hawaii a very unattractive target for tax shelter promoters. Nevertheless, we recognize the valid concern that the House Committee on Ways and Means has expressed concerning tax shelters. Under our proposed solution, including the proposed statutory language, we know of no way for a tax shelter promoter to utilize a Hawaiian sugar plantation to generate artificial tax losses. Since no

such enterprise would have been using the annual accrual method for a period of 10 years prior to the effective date of the bill, it would be required to capitalize all preproductive period expenses of growing crops.

Appendix

Plantation Members of Hawaiian Sugar Planters' Association

Island of Kauai—Gay & Robinson; Kekaha Sugar Co., Ltd.; The Lihue Plantation Co., Ltd.; McBryde Sugar Co., Ltd.; and Olokele Sugar Co., Ltd.

Island of Oahu—Oahu Sugar Co., Ltd.; and Waialua Sugar Co., Inc.

Island of Maui—Hawaiian Commercial & Sugar Co.; Pioneer Mill Co., Ltd.; and Wailuku Sugar Co.

Island of Hawaii—Hilo Coast Processing Co.; Honokaa Sugar Co.; Ka'u Sugar Co., Inc.; Laupahoehoe Sugar Co.; and Puna Sugar Co., Ltd.

TEXT OF PROPOSED AMENDMENTS TO SECTION 204(A) OF H.R. 10612

1. Section 204(a)(1), adding new section 447 to the Internal Revenue Code, is amended by adding the following sentence at the end of section 447(a) (at page 54, line 23):

If a corporation has computed its taxable income on an annual accrual method of accounting for a 10-year period prior to [the effective date of section 447], and if such corporation raises crops which mature not less than 12 months after planting, then for purposes of this section such corporation will be deemed to be computing its taxable income on an accrual method of accounting and with the capitalization of preproductive expenses described in section 468(c)(1).

2. Section 204(a)(1) is further amended by adding the following new subsection 47(f) (at page 58, after line 9):

(f) *Annual accrual method of accounting defined.*—For purposes of subsection (a), taxable income is computed on an annual accrual method of accounting if revenues, costs and expenses are computed on an accrual method of accounting and the preproductive period expenses (described in section 468(c)(1)) incurred during the taxable year are charged to harvested crops or deducted in determining the taxable income for such year.

RAMSEYER PRINT

If the proposed amendments are adopted, the text of section 204(a) of the bill would read as follows: (amendatory language italic).

Sec. 204. Method of Accounting for Corporations Engaged in Farming.

(a) General Rule.—

(1) Subpart A of part II of subchapter E of chapter 1 (relating to methods of accounting) is amended by adding at the end thereof the following new section:

Sec. 447. Method of Accounting for Corporations Engaged in Farming.

"(a) General Rule.—Except as otherwise provided by law, the taxable income from farming of—

"(1) a corporation engaged in the trade or business of farming, or

"(2) a partnership engaged in the trade or business of farming, if a corporation is a partner in such partnership, shall be computed on an accrual method of accounting and with the capitalization of preproductive expenses described in section 468(c)(1). *If a corporation has computed its taxable income on an annual accrual method of accounting for a 10-year period prior to (the effective date of section 447) and if such corporation raises crops which mature not less than twelve months after planting, then for purposes of this section, such corporation will be deemed to be computing its taxable income on an accrual method of accounting and with the capitalization of preproductive expenses described in section 468(c)(1).*

(Subsections (b)(c)(d) and (e) omitted for simplicity.)

(f) *Annual accrual method of accounting defined—For purposes of subsection (a), taxable income is computed on an annual accrual method of accounting if revenues, cost and expenses are computed on an accrual method of accounting and the preproductive expenses described in section 468(c)(1) incurred during the taxable year are charged to harvested crops or deducted in determining the taxable income for such year.*

Statement of Building Owners and Managers Association, International

The Building Owners and Managers Association, International, through its 70 local associations, represents a large percentage of the commercial office space in the United States and many other countries.

The 4,000 high-rise buildings managed or owned by BOMA members have approximately 500 million square feet of commercial space. The international office is at 1221 Massachusetts Avenue Northwest, Washington, D.C.

The limited artificial loss provisions of H.R. 10612 will result in significant long-term disadvantages to the commercial real estate community and to the general public.

It is not our goal to duplicate other lengthy statements on the bill. We will briefly list our objections and some suggestions regarding the LAL provisions.

1. LAL discriminates against the steady person willing to make a long-term investment. Builders and developers will continue to build, if possible, but the rate of return to potential investors would have to be increased to compensate for any new tax disincentives and to compete with alternative investment opportunities. Real estate will be less and less likely to attract risk capital from successful persons, typically doctors, lawyers, and small businessmen, who respond to the current tax incentives. This is particularly likely if a limitation on artificial losses would exempt oil and gas industries and partially exempt farm operations. LAL provisions represent a general bias against individual investors and in favor of corporate enterprises. BOMA believes that sources for needed capital will largely dry up.

2. The end result of discouraging private capital investment in real estate will be a need for increased Government participation in areas such as housing and in revitalization of urban commercial facilities. Private enterprise is frequently able to accomplish more with fewer resources and less social cost.

3. Movement of risk capital away from commercial real estate will have a cumulative effect on commercial centers — the central cores of our cities:

(*a*) New construction will be discouraged;

(*b*) Maintenance and redevelopment of older structures will be discouraged; and

(*c*) The tax base on both land and improvements in center city areas will deteriorate.

Public transportation will be less practical as commercial activity decentralizes from existing high density centers and corridors. Particular disadvantages will be increased use of automobiles and increased air pollution. Jobs will be lost in central city areas—not only in services requiring office space but in many supporting services — restaurants, theaters, shops. There will be increasing demands for Federal money to replace lost tax revenue in the face of continuing social problems. Over a period of time there will be an erosion of the central city tax base and abandonment of marginal income properties.

4. The provisions add another layer of complexity to already complicated, often inequitable tax laws.

5. Canada recently relaxed its LAL-type rule, enacted in 1971, because of a downturn in real estate activity. Lawmakers there underestimated the effect of barring certain real estate losses—so-called capital cost allowances—from being deducted against income from other sources.

The best plan for limiting urban sprawl is to regenerate our city cores and the corridors leading to them. These are the areas where commercial and residential facilities are most concentrated and where rapid transit is available or most feasible for development.

As Congressman William M. Ketchum of California noted in his dissenting views to H.R. 10612, "You cannot tax a business whose doors you have forced to close."

Statement of the National Christmas Tree Association

INTRODUCTION

The Christmas tree industry is composed of over 10,000 small landowners in almost every State. Virtually all of these are family enterprises. These people are investing more than 10 years of their time, money, and effort to bring their trees to the marketplace.

The growing of Christmas trees is a long-term high-risk business. The grower is subject to many hazards from both natural and manmade causes. Disease, wind, frost, heat, drought, ice, blizzards, hail, insects, rodents, fire, vandalism, theft, and air pollution are typical of problems that face the grower. With the exception of theft and to some extent vandalism, all of the mentioned risks are uninsurable. Thus, the Christmas-tree grower is unlike any other small businessman. The

grower is also subject to these risks for a longer period than any other small businessman.

Although these are small family businesses, we are providing employment for more than 100,000 people. Many of these jobs are in economically depressed or low income rural areas. Growers provide employment for many types of workers, male and female, unskilled, semiskilled, students and economically unemployed.

As Christmas tree growers, we are producing a valuable and useful crop on lands abandoned by agriculture or unsuitable for agricultural crops. The leading species of Christmas trees in consumer preference are the pines, and these will grow well on the poorest of soils that will sustain no cash crop.

Today there are over 450,000 acres planted in Christmas trees. In addition to helping perpetuate one of our oldest and greatest traditions, these acres are providing green belts of natural beauty, wildlife habitat and improved watersheds. Each acre of young growing trees supplies the daily oxygen requirements of 18 people.

Christmas trees are a renewable, nonwasting, biodegradeable natural resource. There are 30 million Christmas trees harvested each year. It requires the planting of 80 million seedlings annually to sustain this level of production.

Christmas tree growing is a long-term endeavor requiring extensive training and knowledge. During the 10- to 20-year growth period to maturity of the tree, the grower must personally practice intensive management. This management takes a substantial amount of time and effort on the part of each grower. It is apparent from these requirements that the industry has never proven to be a desirable tax shelter for the investor. The growing of Christmas trees does not provide noncash deductions to apply against ordinary income. A substantial portion of the grower's expenditures are for labor which cannot be prepaid at the whim of the grower. These expenses must be made annually or the grower will lose his investment. Some of these expenses come without warning when a grower must combat insects, disease or other disaster.

Due to the high risk factors, Christmas tree growing is not susceptible of leveraging. We know of no syndication in the Christmas tree industry. We do know that it has been tried in several forms and that each time it has resulted in a disastrous experience for the investor and has been abandoned by the promoter and speculator.

It should be clearly understood that the Christmas tree industry is an integral part of the timber industry for it becomes an important part of the total land management program. Furthermore, Christmas tree growing has tended to become more specialized due to consumer preference requirements and the intense forest management practices which must be used.

Limitation on artificial losses

We as Christmas tree growers of this country are highly disturbed by the provisions of H.R. 10612 which include us in the definition of "farm operations" with respect to the provisions relating to limitation on artificial losses (LAL).

The Congress has never placed Christmas trees in the definition of "farm operations" nor considered LAL provisions applicable to

Christmas trees. We were never granted an opportunity to be heard, nor did we have knowledge of the action of the House Committee on Ways and Means until after the fact.

The expenses of the Christmas tree grower are not capital expenses but ordinary and necessary maintenance expenses. This issue has been litigated, and the Courts have been consistent in this opinion, first in the case of *Ransburg* v. *United States*, 21 AFTR 2d 560, in the District Court, Southern District of Indiana, in 1967. Later in the Tax Court case of *Kinley* v. *Commissioner*, 51 TC 1000, 1969, which decision was affirmed in the Second Circuit Court of Appeals, 26 AFTR 2d 5127, 1970.

The Internal Revenue Service has also accepted this position in Revenue Ruling 71–228. They are not "artificial" expenses. They are real, actual cash expenditures.

Prior to Congress granting the use of long-term capital gains treatment to the Christmas tree industry, 20 million foreign Christmas trees were imported annually. Now this is less than 4 million trees annually. Capital gains as it exists today has made it possible for the American grower of quality grown plantation trees to capture this market. Any change in the law will drastically affect the American growers' competitive position. Consumer demand will not change, but this demand will be met with foreign trees and the petrochemical (energy wasting) artificial object.

Even today the Christmas tree growers must keep extensive records. The basic practice of the industry is to cut in one field for 3 years and then replant. The changes in H.R. 10612 would add another recordkeeping burden on a small businessman.

If the provisions of H.R. 10612 concerning Christmas trees and LAL are not changed, several results will occur. There will be no new investments in this area. Small family land holdings will be consolidated into large holdings. Sound forest management practices will cease. The green belts of beauty will disappear, and many will become brick and mortar.

Unfortunately, due to the nature of the investment, the Christmas tree grower cannot easily or casually abandon his investment. He made his investment decision based on a set of rules. But when the rules are changed, he cannot quit and get his money back. He has acted in reliance on the good faith of the Congress.

It is most difficult to understand why the Congress would pass tax legislation that will, without doubt, discourage and deter tree planting when the USDA—U.S. Forest Service, Department of the Interior, State governmental agencies and local governmental agencies are all conducting programs to increase tree planting. There can be no question but that Christmas trees are a true long-term capital asset.

We ask that Christmas trees not be considered as a farming activity for the purposes of the LAL provisions, inasmuch as Christmas trees are not considered as a farming activity for other provisions in the tax code.

Holding period

The Christmas tree industry is highly concerned about the extension of the holding period from 6 months to 1 year. The industry feels that, if the language of section 631(a) was changed so that the phrase "be-

fore the beginning of such year" was removed, this would put the grower on the same basis with all other investors.

Minimum tax

The Christmas tree industry whole-heartedly supports the concept of a "True Minimum Tax." The unfortunate fact is that the 1969 law did not accomplish this goal. The changes in the minimum tax law in H.R. 10612 still do nothing new to accomplish that goal.

Certainly the inclusion of the untaxed portion of capital gains in the listed preferences was not proper as the capital gain was already taxed. The only result has been to put a further deterrent on capital formation. The changes in H.R. 10612 will only further discourage capital formation. If this trend continues, capital gains will be nothing but print on the pages.

There can be no question that we must encourage capital formation to rebuild our economy.

We request that a true minimum tax be adopted and the capital gains be dropped from the preferences taxed under the present law.

TESTIMONY OF RICHARD J. BJELLAND, PRESIDENT OF LANDURA CORP.

I would initially like to express my appreciation to Hon. Russell B. Long, chairman, and members of the committee for their time and effort in reviewing and considering my testimony. Most of us outside the political spectrum do not realize the total time and effort that is contributed to legislative acts, and we tend to be overly critical when those acts pertain to our specific industry.

Our specific industry is related to real estate development and investment and, as we all know, is slowly recovering from the "recessionary blues." The 1975 residential construction picture was at its lowest point in 29 years, with both single and multiple family suffering from high costs for land, labor, material, and especially financing. A brighter picture is predicted for 1976, with most housing economists estimating 1.5 to 1.7 million housing starts. Also, in their estimates, they concede that the vast majority of housing starts will be in the single-family submarket, with the multiple-housing submarket receiving less stimulation due to high finance costs for both interim and permanent financing.

The Tax Reform Act of 1975 (H.R. 10612) as presented to the Committee on Finance from the House Ways and Means Committee, outlines a wide variety of tax reforms and alternatives. The goals of the bill are to improve the equity of our tax system and reduce undesirable effects on the allocation of resources, simplify the tax law, extend individual and business tax reductions, and improve administration of the tax laws and strengthen the rights of the taxpayer.

My current concern is not with the general goals of the Tax Reform Act, but with a specific omission from the proposed act. In researching and analyzing H.R. 10612, I realized that a possible error has been made pertaining to the low/moderate-income housing programs, which are to receive a 5-year exemption under the LAL provision. Generally, the House of Representatives included the various Housing and Urban Development (HUD) programs, that is, section 236, 221(d)(3) and

section 8, but did not include Farmers Home Administration (FmHA) rural rental housing program (515).

FmHA housing delivery process was established in 1949 under the Federal Housing Act, but was oriented toward farm ownership programs. Currently, the 502 single-family program represents these past housing efforts. The current 515 multiple-family housing program was started by the Senior Citizens Housing Act of 1962, and did not start expanding until fiscal year 1972–73. (See app., History of FmHA Housing Program Summary.)

RURAL RENTAL HOUSING GROWTH (1970-77)

	Funding level	Number of units
Fiscal year:		
1970	$28,440,740	2,995
1971	26,788,690	2,624
1972	40,117,880	3,868
1973	105,062,630	8,839
1974	173,314,630	12,590
1975	252,349,000	19,490
1976	340,000,000	21,250
Subsequent	200,000,000	13,333
1977 proposed	400,000,000	23,529

Generally, FmHA rural rental housing program can be utilized for the construction, purchase, or rehabilitation of multiple-family housing within communities of 10,000 persons, or up to 20,000 persons if the community is outside a SMSA area and has a shortage of mortgage credit, and is not being serviced by HUD.

Rental housing loans can be made to individuals, trusts, associations, partnerships, limited partnerships, State or local public agencies, consumer cooperatives, and profit and nonprofit corporations. If the applicant is a profit organization, they are limited to an 8-percent return on their initial investment in a project. Besides limiting the investment return, FmHA determines the appropriate rent levels (through income limitations), thus insuring residents of low/moderate incomes or 62 years and older. (See app. II, FmHA Rural Rental Housing.)

FmHA rural rental housing programs conform with the IRS code, section 1039(b)(1)(B), which defines a "qualified housing project" for lower income families:

Section 1039(b)(1)(B) IRS Code—

(b) Definitions—for purposes of this section:

(1) Qualified Housing Project—term "qualified housing project" means a project to provide rental cooperative housing for lower income families—

(A) With respect to which a mortgage is insured under Section 221(d)(3) or 236 of the National Housing Act, and

(B) With respect to which the owner is, under such sections or regulations issued thereunder—

(i) Limited as to the rate of return on his investment in the project, and

(ii) Limited as to rentals or occupancy charges for units in the project.

The Tax Reform Act of 1975 defines the specific housing projects which are allowed a 5-year extension under the LAL provisions. The Ways and Means Committee specified certain low/moderate housing programs administered by the Department of Housing and Urban Development (HUD) as receiving a 5-year extension pertaining to the LAL provision (limitation on artificial losses).

Section 470(c) subpart, page 30–31, H.R. 10612, in the Senate of the United States:

(3) Low Income Housing—In the case of low-income housing, subpart shall not apply to real property if—

(A) Before January 1, 1979, there is a subsidy commitment to support new construction or substantial rehabilitation under Section 8 of the United States Housing Act of 1937, as amended (or under the provisions of State or local law authorizing similar levels of subsidy for lower income families) and such commitment was made before the beginning of the construction or rehabilitation of such property, and

(B) The construction period for such property begins before January 1, 1981.

Also included in the definition of the low-income housing are other low/moderate-income housing programs sponsored by HUD.

Section 470, page 27, H.R. 10612:

(4) Low-income Housing—the term "low-income housing" means—

(a) Property with respect to which a mortgage is insured under Section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restriction of Section 1039(b)(1)(B).

FmHA rural rental housing program, as previously described in a preceding section, indicates that the program limits the amount of return the owner can acquire as well as the amount of rent which can be levied against tenants. Due to the restrictions and limitations which the low/moderate-income housing programs place upon investors/owners—that is, limited profit and restricted market—another incentive is required to enhance persons/companies to construct and manage low/moderate-income housing.

Currently, we are slowly recovering from a housing crisis which paralleled the lowest production points of the 1940's. Single-family housing was reduced to extremely low levels and multiple-family housing was impacted more severely. It is important that we recognize housing as a high national priority, and design/implement policies which maximize this goal.

Since Mr. Nixon's moratorium on Federal housing programs in 1973, low/moderate-income housing production has decreased to low levels, and there is an obvious need for housing of this type. The majority of builders/developers do not respond to this specified housing submarket due to a "possible" high risk and low return.

Currently, the major emphasis in providing low/moderate income housing is through the "filtering process" and HUD's section 8 program. Neither currently are providing the needed units or functioning effectively. The only available housing program which provides low/moderate income housing in rural areas is the FmHA programs. For those persons in rural areas who do not have adequate moneys to purchase homes, rental units are a viable living alternative. FmHA rural rental housing program is the only rental housing program available to persons of low/moderate incomes within rural areas, and there is a well-documented need.

We feel that the exclusion of the FmHA rural rental housing program was an oversight by the House Ways and Means Committee, and not one of the merits or credibility of the program.

I appreciate your taking the time in examining my testimony, and wish you the best of luck on a very delicate and controversial legislative matter.

Thank you.

Appendix I.—FmHA History

Summary

The Farmers Home Administration (FmHA), an agency within the United States Department of Agriculture (USDA), was established in 1946. (Previous agency title: 1937–46, Farm Security Administration.) The primary objective of FmHA was to provide assistance to rural/farm related problems, which included loan programs for farm ownership.

The FmHA housing delivery system that currently exists, evolved from a series of legislative acts concerning both housing and rural development. These were:

Federal Housing Act of 1949.—Legislated the responsibility of FmHA to provide housing to the farm industry.

Federal Housing Act of 1961.—Authorized FmHA to obligate housing loans to persons residing within a rural incorporated community of up to 2,500 persons. (Current 502 single family housing program.)

Senior Citizens Housing Act of 1962.—Established loans for low-rent apartment projects for elderly persons (62+ years). (Current 515 multifamily housing program.)

Federal Housing Act of 1965.—Raised population limit of rural areas to 5,500 persons.

1966.—Eligibility was equalized for senior citizens and low-income persons in both rural housing (single family) and rural housing (multifamily).

Housing Act of 1968.—Established interest supplement housing loan programs for low-income persons.

Housing Act of 1970.—Again, raised the population definition of a rural area to 10,000 persons.

Rural Development Act of 1972.—FmHA was authorized to finance, construct and market multifamily (515) housing projects through limited partnership syndication procedures.

Housing and Community Development Act of 1974.—Again, increased the definition of rural areas to include communities of up to 20,000 persons, not within a SMSA area. (Current status: Federal Register Review, December 1975, authorization by FmHA by March 1976.)

Appendix II.—FmHA Rural Rental Housing

Loans for rental housing in rural areas are available from Farmers Home Administration (FmHA) to provide living units for persons with low and moderate incomes and for those age 62 and older. Loans may be made for housing in open country and communities up to 20,000 people, but applicants in towns of 10,000 to 20,000 should check with their local FmHA office to see whether the agency can serve them.

All phases of this program are available to persons of either sex or any race, creed, color or national origin.

How many loan funds be used?

Loans are primarily made to build, purchase or repair apartment-style housing, usually consisting of duplexes, garden-type or similar multi-unit dwellings. The housing must be modest in size, design, and cost, but adequate to meet the tenant's needs.

Funds may also be used to: Buy and improve the land on which the buildings are to be located; provide streets and water and waste disposal systems; supply appropriate recreation and service facilities; install laundry facilities and equipment; and landscape, including lawn seeding, shrubbery, and tree planting, or other measures to make the housing an attractive addition to the community.

Funds may not be used for nursing, special care or other institutional types of housing.

Who may borrow?

Eligibility of applicants will be determined by Farmers Home Administration. Borrowers should have the ability and experience to operate and manage a rental housing project successfully.

Rental housing loans can be made to individuals, trusts, associations, partnerships, limited-partnerships, State or local public agencies, consumer cooperatives, and profit and nonprofit corporations. Nonprofit corporations may be organized in a regional or multicounty basis. Borrowers must agree to provide rental units for occupancy by eligible individuals or families. They must be unable to finance the housing with personal resources and, with the exception of State or local public agencies, be unable to obtain credit from other sources on conditions and terms which would permit them to rent units to eligible families. If the borrower is a profit or limited-profit organization, the assets of the individual members will be considered in determining whether other credit is available.

FmHA will deal only with the applicant or his authorized representative. In the case of a nonprofit applicant, the representative must have no pecuniary interest in the housing site, the award of contracts, or purchase of equipment.

Does FmHA limit the borrower's profit?

In cases, rent charges must be within the limits that eligible occupants can afford to pay. Borrowers are required to deposit rental income in special accounts and establish reserve funds to meet the long-term capital replacement needs. Limited profit borrowers are allowed an 8 percent return on their initial investment in a project.

Who may occupy the housing?

The housing is for families and individuals with low and moderate incomes, and for senior citizens age 62 or over. The maximum income level for occupancy will be established by Farmers Home Administration.

What are the terms?

The maximum repayment period is 50 years for projects designed for senior citizens and 40 years for all other projects. All applicants are required to provide initial operating capital equal to at least 2 percent of the cost of the project. For nonprofit organizations and

State and local public agencies, the 2 percent operating capital may be included in the loan as part of the development cost.

Loans to nonprofit organizations and State or local public agencies can be up to 100 percent of the appraisal value or development costs, whichever is less. Loans to all other applicants are limited to not more than 95 percent of the appraisal value or development cost, whichever is less. Loans for the purchase of buildings less than 1 year old will, however, be limited to 80 percent of the appraised value.

Is the borrower expected to refinance the loan?

When the financial position of the borrower reaches the point that he can repay or refinance through a commercial lender, the loan contract provides that he shall do so.

How will planning and construction be performed?

Before a loan can be approved, applicants must provide detailed plans, specifications, and cost estimates. The applicant must provide complete architectural services, including inspections during construction. The Farmers Home Administration will review the plans and inspect the construction as it progresses.

A borrower who is a builder and capable of building his own project may be permitted a contractor's fee which is typical for the area.

All borrowers are encouraged to obtain interim construction funds from local lenders. A borrower must show that local construction funds are not available before FmHA will provide such funds.

What are the construction standards?

All project development work such as buildings, streets, water, waste disposal, heating, and electrical systems must fully conform with applicable laws, ordinances, codes, regulations, and Farmers Home Administration requirements.

When can construction be started?

The borrower must wait until the loan is closed and authorization given by Farmers Home Administration to start construction. If interim construction financing is to be used, construction will start only after the loan is approved and funds obligated.

Where may housing be located?

The housing will be located on desirable sites in a residential area that is easily accessible to community services and amenities, with an assured supply of safe drinking water and suitable arrangements for waste disposal approved by FmHA. Housing will be arranged on the site in an attractive manner to accent and preserve the advantages of natural topography, trees, and shrubbery.

What information is needed?

The local county supervisor of the Farmers Home Administration will provide information on how to complete and file applications. Applicants must furnish: Complete financial information; preliminary plans, specifications, and cost estimates; a budget of anticipated income and expenses; and survey information supporting the need for housing in the area.

Applicants may secure application forms and other sample FmHA forms for completing budgets and market surveys.

What about loan applicant fees and other charges?

Fees are not charged for appraisals or loan processing. However, the applicant pays for legal services necessary to guarantee that he has a satisfactory title to the site and for other incidental loan closing costs. These expenses may be included in the loan.

What security is required?

Each loan will be secured in a manner that adequately protects the financial interest of the Government. A first mortgage will be taken on the property purchased or improved with the loan except for public or quasi-public organizations that cannot give a real estate mortgage. In those instances the security will be determined by Farmers Home Administration.

How do these loans aid in rural development?

Rental housing loans are made through the Farmers Home Administration to help provide decent homes in suitable living environments. Good rental units give a balanced housing program to a rural community and make it a more desirable place to live. An adequate supply of quality housing helps check the flow of rural people to urban areas by encouraging families to live in rural communities.

The program raises living standards, creates a healthy environment for family life, and makes rural communities attractive locations for development and expansion of industries.

Rental housing loans stimulate economic activity in rural communities by increasing sales of building materials and home furnishings, and by providing jobs for construction workers.

STATEMENT BY LARRY ETTNER, DIRECTOR OF PLANNING AND MARKET RESEARCH, LANDURA CORP.

LOW-INCOME HOUSING UNDER LAL

Rural rental housing (515) and its relationship to the Tax Reform Act of 1975

In researching and analyzing the recent Ways and Means Committee Tax Reform Act of 1975 and H.R. 10612 as read on December 5, 1975, and referred to the U.S. Senate Committee on Finance, I realized that a possible error has been made pertaining to the low/moderate income housing programs, which are to receive a 5-year exemption under the LAL provision. Generally, the House of Representatives included the various Housing and Urban Development (HUD) programs—that is, section 236, section 221(d)(3), and section 8—but did not include Farmers Home Administration (FmHA) rural rental housing program (515).

We have initiated several inquiries into the matter and have received positive responses, but presently no results. With realization of the problem, we initiated letters to several persons within Congress and the administration; that is, Paul Conn, Director of Multiple Family Housing, FmHA; Senator Al Ullman, Chairman, Ways and Means Committee; and the Joint Committee on Internal Revenue Taxation. Our intent was to inform persons of the problem as well as seek assistance or initiation of action to relieve the problem.

Preceding this effort, we felt it important to assess the reason for the omission from the act, so we initiated meetings with Paul Conn of FmHA; and Don Ricketts, Alan Rosenbaum, Lawrence Woodworth, staff persons of the Joint Committee on Internal Revenue Taxation. Both proved helpful in trying to assess and resolve the problem.

Paul Conn, Director of Multiple Family Housing, FmHA, was assessed of the problem, and he thought that he had an understanding with the Ways and Means Committee that the rural rental housing program (515) was to be included with other low/moderate income housing programs sponsored by HUD. He felt that the problem was one of oversight and not one of the merits and importance of the 515 program. I requested that he write a letter to the Joint Committee on Internal Revenue Taxation and Senate Finance Committee assessing them of the oversight, and he said he would.

After my visit with Mr. Conn, I met with Don Ricketts, Alan Rosenbaum, and Lawrence Woodworth, staff persons of the Joint Committee on Internal Revenue Taxation, and spoke to them about the problem. They said they were not aware of the program, how it functions, and have had no communication with FmHA. I highlighted the 515 program to the staff persons, as well as compared the program with other low/moderate income housing programs. The initial conclusions were that the program did have the necessary merits to be included with the HUD programs, and that again it was a legislative oversight. For the staff to make specific recommendations, they requested specific information from myself (Landura Corp.), a letter from FmHA, and a meeting with FmHA to discuss appropriate program details.

At this point, I realized that a lot of material, meetings, and recommendations had to be completed in a very short period of time (April 23, last day for written testimony), and that "those involved may not make it." It was at this time I contacted your office for a "possible" direct solution.

FmHA rural rental housing

FmHA housing delivery process was established in 1949 under the Federal Housing Act, but was oriented toward farmownership programs. Currently, the 502 single-family program represents these past housing efforts. The current 515 multiple-famly housing program was started by the Senior Citizens Housing Act of 1962, and did not start expanding until fiscal year 1972–73. (See appendix, "History of FmHA Housing Program.")

RURAL RENTAL HOUSING GROWTH

	Amount	Number of units
Fiscal year:		
1970	$28,440,740	2,995
1971	26,788,690	2,624
1972	40,117,880	3,868
1973	105,062,630	8,839
1974	173,314,630	12,590
1975	252,349,000	[1] 19,490
1976	340,000,000	[1] 21,250
Subsequent	200,000,000	13,333
1977	400,060,000	23,529

[1] Approximately.

Loans for rental housing in rural areas are available from Farmers Home Administration (FmHA) to provide living units for persons with low and moderate incomes and for those age 62 and older. Loans may be made for housing in open country and communities up to 20,000 people, but applicants in towns of 10,000 to 20,000 should check with their local FmHA office to see whether the agency can serve them.

All phases of this program are available to persons of either sex or any race, creed, color, or national origin.

How may loan funds be used?

Loans are primarily made to build, purchase or repair apartment-style housing, usually consisting of duplexes, garden-type, or similar multiunit dwellings. The housing must be modest in size, design, and cost, but adequate to meet the tenant's needs.

Funds may also be used to: Buy and improve the land on which the buildings are to be located; provide streets and water and disposal systems; supply appropriate recreation and service facilities; install laundry facilities and equipment; landscape, including lawn seeding, shrubbery and tree planting, or other measures to make the housing an attractive addition to the community.

Funds may not be used for nursing, special care or other institutional types of housing.

Who may borrow?

Eligibility of applicants will be determined by Farmers Home Administration. Borrowers should have the ability and experience to operate and manage a rental housing project successfully.

Rental housing loans can be made to individuals, trusts, associations, partnerships; limited-partnerships, State or local public agencies, consumer cooperatives, and profit and nonprofit corporations. Nonprofit corporations may be organized on a regional or mutlicounty basis.

Borrowers must agree to provide rental units for occupancy by eligible indiviluads or families. They must be unable to finance the housing with personal resources and, with the exception of State or local public agencies, be unable to obtain credit from other sources on conditions and terms which would permit them to rent units to eligible families. If the borrower is a profit or limited-profit organization, the assets of the individual members will be considered in determining whether other credit is available.

FmHA will deal only with the applicant or his authorized representative. In the case of a nonprofit applicant, the representative must have no pecuniary interest in the housing site, the award of contracts, or purchase of equipment.

Does FmHA limit the borrower's profit?

In cases, rent charges must be within limits that eligible occupants can afford to pay. Borrowers are required to deposit rental income in special accounts and establish reserve funds to meet long-term capital replacement needs. Limited-profit borrowers are allowed an 8-percent return on their initial investment in a project.

Who may occupy the housing?

The housing is for families and individuals with low and moderate incomes, and for senior citizens age 62 or over. The maximum income

level for occupancy will be established by the Farmers Home Administration.

What are the terms?

The maximum repayment period is 50 years for projects designed for senior citizens and 40 years for all other projects. All applicants are required to provide initial operating capital equal to at least 2 percent of the cost of the project. For nonprofit organizations and State and local public agencies, the 2-percent operating capital may be included in the loan as part of the development cost.

Loans to nonprofit organizations and State or local public agencies can be up to 100 percent of the appraisal value or development costs, whichever is less. Loans to all other applicants are limited to not more than 95 percent of the appraisal value or development cost, whichever is less. Loans for the purchase of buildings less than 1 year old will, however, be limited to 80 percent of the appraised value.

Is the borrower expected to refinance the loan?

When the financial position of the borrower reaches the point that he can repay or refinance through a commercial lender, the loan contract provides that he shall do so.

How will planning and construction be performed?

Before a loan can be approved, applicants must provide detailed plans, specifications, and cost estimates. The applicant must provide complete architectural services, including inspections during construction. The Farmers Home Administration will review the plans and inspect the construction as it progresses.

A borrower who is a builder and capable of building his own project may obtain a loan under the same conditions as any other applicant. The builder-applicant may be permitted a contractor's fee which is typical for the area.

All borrowers are encouraged to obtain interim construction funds from local lenders. A borrower must show that local construction funds are not available before FmHA will provide such funds.

What are the construction standards?

All project development work such as buildings, streets, water, waste disposal, heating, and electrical systems must fully conform with applicable laws, ordinances, codes, regulations, and Farmers Home Administration requirements.

When can construction be started?

The borrower must wait until the loan is closed and authorization given by Farmers Home Administration to start construction. If interim construction financing is to be used, construction will start only after the loan is approved and funds obligated.

Where may housing be located?

The housing will be located on desirable sites in a residential area that is easily accessible to community services and amenities, with an assured supply of safe drinking water and suitable arrangements for waste disposal approved by FmHA. Housing will be arranged on the site in an attractive manner to accent and preserve the advantages of natural topography, trees, and shrubbery.

What information is needed?

The local county supervisor of the Farmers Home Administration will provide information on how to complete and file applications. Applicants must furnish: Complete financial information; preliminary plans, specifications, and cost estimates; a budget of anticipated income and expenses; survey information supporting the need for housing in the area.

Applicants may secure application forms and other sample FmHA forms for completing budgets and market surveys.

What about loan applicant fees and other charges?

Fees are not charged for appraisals or loan processing. However, the applicant pays for legal services necessary to guarantee that he has a satisfactory title to the site and for other incidental loan closing costs. These expenses may be included in the loan.

What security is required?

Each loan will be secured in a manner that adequately protects the financial interest of the Government. A first mortgage will be taken on the property purchased or improved with the loan except for public or quasi-public organizations that cannot give a real estate mortgage. In those instances the security will be determined by Farmers Home Administration.

How do these loans aid in rural development?

Rental housing loans are made through the Farmers Home Administration to help provide decent homes in suitable living environments. Good rental units give a balanced housing program to a rural community and make it a more desirable place to live. An adequate supply of quality housing helps check the flow of rural people to urban areas by encouraging families to live in rural communities.

The program raises living standards, creates a health environment for family life, and makes rural communities attractive locations for development and expansion of industries.

Rental housing loans stimulate economic activity in rural communities by increasing sales of building materials and home furnishings and by providing jobs for construction workers.

TAX REFORM ACT OF 1975

The House of Representatives Ways and Means Committee forwarded H.R. 10162, that is, Tax Reform Act of 1975, to the Senate Finance Committee for their consideration and recommendation of the Senate. The Ways and Means Committee specified certain low/moderate income housing programs administered by the Department of Housing and Urban Development (HUD) as receiving a 5-year extension pertaining to the LAL provision (limitation on artificial losses).

Section 470(c) subpart, page 30/31, H.R. 10612 in the Senate of the United States:

(3) Low Income Housing—In the case of low-income housing, this subpart shall not apply to real property if—

(A) before January 1, 1979, there is a subsidy commitment to support new construction or substantial rehabilitation under Section 8 of the United States Housing Act of 1937, as amended (or under the provisions of State or local law authorizing similar levels of subsidy for lower income families) and such com-

mitment was made before the beginning of the construction or rehabilitation of such property, and

(B) the construction period for such property begins before January 1, 1981.

Also included in the definition of the low-income housing are other low/moderate income housing programs sponsored by HUD.

Section 470, page 27, H.R. 10612:

(4) Low-Income Housing—The term "low-income housing" means—

(A) property with respect to which a mortgage is insured under Section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State of local laws, and with respect to which the owner is subject to the restriction of Section 1039(b)(1)(B), or

Section 1039(b)(1)(B) IRS code—

(b) Definitions—for purposes of this section

(1) Qualified Housing Project—term "qualified housing project" means a project to provide rental cooperative housing for lower income families—

(A) with respect to which a mortgage is insured under Section 221(d)(3) or 236 of the National Housing Act, and

(B) with respect to which the owner is, under such sections or regulations issued thereunder—

(i) limited as to the rate of return on his investment in the project, and

(ii) limited as to rentals or occupancy charges for units in the project.

(Further explanations of LAL provisions and low/moderate income housing, Tax Reform Act of 1975—Report of the Committee on Ways and Means * * * on HR 10612, page 28-37.

FmHA rural rental housing program as previously described in a preceeding section, indicates that the program limits the amount of return the owner can acquire as well as the amount of rent which can be levied against tenants. Due to the restrictions and limitations which the low/moderate income housing programs place upon investors/owners, i.e., limited profit and restricted market, another incentive is required to enhance persons/companies to construct and manage low/moderate income housing.

Currently we are slowly recovering from a housing crisis which paralleled the lowest production points of the 1940's. Single family housing was reduced to extremely low levels and multiple family housing was impacted more severely. It is important that we recognize housing as a high national priority, and design/implement policies which maximize this goal.

Since Mr. Nixon's moratorium on Federal Housing programs in 1973, low/moderate income housing production has decreased to low levels, and there is an obvious need for housing of this type. The majority of builders/developers do not respond to this specified housing submarket due to a "possible" high risk and low return.

Currently the major emphasis in providing low/moderate income housing is through the "filtering process" and HUD's section 8 program. Neither currently are providing the needed units or functioning effectively. The only available housing program which provides low/moderate income housing in rural areas is the FmHA programs. For those persons in rural areas who do not have adequate moneys to purchase homes, rental units are a viable living alternative. FmHA rural rental housing program is the only rental housing program available to persons of low/moderate incomes within rural areas, and there is a well-documented need.

Appendix I.—History

SUMMARY

The Farmer's Home Administration (FmHA), an agency within the U.S. Department of Agriculture (USDA), was established in 1946. (Previous agency title: 1937–46, Farm Security Administration.) The primary objective of FmHA was to provide assistance to rural farm-related problems, which included loan programs for farm ownership.

The FmHA housing delivery system that currently exists, evolved from a series of legislative acts concerning both housing and rural development. These were:

Federal Housing Act of 1949.—Legislated the responsibility of FmHA to provide housing to the farm industry.

Federal Housing Act of 1961.—Authorized FmHA to obligate housing loans to persons residing within a rural incorporated community of up to 2,500 persons. (Current 502 single family housing program.)

Senior Citizens Housing Act of 1962.—Established loans for low-rent apartment projects for elderly persons (62 plus years). (Current 515 multifamily housing program.)

Federal Housing Act of 1965.—Raised population limit of rural areas to 5,500 persons.

1966.—Eligibility was equalized for senior citizens and low-income persons in both rural housing (single family) and rural housing (multifamily).

Housing Act of 1968.—Established interest supplement housing loan programs for low-income persons.

Housing Act of 1970.—Again, raised the population definition of a rural area to 10,000 persons.

Rural Development Act of 1972.—FmHA was authorized to finance, construct, and market multifamily (515) housing projects through limited partnership syndication procedures.

Housing and Community Development Act of 1974.—Again, increased the definition of rural areas to include communities of up to 20,000 persons, not within an SMSA area. (Current status: Federal Register Review, December 1975, authorization by FmHA by March 1976.)

EVOLUTION OF FARMERS HOME ADMINISTRATION

Farmers Home Administration has tried to assist in the resolution of farm and rural problems. FmHA's sphere of influence and responsibilities has expanded since its legislative inception in 1933. Legislative acts and administrative directives have all assisted in the expansion of duties.

The linkage of FmHA can be traced back to the Resettlement Administration, a rural rehabilitation agency under the President created by Executive order in 1935. The agency now serves under its 11th administrator.

The Resettlement Administration absorbed depression-era programs that had been carried on in 40 States by Rural Rehabilitation Corporations formed under the Emergency Relief Act of 1933. Rural

Rehabilitation loans were intended to help farm families remain on the land and work their way off relief rolls.

During its 2 years of existence, the Resettlement Administration made hundreds of thousands of short-term loans, often supplemented by grants, to low-income farm families to help them become self-supporting. Resettlement also emphasized follow-up supervision over the progress of its borrowers, to help assure that the purpose of loans would more likely be achieved. Borrowers were given technical counseling in better management of farm and home finances and better farming methods.

In 1937, there was a growing conviction by the U.S. Department of Agriculture (USDA) and in Congress that supervised credit, as pioneered by Resettlement, could be the answer to a worsening national problem of hardship and failure among tenant farmers. On July 22, 1937, the Barkhead-Jones Farm Tenant Act was enacted. It created a new program of supervised 40-year farm ownership loans to farmers who lacked other sources of credit for buying their own land and for farm and home improvement. Administration of the act was given to the Resettlement Administration.

Also enacted in 1937 was the Water Facilities Act which provided loans for individual and association farm water systems in 17 western States where drought and water shortages were familiar hardships. Resettlement shared administration of this act with the Soil Conservation Service and Bureau of Agricultural Economics. It was the forerunner of present-day massive rural programs in water systems, waste disposal, and other rural community facilities now administered by the FmHA.

As administrative actions were taken to carry out the Farm Tenant Act, it was announced in September 1, 1937, that the Resettlement Administration would be renamed Farm Security Administration and placed under the Department of Agriculture. This change took effect in 1938.

In the ensuing 9 years, the Farm Security Administration (FSA) carried on supervised credit programs that enabled thousands of farmers to become farm owners. Farm and home counseling by county office staff was part of FSA's service to borrowers. FSA also carried on Resettlement-oriented projects to establish new farms and communities, services in group medical care, agricultural cooperatives, migratory labor camps, and other social and economic programs. In 1942, FSA also was given full responsibility for the water facilities program in the western States.

By 1946, it was generally conceded, both in and out of Congress and within the agency itself, that a restructuring of FSA was necessary, that some old Resettlement programs were no longer justified, that current programs could be improved, and perhaps new programs would be needed in the postwar period. Accordingly, in August 1946, Congress passed the Farmers Home Administration Act. This measure, which took effect in 1947, reconstituted FSA under the new name, Farmers Home Administration.

Combined in the new FmHA were some programs of FSA and the emergency crop and feed loan program. The latter, a service in short-term feed-seed-fertilizer loans to farmers in designated hardship

areas, had been originated through USDA in 1918, and carried on during 1933–46 through Production Credit Association of the Farm Credit Administration's agricultural credit system.

The Farmers Home Administration Act also gave FmHA new authority: to insure loans made by banks, other agencies and private individuals, as well as to make direct Government loans. The act brought an end to Rural Rehabilitation loans, of which over 3 million had been made since 1935 by Resettlement and FSA for a total exceeding $1 billion.

In its first 3 years, FmHA confined its operations to development of its supervised farm-ownership and farm-operating loan programs, and to water facilities projects in the western States.

The year 1949 brought the first of many additions to FmHA's portfolio of services, all made available to rural people through the now well-established system of FmHA county offices, which still currently exist.

The Federal Housing Act of 1949 gave FmHA the authority to make housing loans to farmers as a part of the national housing program. The Disaster Loan Act of the same year originated the special emergency farm loan for recovery from losses inflicted by natural disaster.

The Water Facilities Act was amended in 1954 to apply nationally, rather than in the area of 17 western States, and to let farm area water systems take on nonfarm customers in rural communities. Rural communities were defined at that time to consist of under 2,500 population.

Rural development was given Federal program status by USDA administrative action in 1955. FmHA's first involvement was a pilot program of loans to small farms inadequate to qualify even for regular FmHA loans. Rural development is planning, financing, and development of facilities in rural areas that contribute to making these areas desirable places in which to live and make private and business investments; the planning, development, and expansion of business in rural areas to provide increased employment and income; the planning, development, conservation, and use of land, water and other natural resources of rural areas to maintain or enhance the quality of the environment for people and business in rural areas; and processes and procedures that have said objectives as their major purposes.

In 1959, FmHA began to make loans to local governmental organizations covering the local share of cost in small watershed projects under Public Law 566.

A major overhauling and expansion of FmHA authorities came with passage of the Consolidated Farmers Home Administration Act of 1961. Its principal provisions—

Raised limits on farmer loans—to $60,000 for farm ownership, replacing a formula whereby each county's limit had been the average value of its family farms, and from $20,000 to $35,000 for farm operating purposes.

Opened up the water system program to the general rural population, including incorporated towns up to 2,500. The loan limit on a project (previously $250,000) was raised to $500,000 for a direct FmHA loan, $1 million for an insured loan.

Also in 1961, the Federal Housing Act was amended to make nonfarm rural residents eligible for FmHA's direct housing loans. This new jurisdiction in rural housing extended to towns of up to 2,500 population.

Still more expansion of FmHA services came in 1962. The Senior Citizens Housing Act set up loans for low-rent apartment projects designed to meet the needs of people age 62 and over—a type of housing acutely lacking in rural communities. Amendment of the FmHA Act authorized loans for shift in land use to outdoor recreational facilities built primarily to benefit rural people. The agency began to make loans to family farmers to set up farm-based recreation and other nonagricultural enterprises that would add to family income, and for association grazing ranges where family farmers and ranchers share the use of more grazing land for livestock production. A pilot program for rural renewal, delegated to FmHA, launched experiments in several States as to what could be accomplished through a concentration of resources to develop better community facilities, improved homesites, and better housing, and to attract new industry to underdeveloped rural areas. Rural renewal was discontinued as an experimental program in 1969. FmFA also was authorized in 1962 to make loans covering local project costs in areas eligible for benefits of a resource conservation and development program which, like the small watershed program, is supervised by USDA's Soil Conservation Service.

The Economic Opportunity Act of 1964 established loans to low-income rural people for small farm improvements or nonfarm enterprises that would add to family income. FmHA performed the lending through its county offices, with funds provided by the Office of Economic Opportunity, until 1971. The agency made nearly 65,000 loans to individuals totaling $109.3 million, and 1,476 loans to cooperatives totaling $21 million.

The expansion of old programs and enactment of new ones during the first 4 years of the 1960's had raised FmHA's total loan and grant volume from the $300 million level of 1960 to $750 million in 1965. But this was only the beginning of the upsurge in FmHA services brought on by the large-scale rural housing and rural development programs enacted during the ensuing 10 years.

Rather than set up new agencies to administer new services, Congress and the administration continued to specify that FmHA's existing system and county offices, long experienced in serving rural communities, would be used as the delivery vehicle for the new and larger rural programs. As a result, FmHA's annual volume now has soared to the $4 billion mark.

The second major expansion of the 1960's in programs serviced through FmHA came under acts passed by Congress in 1965:

Rural housing was changed from a program of direct loans to one primarily of insured loans, and the population limit on towns served through FmHA was raised from 2,500 to 5,500. This opened the way for the annual volume of FmHA rural housing credit to rise from the $133 million level of 1965 to the multibillion-dollar level of present times.

The water facilities loan program was transformed into a loan-and-grant program for both water and waste disposal systems. Rural

towns of up to 5,500 were made eligible to be included in FmHA-financed projects, and the limit on FmHA financing of a project was raised to $4 million.

Rural housing programs were accelerated still more under legislation passed in 3 of the next 4 years:

In 1966, eligibility was equalized for senior citizens and young low-income families seeking FmHA rural housing loans or tenancy in rural rental housing.

In 1968, another overhauling of the Housing Act of 1949 established the interest-supplement housing loan program. It enables some low-income families to pay as little as 1 percent interest, and provides for subsidized loans to developers of low-priced rental housing for low-income families and senior citizens. New programs also were enacted in 1968 for rural homesite development loans and for grants toward support of "self-help" homebuilding group projects. Grants of up to 90 percent, as well as loans, were authorized for farm labor housing projects.

The Housing Act of 1970 permitted the population limit on a rural community where FmHA housing loans may be made to be raised to 10,000 (made effective in May 1971).

In 1970, legislation was passed to remove technical barriers to the use of investors' FmHA-insured funds, rather than direct appropriated funds, for loans to tax-exempt public bodies such as municipalities and public service districts. That year marked the beginning of a period of rapid growth and increased service to small towns.

The two most important recent legislative acts are summarized in the following pages; the Rural Development Act of 1972 and the Housing Community Development Act of 1974. Both delegated numerous responsibilities to FmHA and as yet the majority of sections of these acts have not been enacted into procedural rules.

RURAL DEVELOPMENT ACT OF 1972

As part of Richard Nixon's new federalism, a combination of revenue sharing and community development programs were directed toward decentralizing decisionmaking to the local governing level. The rural Development Act of 1972 was directed to modify and improve many long-standing, agriculturally oriented activity of the Department of Agriculture. This is important because it was directed and emphasized toward rural America. Its primary focus was to add new authority to the USDA programs for accelerating the development of rural areas.

The main rural development features are: (1) Community development, including loan and grant authority for water and waste disposal systems and related facilities, technical assistance and cost sharing for municipal and industrial water supplies, grants to organize and train local fire protection forces, and comprehensive planning grants; (2) business development, which includes guaranteed loans for commercial and industrial projects to improve the job opportunities in rural areas, small business loans, encouragement of one use of private credit institutions to make and service loans, authority for USDA to cooperate in joint financing arrangements with other Gov-

ernment agencies, and safeguards against increasing production when existing capacity is not being efficiently utilized; (3) research and extension in three programs—rural development extension, rural development research, and small farm research and extension activities; (4) natural resources programs which authorize grants for pollution abatement, provide for cost-sharing with landowners for conservation and environmental protection, and provide for a national land inventory and monitoring system; (5) national policy and administration that requires the establishment of national goals for various aspects of rural development and coordination of all Federal activities to accomplish rural development goals, provides authority over the location of all Federal field units concerned with rural development, directs all executive departments and agencies to give "first priority" to locating new offices in rural areas, and establishes an Assistant Secretary for Rural Development in USDA.

It is interesting that except for title VI, the RDA does not establist new types of Federal authorities, but merely adds to USDA program authorities that already existed elsewhere—thus adding to the proliferation of programs. The major innovations of the RDA are the requirement for setting national goals, the authority for coordination of all Federal and delivery systems and annual reports to the Congress in attaining these goals, all contained in section 603 of the act.

The Rural Development Act of 1972 was directed toward creating a viable and stable economic situation in rural areas. Employment opportunities would create a new demand for housing, and the Housing and Community Development Act of 1974 tries to meet this demand.

HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1974

Influence on FmHA and rural housing

The Housing and Community Development Act of 1974 was enacted on August 22, 1974, and will in the upcoming years influence the distribution of housing in all areas of America. This section will not discuss seven of the eight title sections that were enacted. Title V of the H. & C.D. Act pertains to rural housing and specific amendments which alters past sections of previous housing acts.

The act extends rural housing programs to territories and possessions of the United States which include Guam and the Trust Territory of the Pacific Islands. The various programs had already been in operation in Puerto Rico, and has functioned efficiently.

Both the 502 and 504 programs of single-family units pertain to some degree of rehabilitation. The dollar amount of rehabilitation has been increased from $2,500 to $5,000, which will hopefully foster more utilization of the various rehabilitation programs.

One of the most significant amendments was to redefine the term "rural", which is expanded to include places with a population in excess of 10,000 but less than 20,000 which is not contained within a standard metropolitan statistical area (SMSA). Also the area must have a serious lack of mortgage credit as determined by the Secretary of Agriculture and the Secretary of Housing and Urban Development. The previous definition only included those areas which had a population of

10,000. As of yet the total number of cities which qualify has not been determined throughout the United States. Oregon has approximately 10 cities which will qualify for FmHA funding.

Another important element deals with subsidy and assistance payments for low-income persons and families.

The Secretary of Agriculture is authorized to make and insure loans under the rural housing loan programs to provide rental on cooperative housing and related facilities for low-income persons who reside in multifamily housing projects. Assistance payments to owners of such rental housing are authorized to make housing available to low-income occupants at a rate commensurate to income and not exceeding 25% of income. Assistance payments are to be made on a unit basis and may not be made for more than 20 percent of the units in a project except that (1) projects financed by a Section 515 elderly housing loan, a Section 514, domestic farm labor housing loan, or a Section 516 domestic farm labor low-rent housing grant may receive assistance for up to 100 percent of the units; and (2) assistance payments for more than 20 percent of project units may be made when the Secretary determines such action is necessary or feasible. The Rural Housing Insurance Fund will be reimbursed by annual appropriations in the amount of assistance payments as described above.

The act also increases the total loan amount for 515 multifamily projects, from $750,000 to an unlimited loan amount, as long as adequate need on demand is justified.

Condominiums are authorized in both the 502 and 515 programs, to both low and moderate income persons.

The Secretary of Agriculture is authorized, in his discretion and upon terms and conditions (substantially identical insofar as feasible with those specified in Section 502) as he may prescribe, to incite and insure loans to low and moderate income persons and families to cover a one-family dwelling unit in a condominium located in rural areas. The Secretary also is authorized, in his discretion and upon terms and conditions (substantially identical insofar as feasible with those specified in Section 515) as he may prescribe, to make or insure blanket loans to a borrower who certifies that upon completion of a multi-family housing project, (1) each family unit will be eligible for a loan or insurance, and (2) each dwelling unit will be sold only on a condominium basis and sold only to purchasers eligible for loan or insurance.

The amendment which possibly will have the most impact and significance pertains to mobile homes. The term "housing" as used in title V of the 1949 Housing Act is broadened to include mobile homes. The term "housing" as used in title V of the 1949 Housing Act is broadened to include mobile homes and mobile home sites. The Secretary is directed to prescribe minimum property standards for mobile homes and the sites upon which they are to be located. Loans for the purchase of mobile homes and sites are to be made under the same terms and conditions as applicable under section 2 of the National Housing Act in financing the purchase of mobile homes and sites.

CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION,
Long Beach, Calif., April 22, 1976.

Mr. MICHAEL J. STERN,
Staff Director, Committee on Finance,
Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: The following testimony is entered into the record on behalf of the members of the California Independent Producers and Royalty Owners Association. Our association represents the independent oil and gas producers in the State of California.

GENERAL COMMENTS

The most damaging portion of the proposed bill is section 101, limitation on artificial losses. This section will severely impact the industry, but the small independent producer will be hurt the most.

This section is so punitive that it may cause the demise of many independents. Only independents rely on outside capital investments to finance, or aid in financing, a large percent of their drilling activities. The proposed capitalization of "development well" intangible drilling and development cost will remove a large amount of risk capital that independents now receive. The money will be invested elsewhere, because the tax incentives for risking investment dollars in drilling projects is being altered, or removed.

The "ripple effect" of this loss of capital is far reaching. The reduction of drilling dollars will cause a reduction in drilling activity. This means a reduction in employment and taxable income dollars.

Many independents may be forced out of business, causing a consolidation of the industry into larger companies, but the most significant impact will be an increase in our reliance on expensive, unreliable foreign oil imports.

REDUCTION OF CAPITAL/DRILLING

Section 466(b) of the proposed bill places intangible drilling and development cost from development wells into a "deferred deduction" program. Page 55 of the House Ways and Means Committee summary states:

In many cases a deduction for intangible drilling cost is not essential to stimulate additional drilling. This is particularly true given the increases in prices of new oil in recent years, for wells other than exploratory wells which are drilled after a new reservoir of oil has been tapped.

The author fails to consider the fact that intangible drilling deductions provide needed cash flow for development wells required by lease obligations. Even with the very optimistic projections of 70 percent to 80 percent success in "some areas" (as indicated in the committee summary), borrowing the needed money from a bank is not feasible. Independent producers would have to use other producing properties as collateral, thus limiting the number of wells drilled to their proven reserves. The added cost of the money would also necessitate a higher level of commercial production from the well, and some prospects may not be drilled due to this added cost.

Although exploratory wells may deduct intangible drilling cost, the selection of an arbitrary 2-mile distance from existing production for qualification as exploratory is absurd. The oil industry classifies exploratory wells as wells seeking new reserves, regardless of distance. In California, some wells offsetting production are exploratory, but would not be drilled under this requirement. Geological information gained from offset wells is often used in developing new oil prospects, and these prospects may be lost.

Exploratory wells "not more than 2-miles" from production will be permitted, but investors will not know if such wells qualify for IDC deductions until after their drilling money has been spent. This potential change of categories for the IDC deductions will be detrimental to raising funds for drilling within 2 miles of another property.

The bill is also retroactive to the first of the year, yet no agency exists to determine if a well drilled within 2 miles "taps" a reservoir from which there has been "significant oil or gas production". This requirement is outlined in section 470, subparagraph (a) (6) (ii), and states:

The taxpayer establishes (in the manner provided in regulations prescribed by the Secretary) by maps and other evidence that the well will not tap any reservoir from which there has been significant oil or gas production.

Independents will be faced with the impossible, and unfair situation of proving (according to regulations of someone prescribed by the Secretary) that exploratory wells drilled since January 1, 1976, to the passage of the bill, be qualified as exploratory and subject to IDC writeoff provisions.

Also, what is the definition of "tap" and "significant production"? Until these terms are clearly defined (by a person yet unnamed), this section of the bill would only add confusion to the industry.

The proposed bill will destroy the incentive to complete marginal wells. Investors may prefer to take a loss, rather than tying up their funds for a long-term payout, because of the "deferred deduction" provisions of the bill.

The bill further discriminates against the independent producer by requiring that deductions be taken on a property by property basis. Most all other businesses can write off the loss from one source against another profitable source.

REDUCTION OF EMPLOYMENT

Gainfully employed persons in the oil and gas producing industries will be proportionately reduced by the percent that independents are forced to curtail their drilling. In 1974, the industry spent approximately $9 billion in exploration and development. Approximately $4 billion of this was spent by independents and their investors.

Employment in this segment of the industry, nationwide, was approximately 302,000 persons, with 22,600 employed in our State. These persons drilled a total of 31,700 wells of which 22,400 were development wells. In California, 1,918 development wells were drilled compared to only 235 exploratory wells.[1]

Since independents drill the majority of the wells in the Nation, and since only independents raise outside capital to fund this drilling activity, and since the majority of wells drilled are development wells, the adverse impact on employment seems obvious, and employment by independent producers will suffer the most.

REDUCTION OF TAXABLE INCOME

Although the Ways and Means Committee estimated an increase in collected tax revenue over the next 3 years, Government tax revenue may decline. Using a conservative economic turnover factor of five, the independent producer contributed $20 billion to our Nation's economy in 1974. If invested capital declined by only 10 percent ($400 million), the net loss of tax revenue would be a conservative $200 million, or roughly the equivalent of the estimated increase in

[1] Source: American Petroleum Institute's Quarterly Statistical Review.

revenue under the LAL provisions of the Tax Reform Act. (See attached calculations.)

Congressman Morris Udall (D-Arizona) recently stated on national television that no tax "reform" bill ever increased tax income to the Treasury. We agree with the Congressman's analysis.

CONSOLIDATION OF THE INDUSTRY

In the last 20 years, the number of independent producers in the United States has dropped from 20,000 to approximately 10,000. This 50-percent decline was due to an increase in the cost of domestic drilling and production, the low domestic price for crude oil and natural gas, and adverse tax legislation, such as the Tax Reform Act of 1967.

As these independents went out of business, their holdings were taken over by larger companies or abandoned. Loss of IDC writeoffs on development wells could cause further reduction in the number of independents.

There is no reason for an independent producer to risk his after-tax dollars on development drilling when there are many other business opportunities available. Loss of IDC writeoffs will cause many of these independents to sell to larger companies that do not rely on investor capital for development drilling. This will lead to less competition in the industry when many of our legislators are asking for more competition.

INCREASED RELIANCE ON FOREIGN OIL

Domestic production has declined to the point that we now import nearly 50 percent of our crude oil. Projections for 1980 indicate this will increase to 60 percent unless drastic measures are taken to increase domestic production; however, it seems that the Congress fails to realize the significance of energy independence.

In less than a year and a half, over $5 billion has been removed from the industry because of depletion allowance losses and the rollback of prices under the Energy Pricing and Conservation Act. During the same time period, the cost of drilling and production has increased tremendously. Now the industry is faced with another disincentive in the Tax Reform Act of 1975.

If we are to develop a strong domestic industry, the Congress must propose tax relief, not additional tax burdens. Yet, adverse legislation such as H.R. 10612 and the recently proposed increase in minimum tax on preference income (expanded to include intangible drilling and development cost, and depletion) all remove risk capital from the producing industry.

SUMMARY

If the proposed Tax Reform Act, or the proposed expansion of minimum taxes on preference income are voted into law, the net effect will be:

1. A reduction in available capital for domestic drilling.
2. A further reduction in the number of independent operators, and a resulting reduction in drilling activity.

3. A reduction in employment in the oil and gas producing industries.
4. A resulting reduction in the amount of taxable income to the Government.
5. More consolidation of the industry into larger companies.
6. An increased reliance on expensive, unreliable foreign oil.

The proposed Tax Reform Act imposes a condition wherein the independent oil and gas producer and his investors do not know what their tax situation will be until after they drill. This is an impossible condition, injurious to the Government, the industry, and the American people.

Thank you for this opportunity to comment.

Sincerely,

JAMES H. WOODS,
Executive Vice President.

CHART 1

APPROXIMATE REDUCTION IN TAXABLE INCOME

[In billions of dollars]

	Under current tax laws	Under tax reform changes
1974 exploration and development expenditures by independents	[1] $4.0	[1] $4.0
Conservative 10-percent reduction		.4
Adjusted capital amount		3.6
Economic turnover factor	[2] 5	[2] 5
Total economic impact	20.0	18.0
Net reduction in taxable income	$2.0	
Estimated income tax (percent)	10	
Potential tax loss (per year, based on 1974 data)	$0.2	

[1] Independent Petroleum Association of America (approximate).
[2] U.S. Department of Commerce (circulation factor of $1 through the U.S. economy).

STATEMENT ON BEHALF OF THE AMERICAN HORSE COUNCIL, INC.

This statement is filed on behalf of the American Horse Council in response to the request by the Committee on Finance for comments in regard to H.R. 10612, the tax bill passed by the House in December of 1975.

The American Horse Council is a nationwide trade association representing a membership of approximately 2 million horsemen. These members are a cross section of the American people—men, women, and children from all economic segments of society. The council has 78 member organizations including breed registries, breeders associations, racing associations, professional associations, commercial organizations, and activity groups.

Thus, when the council speaks for horse owners and breeders, it is not speaking about just race horses since the majority of the members of the horse council are not engaged in racing.

While no official census of the U.S. horse population is available, estimates indicate that there are now over 8 million horses in this country—double the number recorded in the 1960 agricultural census.

The horse industry is a $13 billion industry which provides hundreds of thousands of jobs to people throughout the country. The racing segment of the industry alone produces over one-half billion dollars in parimutuel taxes to the 30 States which have parimutuel racing.

From the standpoint of the horse industry, particularly horse owners and breeders, there are several provisions in the House-passed tax bill which cause concern.

LIMITATION ON ARTIFICIAL LOSSES—LAL (SECTION 101 OF THE BILL)

The major concern of the council is the imposition of the "limitation on artificial losses," referred to as LAL, on equine farming operations. While certain changes were made in the House bill by the Ways and Means Committee to ease the impact of LAL on the farming industry, the council remains strongly opposed to the LAL concept.

The LAL approach is extremely complicated and discriminatory. In our judgment, LAL could prove to be as unworkable as the excess deductions account provision which, as discussed below, has been a source of confusion since its inception. Many questions as to treatment of income, deductions, dispositions, et cetera under LAL are not answered by the explanation accompanying the House-passed bill.

Moreover, as applied in the Tax Reform Act of 1975, the LAL concept has become a means of discriminating against a few industries, one of which, unfortunately, is farming. We do not believe that the record before the Ways and Means Committee warranted inclusion of horse owners and breeders under LAL. While there have been claims of abuses in some areas, horse farming is certainly not in this category.

The American Horse Council believes that tax reform should take the form of a universal program which is not limited to a few industries in an attempt to "plug loopholes." The abuses which have arisen through the distortion of legitimate tax incentives enacted by the Congress in the past will lose their appeal if the final tax reform package imposes unavoidable obligations on all taxpayers. Such an approach would be designed to force each investment decision to be examined on its own merits without the possibility of a 100-percent or better return from tax savings alone. In this manner, the Congress could cure the flagrant abuses and apply tax reform in an even-handed manner.

One possible approach to the problem is the "at risk" limitation on deductions which is presently contained in the House bill. The council concurs with other livestock organizations which have testified before the committee that this measure would be adequate to close the door on so-called farm tax shelters.

Another avenue is an alternative minimum tax which has received much attention in recent weeks. However, if the Finance Committee does decide to adopt alternative minimum tax measures, the council would like to have the opportunity to work with the commitee and its staff as the legislation develops.

In the event that the LAL approach is adopted by the committee, the council strongly urges that the provision be amended to change the definition of a "farming syndicate."

LAL would limit certain losses to the extent such losses result from farm-accelerated deductions. Generally, accelerated deductions relat-

ing to livestock are (1) prepaid feed, seed, and other similar prepaid items, and (2) the accelerated portion of depreciation. However, in the case of a farming syndicate, preproductive period expenses, such as the cost of raising animals, are also included as accelerated deductions subject to the LAL limitations.

The House bill defines a farming syndicate as (1) a partnership engaged in farming which is registered with a Federal or State securities agency, (2) a partnership engaged in farming if more than 50 percent of the losses are allocable to limited partners, and (3) any other farm enterprise if it is registered under Federal or State securities laws or if the allocation of losses is similar to an allocation of more than 50 percent of the losses to a limited partner. The committee report states that this latter category includes "many forms of organization of farm enterprises such as general partnerships, agency relationships created by management contracts, trusts, and interest in subchapter S corporations." The report goes on to state that a "person is similar to a limited partner if he does not actively participate in the operation or management of the farm." [1]

The definition of farming syndicate as interpreted by the committee report would appear to affect many horse owners and breeders and other legitimate farmers who are not engaged in business for tax shelter reasons. For example, a number of farmers use limited partnerships for estate planning purposes. Under these limited partnerships, the principal equity owner is no longer active in the business but is a limited partner. This would not appear to be the kind of situation that should be subject to the limitation on the deduction of preproductive period expenses. It is extremely complicated and costly to account for these expenses.

Accordingly, we recommend that the definition of "farming syndicate" under LAL be restricted to mean only a partnership engaged in farming if at any time interests in such partnership have been offered for sale in an offering required to be registered with the Federal securities agency having authority to regulate the offering of securities for sale.

ACCRUAL ACCOUNTING FOR CORPORATIONS ENGAGED IN FARMING (SECTION 204 OF THE BILL)

The bill requires corporations engaged in farm operations, other than subchapter S corporations and family corporations, to use the accrual and inventory accounting methods for farm operations. This provision is objectionable for a variety of reasons.

Farm corporations are frequently used for estate tax planning. They are by no means necessarily large corporations. Even though there is an exception for family corporations, over a period of years many family situations can change causing the corporation to no longer come within the exception for family corporations. For example, three first cousins could become 100 percent owners of corporate stock previously owned by three brothers and the corporation would then not qualify as a family farm.

[1] Report of the Committee on Ways and Means, p. 47.

It appears inconsistent to say that a corporation owned by three first cousins—which does not elect a subchapter S—is required to use the accrual method of accounting while a subchapter S corporation which has 10 shareholders who are totally unrelated can continue to use the cash method of accounting.

In short, the provision is discriminatory. The tax law should require taxpayers engaged in similar businesses to use the same general method of accounting.

Therefore, the council recommends that this provision be deleted from the bill. If in fact there is concern about a regular corporation using farm losses to offset nonfarm income, all corporations, not just family corporations and subchapter S corporations, could be placed under LAL. This would mean that similarly situated taxpayers are at least given similar tax treatment.

REPEAL OF THE EXCESS DEDUCTIONS ACCOUNT (SECTION 203 OF THE BILL)

The House bill provides that no additions to the complicated excess deductions account—section 1251 of the Internal Revenue Code—are required for tax years beginning after 1975. Under EDA, farm losses—subject to certain exemptions—are placed in an account and recaptured as ordinary income against gains from the sale of most farm property.

The council wholeheartedly endorses this much-needed change to the current tax law. Unfortunately, the change does not go far enough since it leaves on the books indefinitely EDA accounts which have occurred prior to 1976.

Statements by the chairman of the Ways and Means Committee, the Treasury Department, and the farm community were all in agreement on the fact that this provision is overly complicated and nearly impossible to properly administer. The proposed regulations under EDA, which are 48 pages in the Commerce Clearing House Tax Reporter, are almost incomprehensible. With the termination of future additions to EDA, it is doubtful whether the Internal Revenue Service will ever finalize these regulations. This means that if EDA is left on the books for prior years, both the IRS and taxpayers will have to try to understand and apply this section under unworkable and unintelligible rules.

In view of this, it hardly seems good tax policy to leave existing EDA accounts dangling for many years into the future because of a provision in the tax code which has been repealed for most purposes.

For these reasons, the American Horse Council recommends that the EDA provision be completely repealed for tax years beginning after 1975. This would eliminate EDA accounts after this year, but would not affect sales completed prior to 1976.

Alternatively, if the committee does not completely repeal EDA for tax years beginning after 1975, the council suggests three technical changes to improve the provision: (1) Elimination of the possible double recapture of depreciation deductions under section 1251; (2) removal of soil and water conservation expenditures and land clearing expenditures of farmers from recapture under section 1231; and (3) elimination of the restriction which causes recapture of the divisive

reorganization of a farm corporation, thereby making EDA the same as other recapture provisions in the code.

Thank you very much for allowing the American Horse Council this opportunity to express its views on H.R. 10612.

Summary of Statement of Charles H. Priddy, President of Magnatex Corp.

1. Magnatex Corp. expresses its deep concern over the proposed disallowance of current deductions for intangible drilling costs. This proposal, the latest in a series of Government actions, is greatly inhibiting the exploration for new domestic sources of oil and gas. The statement presents a specific case study, setting forth the actual impact the proposed legislation already has had on Magnatex, a typical small independent oil and gas operation.

2. The proposed changes have failed to take into account the large risks involved in discovery and development of new sources of oil and gas. Because of these risks, which are significantly greater than in most other businesses, tax incentives are critically important, especially at the small producer level, in attracting the capital investment necessary to sustain such operations.

3. The attempt in H.R. 10612 at distinguishing between exploratory and development wells seriously misconceives the realities of oil production and therefore fails to provide sufficient tax incentives for continued exploratory activity. The attached statement contains an alternative definition which recognizes the risks inherent in all drilling operations through utilization of existing State well-spacing standards.

4. The passage of this legislation by the House has already created uncertainty in the petroleum industry, causing serious reductions in drilling rig utilization, domestic oil and gas production and available venture capital, all at a time when Congress should be pursuing our Nation's goals of increased domestic production and reduced dependence on imported oil. Magnatex respectfully urges the Congress not to overlook the realities of oil production and this Nation's need for a continued reliable and economical supply of energy. To do so in an attempt to resolve one problem of national concern will constitute a grave disservice to the people of this Nation who rely on domestic petroleum for their continued well-being.

STATEMENT

My name is Charles Priddy. I am president of Magnatex Corp., a small, independent oil and gas producer located in Midland, Tex. This statement is being filed with your committee as part of its record of the hearings on tax reform to express my company's deep concern over the provisions of H.R. 10612 that would disallow current deductions for intangible drilling costs.

This legislation is the latest in a series of Government actions that are materially inhibiting the exploration for new domestic sources of oil and gas. The passage of this cutback in the deduction for intan-

gible drilling costs by the House of Representatives, with the uncertainty created in the industry by such action, has already caused:

(1) A serious reduction in drilling rig utilization;

(2) A reduction in domestic oil and gas production; and

(3) A drastic decrease in available venture capital with which to engage in further oil and gas exploration.

This trend will, of course, accelerate if the proposal is enacted into law.

I submit that making such a change in our tax laws in the name of tax reform at this point in our Nation's history is manifestly ill-timed and unwise. At the very time that Congress should be developing new incentives for the discovery and development of domestic sources of oil and gas, tax reformers are proposing to eliminate a long-standing rule whose very purpose is to encourage exploration for these critical natural resources. Clearly the denial of the current deduction of intangible drilling costs would be directly contrary to our country's goals of increased domestic production and reduced dependence on imported energy.

Description of Magnatex—a typical small independent oil and gas producer

Much has been said along these lines in general terms. I would like to take this opportunity to speak more specifically about Magnatex Corp., a smal oil and gas operation, one with which I am intimately familiar, and one which is typical of a great number of independent oil and gas operations. As you know, it is the independents who are responsible for drilling about 85 percent of all exploratory wells in the United States each year.

The exploration division of Magnatex accounts for some $3 million of drilling activity per year in the Permian Basin area of west Texas. The funds for these activities are raised from persons both within and without the industry.

Midland is a part of the Permian Basin which comprises some 100,000 square miles covering 27 counties in central-western Texas and four counties in southeastern New Mexico. The population of the area is approximately 500,000 and the 96,000 wells in the area produce some 2.1 million barrels of oil per day and approximately 8 billion cubic feet of gas per day. This amounts to approximately 25 percent of the crude oil produced in the continental United States and some 20 percent of the natural gas. The area is largely dependent upon the petroleum industry as its source of livelihood, as are its two largest cities, Midland and Odessa, which together comprise some 40 percent of the area's population.

Negative effects of recent Government action on the petroleum industry in the Permian Basin

As I have indicated, the petroleum industry in the Permian Basin has been very adversely affected by several recent actions of the Federal Government. The first, the repeal of the depletion allowance for major companies, decreased the moneys available for exploration in our area by a substantial amount. Estimates of this amount vary from $500,000 to $1 million per day, but this is a difficult figure to determine since some of the companies affected were already using cost depletion rather than percentage depletion.

The second injury to the available capital market was caused by the rollback of the price of new oil which reduced the income in the Permian Basin area by a more precisely measurable figure, approximately $2 million per day.

The third damaging Federal action is the threatened disallowance of the intangible drilling costs as a current deduction. This proposal has already had a definitely negative psychological effect upon the plans for industry drilling during 1976. This effect is most accurately measured in terms of drilling rig activity. As of March 8, 1976, there were 308 drilling rigs available in the Permian Basin, 96 of which were not being utilized. During this same period of 1975, only 12 rigs were not being utilized, and in 1973 only 24. It should be noted that the number of active rigs has decreased from a high of 276 in November 1975 to a 3-year low of 212 in March 1976, all at a time when vital national policies seek increased domestic production and less dependence on foreign sources of oil.

Basic differences between oil exploration and other businesses warrant different tax treatment

It would appear to me that the purpose of the Tax Reform Act of 1975 in its purest form is to simplify the tax structure and make it applicable in a more uniform manner to all persons and to all businesses. Magnatex believes, however, that it is extremely important for this legislation to continue to recognize that certain types of businesses have inherent risks which need tax incentives to make them function viably in the marketplace, especially when the product they produce is vitally important to our national well-being. One such business is the oil-producing industry with the attendant high risks involved in the discovery and development of new sources of petroleum. Congress should not attempt a shotgun approach to tax reform that will purportedly resolve one problem of national concern while serving only to intensify another.

A better and more ready understanding of the high risks and unique problems involved in oil production may be obtained by comparison with the problems of other industries. Since we at Magnatex are involved in other types of businesses, such as objective comparison is realistically available to us. For example, before we initiate a new business venture, we always conduct a market survey in an effort to project the economic feasibility of the project. Such a market survey is not very much different in concept from the geological and geophysical work which is required before an oil well is drilled. Where a manufacturing enterprise is involved, one would attempt to establish total costs by carefully studying the product to be developed and by determining through trial runs the labor as well as the material costs involved. With a manufacturing enterprise, these costs can be fairly accurately determined and will indicate the minimum sales volume that must be achieved if the new venture is to succeed.

Similar economic studies are involved in preparation for drilling an oil well. However, the equivalent to the market potential in the case of a manufacturing enterprise is the vast unknown as to the amount of oil reserves to be encountered. This vast unknown highlights the large difference between the risk involved in evaluating whether to engage in a new manufacturing enterprise and that in-

volved in drilling a new oil well. The difference stems from the inherent technological difficulties involved in dealing with a commodity that is located from 2,000 to 30,000 feet below ground with tools of evaluation which, at the very best, are blunt.

The factors involved in assessing the risks of developing a petroleum prospect include a combination of geology, economics, and personal opinion. The geological factors relate to the discovery of an oil or gas reservoir beneath the Earth's surface. The discovery of a new petroleum pool, however, is not enough; there must be enough recoverable oil and gas discovered to return a profit above and beyond all costs of exploration, drilling dry holes, and operation. These are the economic factors, and they involve considerations of the price of petroleum, geological and geophysical costs, lease costs, drilling costs, depletion, and taxes. It must be noted again that Congress has already taken action which seriously affects two of these economic factors—the price of petroleum and depletion.

Even once a reservoir is pinpointed geologically, it remains impossible to predict the economic viability of a recovery process. This is because the technology developed in the drilling industry is, unfortunately, far from perfect, and unanticipated problems are the rule rather than the exception. In many cases, numerous test wells will have to be drilled before a productive well is located, and in most cases there is not sufficient information gathered as the well is drilled to stop the venture at any point below its target depth. This is quite a different situation from that found in a normal business venture where trends of sales, and so forth become apparent early in the venture and can indicate that the project should be discontinued long before a complete loss is incurred. In the petroleum industry, even on a highly rated prospect, the operator normally encounters such difficulties as casing failures, lost circulation, blowouts, directionally drilled holes, stuck drill pipe, and lost holes. Those of us involved in the petroleum industry recognize these as the unseen and unpredictable risks which make an extra incentive mandatory if the petroleum business is to continue to operate as a viable economic entity.

The "exploratory well" definition is basically ill conceived

The proposed legislation has attempted to recognize the need not to discourage continued exploration for new oil and gas resources by excepting the intangible drilling and development costs incurred in connection with "exploratory wells" from the limitation on artificial loss provisions. Unfortunately, this distinction is misplaced because the risks inherent in oil production do not disappear based on a differentiation between an exploratory and a development well. The risk of not obtaining production, if a successful economic penetration is made to the depth desired, is reduced in the drilling of a development well. Nevertheless, because of the problems inherent in all drilling technology, the reduction in risk is not all that great. Accordingly, while there is a difference between an exploratory well and a development well, each of these ventures involve risks far beyond those of the normal business venture. As a result, continued tax incentives must be provided for all such drilling operations if the national interest in increased domestic production and decreased dependence on foreign sources of oil is to be fulfilled.

If the concept of an exploratory well is nevertheless to be retained it should be modified so as to conform to the practical and understood realities of the oil producing business

As its primary position Magnatex believes that any attempt to distinguish between so-called "development" and "exploratory" wells is counter-productive. However, if such a distinction ultimately becomes a part of the tax law Magnatex strongly feels that the proposed definition of "exploratory" well needs radical revision because it is totally inconsistent with industry concepts and is not based on sound geological and engineering information. The proposed definition seeks to distinguish between "exploratory" and "development" wells on the arbitrary basis that an exploratory well consists of a well each point on which, at the time the well is completed, is more than 2 miles from the nearest point on the nearest producing well or which is completed 2 years or more after the completion of the last producing well that is less than 2 miles away. Furthermore, other provisions of the legislation would make it virtually impossible to determine with any degree of certainty whether a well would qualify as an "exploratory well" until after the well was completed.

I believe that this proposed definition is arbitrary and unnecessarily complex and is based on no sound technological foundation. Under the proposed definition a large portion of those wells which are in fact "exploratory," as the term is recognized in the petroleum industry, will be excluded from the tax incentives necessary to stimulate exploration. Furthermore, the uncertainty resulting from possible after-the-fact disqualification of an exploratory well is likely to act as a further deterrent to investment and exploration for new oil reservoirs in the immediate vicinity of existing wells.

More specifically, the proposed definition fails to take into account accepted petroleum industry concepts as to what constitutes an exploratory well and what constitutes a development well. The generally accepted industry definition of a development well is one which is drilled on a minimum risk property to enhance and improve the daily productive capacity of a given reservoir in a given field. Development, therefore, is more for the purpose of maintaining daily capacity than it is for proving the existence of producible reserves. An exploratory well, on the other hand, is recognized by the industry as a well which is drilled in unproven or semiproven territory for the purpose of ascertaining the presence of commercially producible reserves.

As has aleady been indicated, one cannot determine with absolute certainty the existence of commercially producible reserves until drilling is completed. Furthermore, the legislative definition does not take into account the fact that adjacent wells may be producing from different fields or from different reservoirs. For example, where a field is confined by a fault it is very possible that a well drilled adjacent to an existing well and within the 2-mile limit of the proposed definition would be tapping an entirely different field quite unrelated in terms of risk to the field already producing.

Also, the risks involved in drilling for nonproducing reservoirs within the confines of an existing field are equivalent to those involved in drilling for similar reservoirs quite far from an existing field.

As we see it at Magnatex, the problem is one of arriving at working definitions that are both administratively feasible and recognize the

risks inherent in oil drilling operations. In terms of administration, the major oil producing States have already established "field spacing regulations" designed to regulate the number and spacing of wells producing from given reservoirs and given fields. For example, the State of Texas has established statewide spacing standards ranging from 40 acres on oil wells to 160 acres on gas wells. These spacing requirements may be increased at a hearing before the Railroad Commission of Texas, but in general will not be decreased. For practical purposes, the Railroad Commission maintains the 40-acre spacing on shallow wells (down to 7,000 feet) and will allow 80-acre spacing on deeper wells because the pressures encountered in the deeper depths will allow more adequate drainage and recovery on larger spacing units. Magnatex believes that the Congress should utilize, to the greatest extent possible, existing concepts of exploratory and development wells and existing State conservation and spacing systems in arriving at workable procedures for implementing the proposed tax changes.

With this in mind, Magnatex suggests that a much more sound and workable definition of exploratory wells would relate to existing State spacing standards where such standards are available. A workable definition of an exploratory well that should be provided as an option to the existing definition would be:

> Any well drilled more than one field spacing unit from any other well producing in the same reservoir in the same field.

Such a definition recognizes the risks inherent in passing over an adjacent, undeveloped spacing unit to explore for reserves which would not be expected to be recovered in a reasonable length of time through existing wells, as opposed to the drilling of minimum risk properties on adjacent spaces in order to enhance and improve the daily productive capacity of the existing reservoir.

Furthermore, in order to qualify an exploratory well a taxpayer should only have to establish, on a prospective basis, that a well will recover oil that is not expected to be recovered in a reasonable period of time from existing wells. Investors must not be subjected to the uncertainty involved in post-drilling disqualification.

The definition of "property" is overly broad

Another area where the legislation has failed to recognize the risks inherent in a total drilling operation is in its definition of the term "property" as it relates to the source of income against which intangible drilling costs may be expensed. The legislation proposes to limit deductions to the extent of net related income from the same "class of property" and the definition of "property" requires each oil and gas property to be treated as a separate class of property for purposes of determining deductions. Thus, the intangible drilling expenses with respect to one oil or gas property could not be utilized to offset the income from another such property regardless of the proximity of the properties, geographically, or geologically.

To the extent that this definition would require each well to be treated as a separate property, Magnatex believes that it fails to recognize the economics of oil production where many test wells and dry holes usually have to be drilled in order to prove the reserves of a given reservoir and to establish commercial levels of production.

The limitation resulting from the definition of property proposed would be similar to permitting a manufacturing concern to deduct research and development costs only from the income produced by a particular new product line which resulted from such research and development efforts. The fact that research and development costs can be written off against the total lines of a company of course encourages the company to engage in additional research and development that may or may not produce more viable and more useful economic products. Any other tax treatment would serve only to discourage such additional development.

The same is true in the case of the petroleum industry. Any attempt to limit recovery of intangible drilling costs on less than a reservoir basis will serve only as a disincentive to the increased petroleum production so necessary to our Nation's well-being. Furthermore, any required calculation of costs on a well-by-well basis would impose an extreme hardship since, in general, central tank batteries are maintained with respect to a given lease whether it encompasses 40 acres or 4,000 acres. The production from all the wells on such leases are normally pumped to, measured and sold from a central battery. A typical tank battery for a small lease represents an expenditure of perhaps $50,000. Under the proposed definition, if producers were required to measure production on a well-by-well basis it would require the installation of new tank batteries and measuring devices for a large number of wells at an additional expenditure of $50,000 per well, which would serve only to unnecessarily inflate the price of petroleum products to the consumer.

The probable consequences if the House treatment of intangible drilling and development costs is enacted

These then are the economics and practicalities of oil production of which Congress must be aware before it acts in its enthusiasm to correct one problem of national concern at the expense of another. What will be the consequences of a failure to give adequate consideration to the economics of oil production? The provisions of the Tax Reform Act of 1975 that would discontinue the allowance of current deductions for intangible drilling costs have already had and will continue to have a major impact on oil production and especially on the small producer. The small producer, in particular, relies on outside capital for his exploration activities. To obtain or attract such investment he must compete in the capital markets with other types of investments that provide both economic gain and tax deferral benefits. The economic gain that the small producer can offer to prospective investors has already been materially reduced by the provisions of the Energy Policy and Conservation Act which require a reduction in the price of new crude oil by some 15 percent. These price controls have had a direct effect on the ability to attract outside capital investment in oil and gas properties. In enacting the Tax Reduction Act of 1975, it is quite clear that Congress intended to encourage the activities of the small producers relative to their larger competitors, the major oil companies. The proposed legislation, however, cuts in exactly the opposite direction, directly zeroing in on the small producers' available capital market, and thus materially reducing their operations.

Furthermore, while the maintenance of price controls on crude oil may provide some interim benefit to consumers, that benefit will be

seriously reduced if domestic production decreases and consumers are required to rely on higher priced, uncontrolled foreign oil. To the extent that the proposed intangible drilling cost provisions result in a disincentive to production, they also cut in the direction opposite to the Energy Policy and Conservation Act which requires even price controls to be "consistent with obtaining optimum production of crude oil in the United States."

The incompatibility of this proposed legislation with the Tax Reduction Act of 1975, with the Energy Policy and Conservation Act, and with the general attitude of Congress toward the small producer and toward the Nation's domestic energy problems is confusing to the industry and especially to the small producer. Such uncertainty has already affected the ability to raise outside capital at a time when the Nation's energy needs are at a maximum.

In exploration efforts at Magnatex, we have seen our annual drilling expenditures in the United States increase from $50,000 a year in 1972 to approximately $3 million per year for 1976. While prior to 1972 Magnatex conducted substantial drilling operations in Canada, along with other producers it has had to give up those drilling operations solely because of oppressive tax measures adopted by the Canadian Government. The bulk of Magnatex's drilling operations are now conducted in the continental United States. As of March 15, we have just completed our money-raising efforts for 1976 and have found that investment by parties outside of the industry has decreased some 40 percent in anticipation of the disallowance of the intangible drilling costs deduction.

Magnatex is specifically aware that the threat of tax legislation as passed by the House of Representatives has deterred the potential investment of several new investors who have chosen to channel their funds into real estate investment and municipal bonds. These additional funds alone would have increased our drilling activity by some $300,000. It is our experience at the present time that the cost of finding a barrel of new crude oil is approximately $3 to $4 per barrel in the ground for the longer term reserves, and $5 to $6 per barrel in the ground for the short-term reserves. A translation of these figures indicates that, in the case of our own very small operation, the failure to attract new investors who had indicated interest prior to the proposed legislation, will deprive the Nation of some 75,000 to 100,000 barrels of new oil during the year 1976.

Of course, our situation is a very small part of the entire industry, but we believe that it typifies what is happening to most independent producers. Moreover, the drilling rig count in the Permian Basin should provide an excellent indication of what is happening nationwide. The approximately 100 inactive rigs in our area indicate a decrease in expenditures on discovery of new petroleum reserves of approximately $830,000 per day in the Permian Basin alone. This would mean, in turn, that new reserves which are readily available are being left undrilled at the rate of approximately 100,000 to 150,000 barrels per day. The causes of this lack of activity are economic, both in terms of available return on investment relative to the risk incurred and in terms of the lack of available investment capital due to the uncertainty forced upon the industry by recent congressional acts and proposals. Naturally, the increased tax revenue that this drilling ac-

tivity would generate is substantial and is being lost along with the needed hydrocarbons.

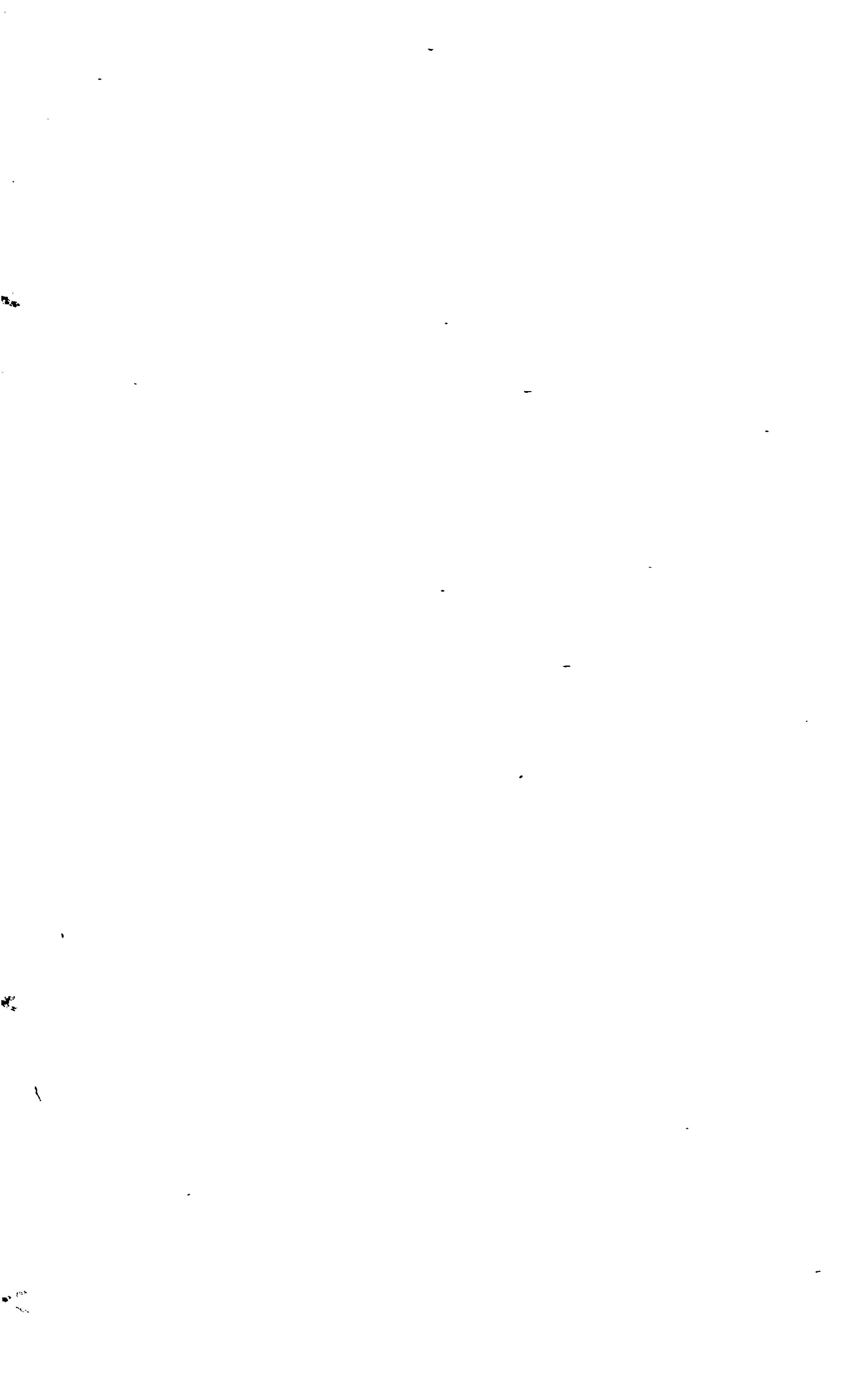
It is extremely important to those of us who live in petroleum-industry-oriented communities that the Nation as a whole be aware of the widespread impact which administrative regulations and congressional enactments have upon the economy and employment of our entire communities. The Permian Basin has approximately one-half million residents of which we approximate 150,000 to be under primary employment. The recent decrease in drilling rig activity in the Permian Basin alone has caused direct unemployment of approximately 5,600 persons, and it is anticipated that the indirect effect will decrease employment in the Permian Basin by another 13,000 people within the immediate future, affecting 8.7 percent of the available primary work force.

In summation, the recent governmental roadblocks affecting the orderly progress of the petroleum industry are of great concern to all segments of the industry but especially to us small producers who are so directly and severely affected by the proposed House legislation. The industry has been wounded; the facts are currently available to indicate this beyond any shadow of any doubt. We anticipate serious problems for the community in which I live and for the 13,000 people whose employment is threatened. But perhaps the most serious consequence of the way things are going is the certain decline in this Nation's future reserves of oil and gas.

This is not a regional problem. The welfare of the entire Nation depends on an assured, reliable, stable source of domestic fuel. Magnatex and other independent producers are doing their part to pursue the goal of energy independence for the United States, but tax proposals such as these are strongly undercutting this thrust. The goal of increased domestic production and decreased dependence on imported oil led to the price decontrol provisions of the Energy Policy and Conservation Act. This is not the time to create more uncertainty or to eliminate those incentives which influence potential investors in oil and gas ventures. To enact these measures and eliminate the source of capital needed to sustain the independent producer in his search for and production of additional domestic reserves is counterproductive, is incompatible with the intent of both the Tax Reduction Act of 1975 and the Energy Policy and Conservation Act, and is contrary to the Nation's interests.

Capital Gains Tax

3181



Statement by Margaret Cox Sullivan, President, Stockholders of America, Inc.

Mr. Chairman and members of the Committee on Finance, I appreciate this opportunity to present the views of Stockholders of America to this distinguished committee. I am Margaret Cox Sullivan, president of Stockholders of America, Inc., national, nonpartisan, nonprofit organization of individual stockholders, headquartered in Washington. We have members in all 50 States. Our diversified membership is representative of the makeup of stockholders generally. They really are from every "walk of life." We know. The only requirement for membership is stock ownership. We are not concerned with what specific stocks or how many shares are owned. We do not get involved in the internal affairs of any one company nor do we join in class action suits or proxy fights. However, we do have a deep and abiding concern that stockholders' interests be represented and their collective voice be heard.

You gentlemen do not need to be told that our country has been through some very rough economic times. While there seems to be reason to be optimistic, these times are still critical. There is not solid confidence in the country's economy. Rather, it is more a feeling of touch and go. Therefore, the decisions made by your committee are not only important, they are vital. Strong, positive steps are required to guide this economy to a solid base to sustain strong and continuing real economic growth. To keep our enterprise economy going and growing we must insure the constant flow of capital investment which is the financial fuel—the driving force of it. This must not be forgotten if as a Nation we want to keep our industrial leadership in the world, keep our country strong, and keep our standard of living known as the American way of life.

And we are not talking about capital needs in the future; the need for capital is now. The storage of investment capital has reached the crisis stage in our country today, and the projected needs for new capital in the next decade are staggering.

Historically, it has been the individual stockholders who have been the mainstay of the equity capital market. Its success and strength has come from the fact that there are millions of differing decisions, judgments, and opinions being made daily in diversified market transactions. This makes for liquidity; this makes for a true auction; this makes for a true market value of stocks. The individual investors make the market. They are often called the backbone, the strongest ingredient of our economic system, and sometimes just the "little guys," but they are a fundamental part. They play a vital role in our economic system—call it the capitalistic system, or free enterprise, private enterprise or the profit system, because they are the capital force of our country. Just as the labor force supplies labor services, so capital services are supplied by the capital force. Contrary to the

opinion held and voiced by some, they are from every "walk of life." But they all have one thing in common: they are all capitalists. They are all in the equity capital market. They are the owners of American business. They supply the capital—their hard-earned moneys—to create the jobs, to make the products, to do the research for technical advancement, to start up new companies, to enlarge existing ones in return for shares of ownership. That is the American economic system. This system has built out of a wilderness the most powerful industrialized Nation ever known, with its people having the highest standard of living. It has made us a Nation of owners. The success and strength of this system are due to this large ownership base. It is this system that makes the goods and services on which our tax structure is based.

However, in the past several years we have witnessed some very disturbing trends that have had a major impact: the number of individual stockholders has declined. For the first time since 1952 when such figures were recorded, the number of stockholders did not increase but rather decreased by over 18 percent in the last 5 years, according to statistics released by the New York Stock Exchange. The figure slid from 32 million to 25.7 million. This is particularly frightening when it has been estimated that 50 million stockholders would be needed by 1980 to meet the capital needs for a growing work force and continuing economic development. This alarming unprecedented decline in stock ownership must not go unnoticed but should be taken as a warning signal.

For it must not be overlooked that at the same period in our national history that the number of stockholders was growing, we as a country were enjoying rapid, prosperous economic expansion. Therefore, in the interest of the well-being, vigor and health of the national economy, your committee in its deliberations should consider actions not only to attract the potential investor to the equity capital market, but to insure the return of those who have defected from the marketplace—in many cases just for liquidity to pay their household bills—as well as to keep the present stockholders in the market as continuing investors. Your committee has the power to initiate tax revisions in the investment area, to relieve investors of the tax burden they are carrying and to create a better and more attractive investment climate to make saving and investing not only possible but worthwhile. With all the high-sounding talk about capital formation, it begins with the dollar saved in the pocket. These are our concerns at Stockholders of America.

Therefore it was very heartening to us as stockholders when the Stockholders Investment Act was introduced by Senator Bentsen in 1973 and reintroduced this session. It was the first time in many years that stockholders were considered and that vital role they play in our national economy was recognized. In introducing this legislation, Senator Bentsen not only brought out the plight of the individual stockholder, but his flight from the market as well. We heralded this legislation as "an historic good 'turn in events' for our national economy" and immediately devised a plan for alerting individual stockholders to the tax relief they would receive with the sliding scale tax treatment of capital gains and with more realistic tax treatment of capital losses, as included in the Bill.

It was a new plan; it had never been done before because there was never a national stockholder organization such as ours before. We designed a postcard-type ballot for individuals to use in endorsement of the Stockholders Investment Act. These were not only sent to our own membership but we also asked corporations to inform their stockholders of this legislation by means of a fact sheet and letter covering all the issues of the act along with a ballot for stockholder endorsement. All the identical ballots were returned to SOA and even though they did not carry prepaid postage, thousands and thousands were mailed to us. Some corporations who did not participate in the plan gave a brief explanation of this legislation to their stockholders in either their publication or by letter. The plan was recognized in the financial community as a professional and innovative approach, and further, SOA has been credited with creating better communications between stockholders and managements.

This cooperation within our business system can be very beneficial not only to the system itself, but to the entire national economy.

We cannot overemphasize the importance of stockholders' endorsement of this act, particularly the sliding scale tax treatment of capital gains and more liberalized treatment of capital losses. We know these are vital issues to stockholders because in addition to our ballot plan we have undertaken several surveys of stockholder opinion. In all cases we have found that the three most important issues to stockholders collectively are unfair taxation of capital gains and losses and the grossly unfair double taxation of dividends.

With the demand for capital never greater, with an 18 percent decline in the number of individual investors and with the economic recovery process needing stabilization to restore confidence, it is imperative that strong remedial steps be taken to encourage equity investment and broader participation in our system.

Therefore, Stockholders of America advocates:

(1) The establishment of a stockholder dividend tax credit to eliminate double taxation of dividend payments to stockholders. Under the stockholder dividend tax credit plan the stockholder would report the actual dividend "grossed up" by the corporate tax deemed to have been paid with respect to that dividend, and then claim a credit against his tax for those taxes already paid. The plan is not complicated and the mechanism for it can easily be worked out. Data necessary to calculate the tax credit could be furnished on form 1099 which corporations are already required to send to dividend recipients. Taxpayers would merely transfer the numbers to the appropriate lines on their income tax form.

(2) The authorization of a $5,000 annual deduction against ordinary income for net capital losses with a 3-year loss carryback.

(3) The establishment of a graduated or sliding scale capital gains deduction plan, beginning at 50 percent after 6 months holding and increasing by 2 percent at the end of 1 year and each year thereafter through the 15th year of holding to a maximum capital gains of 80 percent.

(4) Additionally, Stockholders of America supports the President's plan for broadened stock ownership (BSOP) which would permit a stockholder to deduct annually an amount, within limits, in-

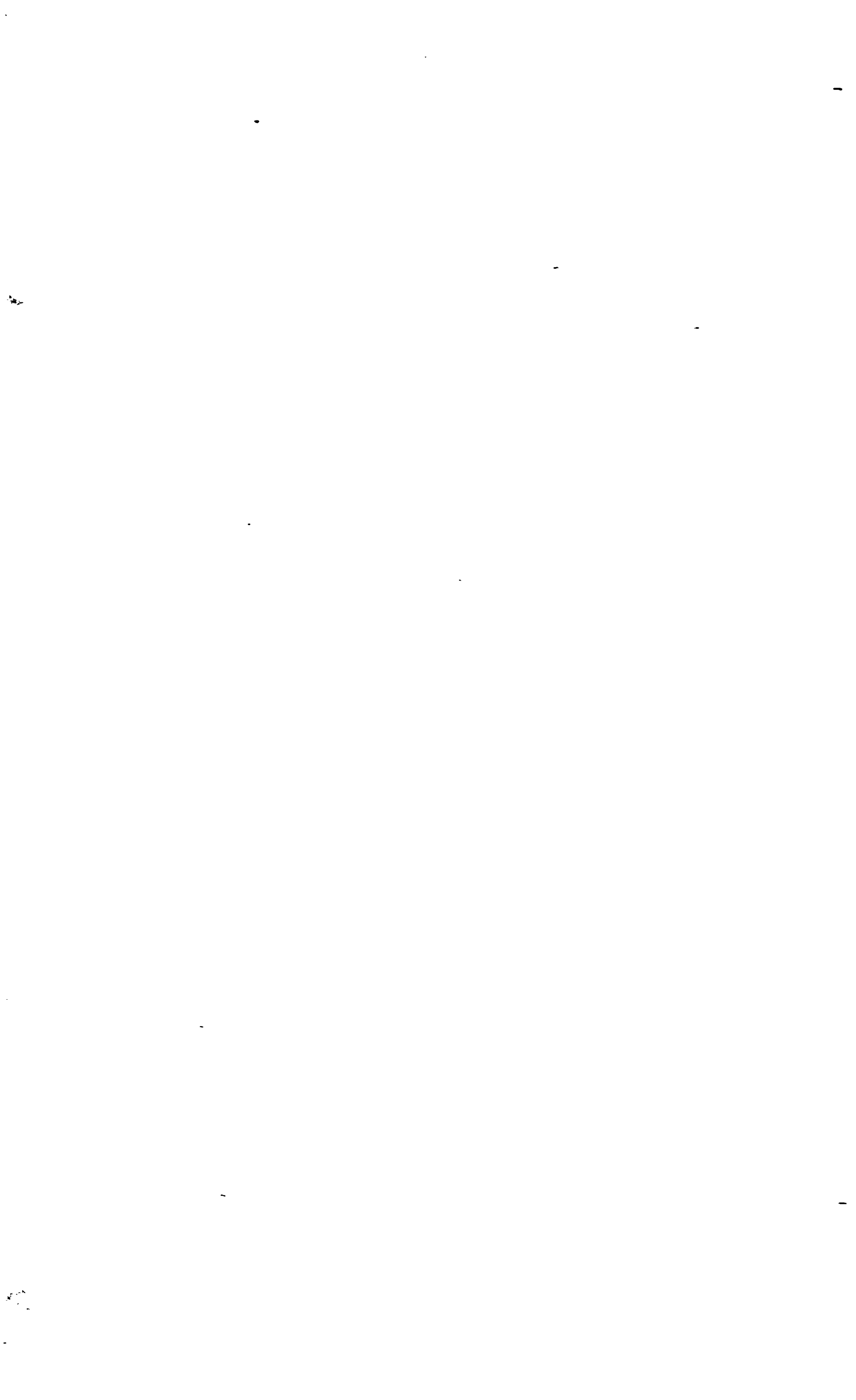
vested in stocks or mutual funds. Such a plan would serve the goal of increased individual participation in building our needed capital force.

(5) Since stock holdings are an integral part of most estates, we would also encourage the adoption of the President's proposal to increase the estate tax exemption from $60,000 to $150,000. Such an increase would give at least some recognition to the rise in the Consumer Price Index since the setting of the original deduction. Likewise, the increased exemption would reduce the need for forced liquidation of stocks to meet tax payments and would lead to further reliance upon stocks for future estate building.

We believe our proposals in the investment tax area are good, sound steps that will attract new investment capital and unlock capital resources. This, in turn, will stimulate the economy and create jobs, develop new job opportunities, technologies and ideas that will make the companies of the future and lead the country to the desired goal of full-scale economic recovery.

The actions taken by your committee and your colleagues in the weeks ahead could well be the determining factor in the state of the Nation's economic health. The responsibility and the opportunity are yours.

Withholding Tax on Certain Gambling Winnings



U.S. SENATE,
Washington, D.C., March 30, 1976.

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

DEAR MR. CHAIRMAN: This letter is offered in the hope that that section of the House tax reform bill dealing with the new proposed 20 percent withholding on large gaming winnings be deleted.

I have had extensive contact with the representatives of all forms of legalized gambling in the United States, including thoroughbred racing, casino operators, lottery, and harness racing representatives. All agree that the House proposal of withholding 20 percent of all winnings of $1,000 or more in which the odds are at least 300 to 1 would be highly discriminatory in that it makes no provision for the deduction of losses. Additionally, it would represent a bookkeeping burden far in excess of the amount of additional revenue which could be gained. I would also point out that there is a very significant compliance with the tax laws on gambling windfalls now which I understand has been estimated as high as 85 percent.

This view is shared by the National Commission on Policy Toward Gambling which the Congress set up in 1970 and which has been studying the overall problems of gambling as a national legal enterprise for more than 2 years. Their report will be due this fall and I think it would be an injustice for the Congress to act precipitously at this time in advance of the Commission's recommendation, which will be based on a tremendous national search for the facts and the expenditure of approximately $2 million. I am certain that you will be hearing directly from Charles Morin, Chairman of the Commission, during the course of the inquiry. You will also be receiving letters for the record from various Governors and executives of leading legal gambling enterprises who have been in contact with me and others on the burdens which arise from the House proposal.

The trend in more than one-half of the States has been to seek additional revenue through various controlled wagering schemes which serve the important dual purpose of denying the proceeds to organized crime as well as raising revenue for desperately needed educational and other public social needs. The proposed 20 percent withholding would create very real problems in discouraging these lawful efforts by the States and would serve only to lend confusion and an administrative nightmare to these legitimate efforts.

Since the House made no effort to call witnesses or receive testimony, I respectfully suggest that this premature and ill-advised effort be dropped from the Senate bill and I assure you that the necessary statistical information from all of the parties concerned will be in the hands of the committee prior to the time you and your associates need to make a decision on this matter.

With kind personal regards,

Sincerely,

HOWARD W. CANNON.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., April 27, 1976.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This will inform you of my strong opposition to section 1207 of the House-passed tax reform bill and my hope that you and members of your committee will drop this section from the Senate version of H.R. 10612.

Section 1207 requires the withholding of 20 percent on all winnings of $1,000 or more in which gambling winnings are 300 times more than the wager. This section of H.R. 10612 was adopted by the House committee in markup without prior hearings.

The language in House Report 94–658 gives the reason for adoption as follows:

"Although most wagering transactions have no tax significance since the majority of bettors end up the year with no net wagering gains, the special types of wagers mentioned above represent unique and occasional windfalls that generally produce significant tax liability."

The report language indicates a negligible amount of tax revenue would be forthcoming to the Treasury. I believe the cost placed on the gaming establishment operator and the cost of enforcement would further deplete the tax provision proceeds.

There was no opportunity for a Member of the House or any representative of the gaming industry to appear and give testimony on this provision at the hearings. As the bill was reported to the House Rules Committee, it was the recommendation of the committee that only several sections of the bill be open for debate on the floor and, as a result section 1207 was not open for discussion.

This in itself, in my opinion, was unfair to our democratic processes and to those who may have wished to develop additional facts and refute the advisability of inclusion of the language in section 1207.

I seriously doubt the broad effect the amendment places on those States which have legalized gambling was seriously considered. As I read the language of section 1207, a church bingo game or church or club sponsored raffle where tickets are sold for very small amounts and often times see the winner receiving a payout or prize valued at several thousands of dollars would require the sponsor to withhold taxes on the payout. I was advised that county fairs, which are so popular in many Midwestern and other States, where several days of races are held, would also cause the sponsors to withhold on certain types of bets if the winnings such as a daily double were over $1,000 and where the wager conformed with the bill language definition.

It is apparent to me the administration of this provision would cause much unfavorable comment from the public if, in fact, IRS or the tax collecting agents were effective at the enforcement level.

Gaming operators in Nevada, now pay taxes on their winnings. To expect these business operators to become a watchdog for the Treasury and to force them to the additional expense of collecting and reporting, is in my opinion unwarranted.

In addition, Congress passed Public Law 91–452 which set up a Commission on the Review of the National Policy Toward Gambling.

Three million dollars was appropriated for the Commission to study the problems of gambling and taxes. The Commission is made up of Members of Congress and the public. The Commission report and findings as a result of hearings and studies will be available in October 1976.

This Commission has no opportunity to report to the Ways and Means Committee on its findings to date. It seems reasonable to expect that any new taxes or prohibitions placed upon the individual States with respect to gaming operations should first follow close scrutiny and study of the Commission report.

Nevada, as well as other States, has depended upon gaming receipts to supplement State tax revenues. Much of this income is earmarked for schools and other social problems. The States are now hard pressed to raise sufficient tax revenues and to further impair this effort by additional controls and additional tax collection efforts at the Federal level is unnecessary and undesirable.

As you may be aware, representatives of the thoroughbred racing, casino operators, lottery and harness racing associations have all voiced objections to this provision of the Tax Reform bill.

It is for these and other reasons that I respectfully trust you and your committee will delete language in section 1207 from the Senate version of H.R. 10612.

Sincerely,

JAMES D. SANTINI.

OREGON RACING COMMISSION,
Portland, Oreg., April 28, 1976.

Hon. RUSSELL LONG,
Chairman of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: As you are aware, one of the provisions of the Tax Reform Act proposes a 20 percent Federal withholding tax at the source on large gambling payoffs. I would hope that you and your committee would conclude that the retention of such provision was not necessary. Its inclusion, in my opinion, is not in the best interest of the sport of racing.

Among other things, it reduces from circulation and additional wagering the 20 percent of the payoff retained. This affects the "handle" of subsequent races which, in turn, affects the amount of needed funds available to the State, the horsemen and the track.

While I have neither proof or statistics to support this premise, it does not appear unreasonable to assume that it could encourage more people to take advantage of bookmakers and illegal gambling sources, in which case the State revenue, horsemen and tracks all lose.

I am also concerned about the extent a business entity should become a specialty tax collector. Already, the IRS is furnished with identification of large payoff winners.

In the final analysis, the basic question is whether the benefits offset the costs and additional administrative burdens involved. It is my personal conclusion that they do not.

Sincerely,

WILLIAM E. LOVE, *Member.*

GAMING INDUSTRY ASSOCIATION OF NEVADA, INC.
Reno, Nev., March 31, 1976.

Hon. MIKE O'CALLAGHAN,
Governor, State of Nevada,
Capitol Building, Carson City, Nev.

DEAR GOVERNOR: Several weeks ago Mr. David W. Hagen of the firm of Guild, Hagen & Clark, Ltd., represented our association at a meeting in Washington with Senator Cannon in regard to the proposed 20 percent withholding amendment contained in H.R. 10612, commonly referred to as the "Tax Reform Act of 1975."

The enclosed letter was directed to him as the attendant representing Nevada interests. There is no indication, however, that a similar letter was sent to you by the Senator so I am taking the liberty of forwarding this copy to you.

We are hoping that you will find time in your busy schedule to direct a letter to Senator Russell Long, chairman of the Senate Finance Committee, prior to or not later than April 9, with copies to Senator Cannon, myself, Mr. Hagen and Bob Cahill of the Nevada Resort Association.

I am also enclosing a copy of that portion of the bill which we feel would be disastrous to Nevada's Gaming Industry.

Thanks very much for your help.

Sincerely,

LES KOFOED, *Executive Director.*

GAMING INDUSTRY ASSOCIATION OF NEVADA, INC.,
Reno, Nev., April 6, 1976.

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

DEAR MR. CHAIRMAN: Our industry has been deeply concerned about the 20 percent withholding provisions contained in section 1207 of H.R. 10612, now being considered by your committee.

Section 1207 provides for the mandatory withholding on all winnings over $1,000 (with odds of more than 300 to 1), with no provision for deduction of losses. As a matter of fact, most of the payouts in Nevada casinos are just that—payouts—and not winnings. In other words, they are actually a return of previous losses which properly would not be classified as winnings or as taxable income to the player. Reduced to fundamentals, if all casino players were permitted to deduct all losses from all payouts received there would be no taxable income to players.

Casinos are the winners as is evidenced from the report of the gaming control board for the calendar year of 1975. Gross win for all Nevada casinos was in excess of $1 billion on which the casinos paid in excess of $100 million in gaming privilege taxes to the cities, counties, the State of Nevada and the Federal Government. This amount is in addition to all the property, sales and use, Federal income, payroll and other usual taxes paid by other types of business, all of which are paid by gaming, too.

We sincerely hope that these facts, together with those which you will undoubtedly receive from other interested industries and individuals, will justify the complete deletion of section 1207 from the bill.

Sincerely,

LES KOFOED, *Executive Director.*

MARYLAND RACING COMMISSION,
Baltimore, Md., April 6, 1976.

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

DEAR SENATOR LONG: I am writing to you in behalf of the Maryland Racing Commission in regard to our objection to the proposed 20 percent withholding amendment to all legalized gambling businesses. This proposed amendment would have severe adverse effect on the revenue from horseracing, not only to the State but to the racing associations, the horse owners, trainers, and breeders.

In the year 1975, the State of Maryland was the beneficiary of $20 million in revenue from horseracing. The adoption of the 20-percent withholding tax will have two very important impacts on pari-mutuel tracks:

A. The money withheld will not be wagered.

B. Deducting 20 percent of the winnings on such races will provide a disincentive and accordingly reduce total wagering.

Further, the costs to implement the withholding measure are excessive and exceed the potential increased revenue to the Federal Government.

The Maryland Racing Commission would like to reiterate its opposition to the 20-percent withholding amendment because of the adverse fiscal impact it will have on pari-mutuel wagering, and trusts your committee will act unfavorably on same.

Very truly yours,

J. NEWTON BREWER, Jr.,
Chairman.

STATE OF MAINE,
STATE LOTTERY COMMISSION,
Augusta, Maine, March 31, 1976.

Senator HOWARD W. CANNON,
State of Nevada,
U.S. Senate, Washington, D.C.

DEAR SENATOR CANNON: It has been the sentiment and conviction of the Maine State Lottery that the effect of the proposed 20 percent withholding amendment to all legalized gaming businesses, including lotteries, would have very adverse effects.

The mandate of this Commission is that it generate to its fullest potential as great an amount of profit for the State's treasury as is possible within the purview of the meaning of the term "lottery."

Our senior senator, Edmund S. Muskie, and our junior senator, William D. Hathaway, as well as our Congressman from the second district, William H. Cohen, all have supported our view that the proposed 20 percent withholding amendment would have the effect of slowing down lottery ticket sales.

We would be honored and pleased to have these recommended sentiments, which we hereby forward to you, lend their weight as an addition to the similar sentiments which we know have been expressed to you on behalf of all other States which maintain lotteries.

I close with my sincerest appreciation for your efforts and discussion with Senator Long of the Senate Finance Committee. Your support of our view and your intercession on our behalf merits our thanks and we extend them to you.

Very truly yours,

PETER J. GORMAN, *Chairman.*

STATE OF NEVADA,
NEVADA GAMING COMMISSION,
Carson City, Nev., April 14, 1976.

Hon. HOWARD W. CANNON,
U.S. Senate,
Washington, D.C.

DEAR HOWARD: Thank you very much for your letter of April 7, 1976, regarding foreign money in our gaming establishments.

I appreciate that you normally do not express views on our gaming control "intrastate" but I certainly appreciate your expression of opinion on this particular subject because I think it is more in your area.

Happily, also, my views coincide exactly with yours (as usual).

Warmest personal regards.

Sincerely yours,

PETER ECHEVERRIA, *Chairman.*

APRIL 8, 1976.

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

DEAR SENATOR LONG: Your committee has under consideration H.R. 10612 known as the Tax Reform Act of 1975. As chairman of the Nevada Gaming Control Board I feel it necessary to bring to your attention problems that portions of this legislation would create for the administration and conduct of the gaming business.

Section 1207 of the bill would be applicable to slot machines, keno and bingo games. These constitute a material percentage of the gaming business conducted in Nevada. To require that management of these businesses act in the capacity of tax-collectors imposes a burden that should properly be performed by duly authorized revenue agents. This requirement will lead to innumerable disputes with customers and direct the resentment of the public towards businessmen who should not have to interpose themselves between taxpayers and government.

What makes this withholding obligation so particularly obnoxious is that in the majority of instances the "winnings" will not truly be income. For example, a customer may be losing several thousand dollars when he "wins" several hundred on a keno ticket. Since losses can be deducted against winnings there is no income, but the businessman would be required to withhold the 20 percent provided in the legislation.

In closing I must remark that Government should have some faith in the American citizen's willingness to fairly pay his proper tax obligations.

Thank you for your consideration.

Sincerely,

PHILIP P. HANNIFIN, *Chairman.*

WEST VIRGINIA RACING COMMISSION,
Charleston, W. Va., April 15, 1976.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee, U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: As chairman of the West Virginia Racing Commission, I would like to express the opposition of our Commission to the proposed legislation in the Tax Reform Act of 1976, wherein there is a proviso for a 20 percent Federal withholding tax on gambling payoffs when the odds are 300-1 or better and the payoff is $1,000 or more.

As you already know, substantial revenue is generated to the various States through the racing industry. Moneys won, as a general rule, are reinvested through the mutuel window, and it is this multiplier effect that generates much of the revenue realized. Enactment of this legislation would cause a substantial decline in the daily mutuel handle and a resulting loss of revenue to the States. Such legislation would likewise encourage illegal gambling operations, where there would be no withholding.

I realize there is some concern about the so-called 10-percenting operation at race tracks, however, this illegal activity could be adequately handled if there were some cooperation between the IRS and the tracks by means of proper surveillance and the use of retaining liens.

It seems to me that such legislation would be far more detrimental to the States' revenue than it would be of benefit to the Federal Government in attempting to correct this illegal activity, particularly, when the Federal Government already has the power and means to eliminate same.

For these and many other reasons the West Virginia Racing Commission is expressing its objections to the proposed legislation.

Very truly yours,

HARRY L. BUCH, *Chairman.*

Commission on the Review of the
National Policy Toward Gambling,
Washington, D.C., April 2, 1976.

Hon. Russell B. Long,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

(Attn: Mr. Michael Stern, staff director, Senate Finance Committee).

Dear Senator Long: In my letter of December 11, 1975, I described the mandate of the Commission on the Review of the National Policy Toward Gambling, and requested that the Commission be given the opportunity to present testimony to the Senate Finance Committee on legislation providing for the taxation of gambling-related activities. We have been advised by Mr. Michael Stern that the Finance Committee is presently considering legislation concerning the withholding of winnings from legal state gambling operations. We appreciate this opportunity to submit a written statement for the record to the Committee.

The Commission—which comprises seven public members appointed by the President, four distinguished members of the House, and your four colleagues of the Senate: John L. McClellan, Howard W. Cannon, Hugh Scott, and Robert Taft, Jr.—has been appropriated $3 million "to conduct a comprehensive legal and factual study . . . of policy and practices with respect to . . . taxation of gambling activities and to formulate and propose such changes in those policies and practices as the Commission may deem appropriate," which necessarily will include our recommendations regarding the provision of income, excise, and occupational stamp taxes, as well as other related taxation policies effecting gambling activities in this country.

The Commission's research effort is nearly completed, although a great deal of analysis remains to be done. Our social survey of gambling behavior has provided substantial information on gambling participation throughout the United States, and testimony has been received from over 200 witnesses, including the Director of the Internal Revenue Service and representatives of many legal gambling industries, at hearings held across the country. Based upon our studies to date, the Commission has reached a preliminary consensus on what the National policy towards gambling should be. We believe that the States should have the primary responsibility for determining what forms of gambling may legally take place within their borders. The only bases for Federal involvement are the protection of the national interest and the prevention of interference by some states with the gambling policies of other states. The Commission thus perceives only two justifications for federal action relating to gambling:

(1) There is an identifiable national interest in reaching a certain type of conduct—as, for example, the national interest in suppressing illegal gambling that is related to organized crime; or

(2) only action by the Federal Government will prevent interference by one state with the gambling-related policies of a sister state, through the use of the facilities of interstate commerce.

Turning now to the issue of whether the withholding of Federal income taxes on certain specified gambling winnings would be consistent with our national policy, it is necessary to examine the probable effects of such withholding, based upon analysis of both Federal taxation practices and the operation of legal gambling industries. The following factors should be considered:

(1) What additional revenues would be realized by the Federal Government, and would they justify this measure? For example, our record indicates that 85 percent of all state lottery prize winners voluntarily pay taxes on winnings, and that information on other winners of large prizes is made available to the IRS on forms 1099, which are filed by the state lotteries. The Treasury Department should provide estimates on how much additional revenue would be collected, and on whether these revenues would warrant the administrative expenses involved.

(2) What administrative burdens would be imposed upon legal industries in complying with such a policy? Would this seriously impair their ability to raise revenues for the purposes of state government? For parimutuel racing, withholding might reduce the amount re-bet in subsequent races, thereby reducing the overall handle and the takeout by the state. Or, withholding might make legal state-run lotteries or numbers games less attractive to bettors than the illegal forms of gambling with which they are in competition. Withholding could thus operate as a disincentive to the realization of state policies.

Moreover, since Federal income tax withholding is not generally applied to transactions within our economic system, to subject only certain types of gambling to withholding may amount to a discrimination against an industry which has been given legal sanction in some or all of its forms by a majority of the state governments, and which has been relied upon to provide revenues for state purposes.

(3) Is there a reasonable relationship between the amount to be withheld and the amount actually owed in taxes? In Nevada, an individual might win at keno on the same day that he incurs heavy losses at the casino tables. The Internal Revenue Code provides that gambling losses are deductable from gambling winnings in determining taxes owed. Hence a policy of withholding taxes on gambling winnings, without regard for losses incurred, might artificially distort the true tax picture of the wagering participant, since most gamblers ultimately lose.

Using the above criteria, at the present time we seriously question whether the legislation before the Finance Committee concerning the withholding of taxes on gambling winnings would serve to further any identifiable national interest; indeed, it would appear that withholding might interfere with the policies of numerous state governments. The Commission awaits the completion of its fact-finding processes before making any conclusory statements in this regard; in particular, the results of our social survey may provide definitive answers to these issues. Our findings on this matter will be made available to the Finance Committee as soon as they have been reviewed by the full membership of the Commission; and, findings on

other aspects of the taxation of gambling activities, such as the excise and occupational taxes and the whole issue of federal taxation of gambling winnings, will also be presented to this Committee upon completion.

Thank you for providing the Commission with this opportunity to present testimony for the record of the Finance Committee. We extend again our invitation to share with the Committee the research materials which we have assembled relating to the taxation of gambling-related activities.

Very truly yours,

CHARLES H. MORIN, *Chairman.*

Taxation of Power Companies

DEAN WITTER & CO. INC.,
New York, N.Y., April 23, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: On behalf of the brokerage firm of Dean Witter & Co. Inc., of which I am a first vice president, I would like to submit the following comments with regard to the Senate Finance Committee hearings on tax revision and extension of expiring tax cut provisions. The testimony that I am submitting is similar to that delivered before the House Ways and Means Committee regarding tax treatment of public utilities on July 23, 1975. I am responsible for research and analysis of regulated industries for our firm, and I am writing you on behalf of our corporate finance efforts and of the utilities that we aid in their financing efforts.

INVESTOR LOSS OF CONFIDENCE

Over recent years we have witnessed a process of disintermediation among institutions and fiduciaries of their holdings in utilities including electric, gas, and telephone companies. Coming at a time when capital requirements for the industry doubled, there was a basic alteration in the market acceptance of new, as well as, existing securities. After the omission of the Consolidated Edison common dividend in the spring of 1974, recognition of a radically different concept of risk entered the market and for a short while threatened the whole stream of distribution. While the problem has not been solved, recent developments in the money markets, plus rate increases by State and Federal regulators, has given temporary respite.

Equity investment in the public utility arena has had an intriguing history. For example, in the mid 1960's when utilities were considered to be the growth stocks of the decade, about 25 percent of the total market value of securities held by many large mutual funds were in electric, telephone, and gas common stocks. Over 60 percent of the common stock of Florida Power & Light Co., as an example, was held by these funds. In total, utility equities comprised 6.4 percent ($2.2 billion) of the total market value of all reporting mutual funds at the end of 1965 ($35.2 billion). At the end of 1974, they comprised only 1.5 percent ($0.5 billion) of the $35.8 billion of market value.[1]

Records of large insurance company and pension fund portfolios are more difficult to obtain, but here, also, there has been a discernible reduction in the holdings. More important, these organizations are not adding utilities to their portfolios, and for the moment this source of funds for new investment seems closed.

[1] "Mutual Fund Fact Book," March 1975, Investment Company Institute, Washington, D.C.

INCREASED MAGNITUDE OF EXPENDITURES

During the next 5 years, approximately 1 million people per year will enter the labor force. If we are to provide them with work—and see unemployment no worse than it is currently, not improving as the administration proposes—it will be necessary to augment our utility services for energy as well as communications. The correlation between job availability and needed increments to utility facilities has been amply demonstrated.

According to estimates, a minimum of 5 percent per year, and probably closer to 7 to 8 percent, must be added to current utility capacity in order to provide the service levels necessary to achieve the employment goal of no increase in unemployment. This works out to $20 billion per year for power, $3 to $5 billion for natural gas, and $12 to $15 billion for communications. Since aggregate capital expenditures for 1976 probably will be in a range of $110 to $125 billion, utilities alone will account for over 30 percent of the total.

NEED FOR TAX BENEFITS TO ATTRACT INVESTORS

Financing of this magnitude for an industry that some investors shun and others believe risky will be difficult at best. For this reason, passage of legislation designed to attract new money through tax advantages is a most desirable course. If such is not forthcoming and companies must depend solely on rate relief—which will be necessary in some measure in any event—the ability to move our economy forward could be impaired to a serious degree.

With the magnitude of capital expenditures facing the electric and telephone segments of the industry, one cannot be aided and the other left in an inferior position. Such a course will result in raising consumer rates to the afflicted segment and, in time, reduce employment in that industry. Both electric companies and telephone companies are regulated by commissions established to set reasonable rates, but they are unlikely to respond favorably if the Congress puts one industry in a disadvantageous position. Others who have testified before you have proposed modifications of the investment tax credit capital gains treatment of reinvested dividends. In general, I agree with their suggestions and would seek additional consideration of treatment of common dividends on new common stock as capital gains for a limited period of time as being beneficial.

INCLUDE ALL UTILITIES

I would offer the financial judgment, however, that these approaches should be adopted for all utilities. The potential loss to the Treasury should not be meaningful, and the tradeoff in enhancing the ability to provide employment for a growing labor force should more than compensate for the cost.

Secretary Simon stated on July 8 before this committee that granting the power industry these tax benefits would cost the Treasury $600 million in fiscal 1976. If this amount were doubled through inclusion of other portions of the regulated industry group, it would be cheap compared to the alternative.

There is one other reason for including all utilities in the package. If one group or sector is anointed and another excluded, higher regulated rates would be diverted to more attractive securities. An approach singling out only one sector of regulated industries might well cause more problems than it solves.

I believe that the modifications to tax laws, as generally being proposed to your committee, are crucial to the ability of the electric and communication industries to attract the capital necessary to achieve the goal of providing utility services for the jobs that the country needs.

Very truly yours,

KENNETH HOLLISTER,
First Vice President—Research.

STATEMENT BY RICHARD S. WEYGANDT, VICE PRESIDENT, MONONGAHELA POWER CO.

The following statement is presented on behalf of Monongahela Power Co., West Penn Power Co., and the Potomac Edison Co., operating companies of the Allegheny power system. Monongahela serves customers in West Virginia and Ohio; Potomac Edison serves customers in West Virginia, Pennsylvania, Maryland, and Virginia; and West Penn serves customers in Pennsylvania. All three companies have ownership in power stations in West Virginia.

We did not have advance awareness of the hearing on S. 1957 which was had 2 weeks ago before the Energy Subcommittee, so I am taking the liberty of now submitting these comments in the hope of providing some background information which may be helpful to your committee in assessing the bill's impact. The Allegheny power system companies would like very much to see S. 1957 enacted for the following reasons.

The bill is one which proposes to prohibit a State from taxing electricity which is generated within that State and transmitted to another State for consumption there. As you doubtless know, the subject attracted attention when New Mexico last year imposed a tax on electricity generated in New Mexico and sold in Arizona. At the present time, some people in West Virginia are evincing interest in similarly increasing the State business and occupation tax on electricity generated in West Virginia and sold out of State. There is presently pending in the State legislature a bill (S.B. 572) which would raise such tax from its present rate of 0.88 percent of the gross proceeds derived from such sales, to 3 percent of such proceeds.

We maintain that an increase in the tax on West Virginia-generated electricity which is sold out of State will actually hurt customers of Monongahela and Potomac Edison in West Virginia as well as customers of West Penn in Pennsylvania and customers of Potomac Edison in Pennsylvania, Maryland and Virginia, and it is to the advantage of all those customers to have such tax kept at a minimum or eliminated completely. In addition, to the extent that such tax discourages out-of-State electric utilities from continuing to build power stations in West Virginia to serve their out-of-State customers, the future of West Virginia's coal industry will be threatened as well as the State's future industrial development.

Let me refer first to the example of an electric utility generating in West Virginia, such as Monongahela, which serves West Virginia customers and which occasionally also sells to out-of-State utilities. When Monongahela builds a new power station in West Virginia it does so because the increased generating capacity is needed to enable it to meet the increasing peak demands of its customers. During times when customer demand is below peak, a portion of the company's available capacity is not being used—particularly immediately following completion of a new power station. In order to avoid saddling its own West Virginia customers with the full cost of maintaining such idle capacity, the company endeavors to sell it to other utilities at a profit.

An out-of-State utility will purchase such so-called economy power from Monongahela only when Monongahela's cost of generating the power is less than the out-of-State utility's own cost of generation. When a sale is made, the difference between the two costs is divided equally between the participating companies so that both benefit. The profit realized by Monongahela from such a sale is then credited against the expense of serving West Virginia customers, thus in effect keeping their rates to a minimum. Without such out-of-State sales, West Virginia customers would have a greater generating capacity cost to bear.

Such transactions also occur in reverse, when Monongahela buys unused capacity from out-of-State utilities needed to meet a temporary surge in the demands of its West Virginia customers. By increasing the tax on electricity generated within the State for out-of-State sale, West Virginia will add to the cost of such electricity which must be borne by customers of the purchasing utility through higher rates. The States in which the purchasing utilities are located can be expected to retaliate by increasing the tax on electricity generated in those States and sold to Monongahela in West Virginia—thus necessitating higher rates in West Virginia.

Let me refer now to the example of an out-of-State electric utility, such as West Penn, generating in West Virginia whose customers are located outside West Virginia—78 percent of Potomac Edison's customers are also located outside West Virginia. Obviously the rates of those customers will have to be increased to absorb the West Virginia tax on the electricity generated in West Virginia for their consumption. However, there is a further effect which can be predicted which will multiply the injury to the State's economy and future industrial development.

West Virginia is, as you know, a major source of coal for the entire country. Because of its plentiful supply of coal, electric utilities serving customers in other States—such as Appalachian Power, Ohio Power and Vepco in addition to West Penn and Potomac Edison—have constructed power stations in West Virginia to be near such supply and to avoid high fuel transportation costs. As a consequence, West Virginia's coal industry has benefited measurably and industry has been attracted to West Virginia by its lower electric rates.

Within the past 10 years, the Allegheny power system companies have constructed two major power stations—Fort Martin and Harrison—in West Virginia and a third, Pleasants, is currently under construction. The annual coal consumption of each of these stations is approximately 3 million tons per year. Each of these stations, upon

completion, thus provides employment for approximately 800 coal miners whose annual wages total more than $10 million. If West Virginia, through its taxing power, increases the cost of West Virginia-generated power to customers of the out-of-State utilities named above, those utilities in the future are certainly going to look for sites near coal reserves in States other than West Virginia on which to construct further new power stations. West Virginians would then begin to find themselves having to rely more and more on imported power at resulting higher rates made necessary by required additional transmission facilities.

Power station construction itself provides a significant benefit to West Virginia. The Pleasants station will cost $681 million and will employ as many as 1,800 construction workers with an average annual payroll of $37,500,000 over a period of 4 years. Upon completion, the station will employ 130 operating employees with an annual payroll of nearly $2 million.

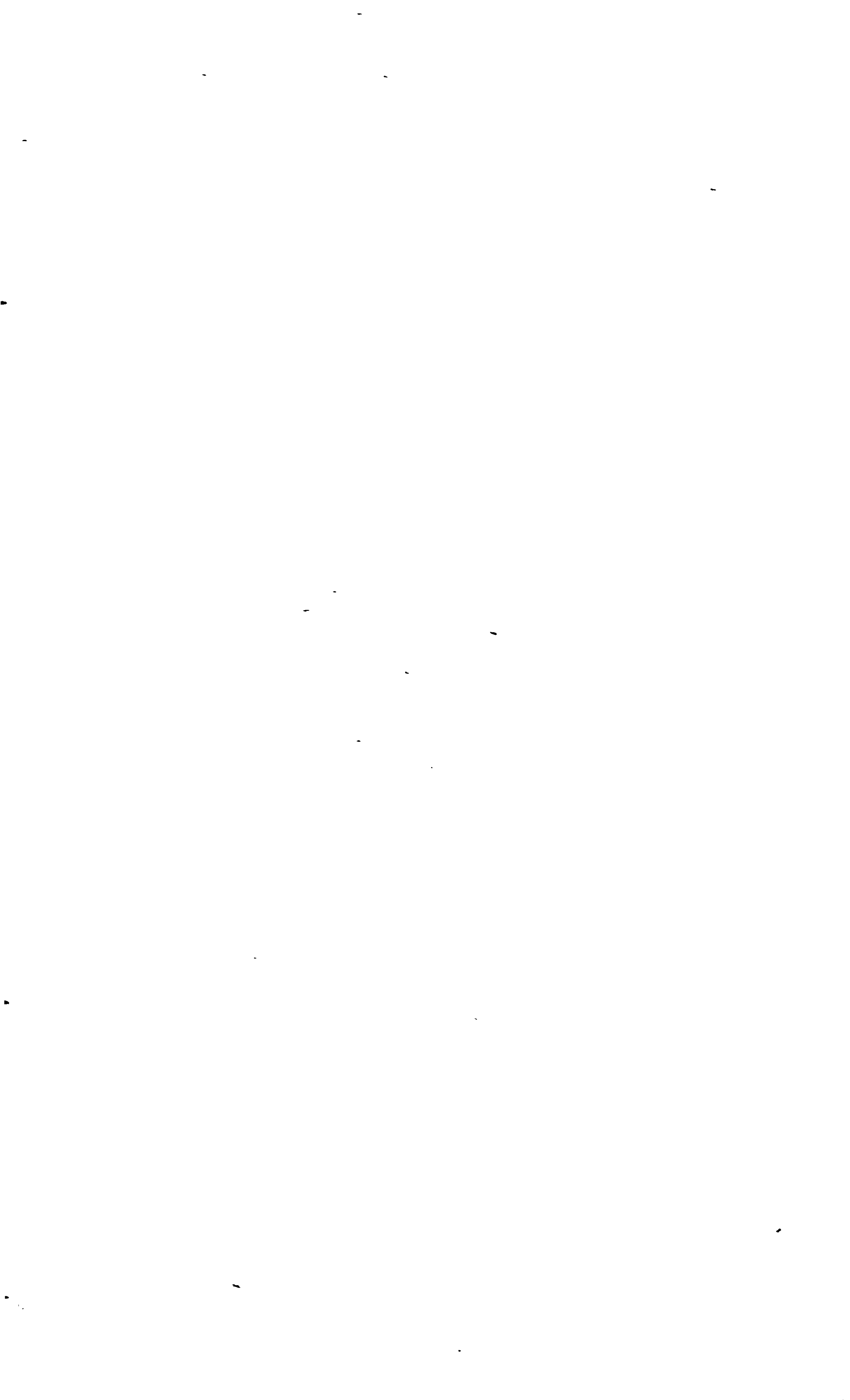
We believe, therefore, that if West Virginia and other States are allowed to tax sales of locally produced electricity sold in other States, all electric utility customers will eventually find themselves paying higher electric rates because, with respect to local electric utilities serving local customers, the resulting high price of electricity which those utilities will have to charge out-of-State utilities will discourage purchases by such utilities; without the revenues from out-of-State sales to help carry the cost of unused generating capacity between periods of peak demand, local—intrastate—rates will have to be increased to reflect such cost. We believe also that the future of the coal industry and industrial development generally in West Virginia and similar coal-supplying States would suffer greatly if a tax-induced increase in the price of electricity generated within a State by out-of-State utilities for sale to their out-of-State customers would discourage further power station construction in such coal-rich States.

I hope that you will give serious consideration to the above factors in evaluating S. 1957 and that you will conclude that its passage would not only forestall retaliatory taxation by the various States but would in fact serve as an anti-inflationary curb on utility costs to the benefit of ratepayers in all the States.

3204

Deduction of Expenses Attributable to Business Use of Homes, Rental of Vacation Homes, Et Cetera

3205



Statement of the Marriott Corp.

Marriott Corp. ("Marriott") appreciates the opportunity to comment on the Tax Reform Act of 1975, as passed by the House of Representatives on December 4, 1975 (H.R. 10612). We are specifically concerned with section 601(B) of this legislation dealing with the deduction of expenses for vacation homes.

Background Information

Marriott's Camelback Inn ("Camelback") located near Scottsdale, Ariz., contains 413 resort condominiums. All the condominiums have been sold. The owner of a condominium is permitted to use his condominimum unit up to 28 days per year while participating in a rental-pool program. Marriott believes that hotel rental-pool condominium projects similar to Camelback Inn should be exempt from this proposed legislation.

Under the present law, section 183 of the Internal Revenue Code provides that if an activity is not engaged in for profit, the amount of the allowable trade or business deductions—such as depreciation, maintenance, and utilities—cannot exceed the amount of gross income derived from the activity less certain deductions otherwise allowable such as interest and taxes. Under the present tax law, the determination of whether an activity is engaged in for profit is made by reference to objective standards taking into account all the facts and circumstances of each case. There is a presumption that a taxpayer is engaged in an activity for profit if in 2 of the 5 preceding years, in certain cases, 7 years, the activity actually produced a profit.

Under legislation passed by the House of Representatives, if a vacation home is used by a taxpayer for personal purposes for the greater of 2 weeks or 5 percent of the actual business use (that is its actual rental time), then section 183 would be applicable (whether or not the presumption under present law would otherwise apply). This clearly produces an injustice when it is applied to a resort hotel condominium project like the Camelback Inn because:

The owners' usage has not reduced the rental income or profitability of the hotel, but in fact has helped to improve sales and profits.

The condominium hotel is managed by a professional hotel company and its occupancy is in excess of 80 percent whereas the industry average for hotels ranges from 65 to 70 percent.

When owners use their condominiums, they pay a service charge which covers their direct expense.

The investments made by these owners have appreciated substantially since the offering was first made.

The condominium owners in this type of project have clearly invested in a business and thus are engaged in an activity for profit; this is not at all like a second home which has not been rented or operated on a professional hotel basis.

PROPOSED LEGISLATION—EFFECT ON REAL ESTATE MARKET

This proposed legislation, if adopted, would have a detrimental impact on the real estate industry, and specifically on Marriott's condominium development program. As a result of our Camelback Inn condominium sales program, we have paid approximately $2,800,000 in Federal taxes, and the sales of these units have provided the economy with approximately $22 million in new construction and development funds. If the legislation restricts the owner's use to 14 days, we believe this could severely hamper anyone's ability to sell second home or hotel-type condominiums in the future.

ANALYSIS OF HOTEL-TYPE RESORT CONDOMINIUMS

There are a number of resort hotel condominium projects around the country. We would like to emphasize that our discussion is based on professionally managed resort condominium hotels. The hotel industry has a 65 to 70 percent year-round occupancy as opposed to the individual condominium owner who manages his unit for his own behalf. We estimate that on the average this type of individual probably has a 30 to 40 percent year-round rental occupancy.

Using Camelback Inn as an example of a resort hotel condominium project, we have analyzed the lost income at Camelback Inn resulting from owners using their condominium units. The amount of room revenue that would have been generated had there been an available room to rent to the public when a condominium owner was staying at the Inn is illustrated in the following table:

	Lost revenue	Actual room sales	Percent
Year ending July:			
1974	$6,800	$3,867,400	0.18 of 1
1975	9,100	4,336,800	.21 of 1

We originally designed our program to limit owners' use to 28 days because we did not want the profits of the hotel to decline should there be an excessive owners' use. Now, after 2 years, our experience as shown in the above table proves that owners' usage has had a very negligible effect on gross revenues. Therefore, tax revenue from the Inn has not diminished as a result of the owners using their condominium units.

As a matter of fact, for the owners who use their units, we have found their vacation time is so varied over the year, that the owners' use generates income which otherwise would not be present in the hotel. Actually, the net effect is that the condominium owners are bringing more business into the hotel. This results in additional tax revenues because of increased sales.

In addition, when owners use their units, they pay for the direct costs of their stay (housekeeping, front office services, etc.) by paying a service charge of $7–$11 per day. Here again, since the condominium owners are paying for the expenses, the profits of the hotel are not reduced.

LOSS OF TAX REVENUE AS A RESULT OF PROPOSED LEGISLATION

We are in the process of planning the development of a number of other resorts which would utilize the same concept as Camelback Inn. The estimated condominium sales value of these projects could exceed $100 million within the next few years. However, if the proposed legislation is adopted, these projects and others which the hotel and other real estate industries might develop, would probably have to be cancelled since the condominium method of financing will not be available. It is our opinion that resort condominiums cannot be marketed if an owner is restricted to only using his unit 14 days a year. Therefore, we feel that enactment of this legislation will cost the Federal Government millions of dollars in tax revenues.

Additionally, everyone connected with the real estate industry knows that the vacation home market has been in an unprecedented economic recession. Although we do not have statistics for the loss of tax dollars and jobs as a result of this slump, we believe that the proposed legislation before this committee will be extremely detrimental to the rebuilding of the vacation home industry.

ALTERNATIVE PROPOSAL

In the alternative, if this committee deems it necessary to enact this proposed legislation, we would strongly recommend that such legislation provide incentives for those who own such units to rent them to the greatest extent possible. This can be done by increasing the owner usage to 10 percent of actual time rented. The individual owner will have the incentive to work much harder to rent out his unit. The more the unit is rented, the more vacation days he will earn. This proposal then has a twofold advantage since it will create additional taxable income to the owner, which will result in greater tax revenues for the Federal Government. We can illustrate this by the following example:

	Single condominium unit		
	Year 1	Year 2	Year 3
Total nights available for rental	365	365	365
Assumed number of nights rented	91	182	273
Occupancy ratio (nights rented divided by total nights (percent))	25	50	75
Gross revenues (nights rented times $60 rate per night)	$5,460	$10,920	$16,380
10 percent of nights rented	9	18	27

SUMMARY

In summary, the Camelback Inn, which is a hotel-type condominium project, is one that has been designed purely on a business basis, so as to maximize profits and provide a reasonable amount of personal use to individual owners. Our experience since implementing the condominium program has proven without a doubt that the 28-day limitation of personal use has not reduced the gross rental income of the hotel. Therefore, we feel that the proposed legislation will produce a harsh result which is not needed.

Our feeling is that the present tax law is adequate to prevent abuses in this area. If this committee decides to enact the legislation as proposed, we feel that it would have a serious impact on the real estate

industry as well as on Marriott's condominium programs and put a further damper on stimulating the vacation home industry. The alternative proposal we have made is to provide owners incentive to maximize rentals which could be a way to minimize the impact to the real estate industry and yet increase revenues and taxes; that is, give usage of 14 days or 10 percent of actual time rented, whichever is greater.

Thank you for this opportunity to present our views to you today. We strongly urge this committee to specifically exclude resort hotel condominiums from section 601(B), or to modify it to increase the usage to 10 percent of time rented.

Statement of the American Land Development Association

The second or "vacation" home industry

The second-home industry has a long history in the United States. It dates to the earliest fishermen's shacks on the edge of oceans and rivers, and hunting cabins in the mountains. In recent generations, the retirement home has become a major segment of the second-home industry. Most recently, interest in condominium-type housing in the resort areas of the country has grown rapidly to become a major new market segment.

The second home has become a significant economic force in contemporary society. It represents the new aspiration of millions of Americans, much as first-home ownership was the driving force which motivated an earlier generation.

To see why this is so requires only a cursory review of well-known trends in the United States. The growth of leisure time and the accompanying desire for healthy, family-oriented outdoor recreation and sports activity have been key factors. Increasing affluence, earlier retirement, the shorter workweek (and its more recent byproduct, the 4-day week, now practiced by some 3,500 companies across the country), improving retirement, and other benefit programs have been fundamental to the growth of the second-home industry. Increasing longevity, a more mobile population, and the well-known problems of the cities have also encouraged this generation to seek a haven in the more tranquil settings which second homes provide. The problems of inflation have encouraged the purchase of real estate, with second homes a popular choice.

Second homes—A major industry

There are more than 3.5 million second homes in the United States today (table 1). More than 5 percent of all housing in this country is now second homes. A study by McKinsey and Co. estimates that in 1972, second-home sales exceeded $7 billion, and notes that second homes have become a major business.

Growth of second-home industry

The total number of second homes is increasing by in excess of 150,000 units per year. It is currently estimated that between 8 and 10 percent of all new housing starts are now second homes.

Income characteristics of second-home owners

The typical second-home owning household is not substantially more affluent than the average household. A 1967 income study indicates that

median income of second-home households was $10,950, compared with $8,600 for all households. Forty-three percent of all second home households had less than $10,000 in annual income, while only 2.9 percent made over $50,000 a year and only 9.2 percent made between $25,000 to $50,000 per year.

Use of second homes by owners

The typical second-home owner makes frequent use of his home, with an average of 53 days of occupancy per year (table 2). Recent surveys indicate usage is increasing steadily over time. Almost all (92 percent) second homes are occupied by their owners at some time during the year, according to census data.

States most affected by second-home industry

There are two significant ways of looking at the geographic implications of the second-home industry. It is necessary to look at both the States which have the most second homes and the States which have the most second-home owners. For example, in Maine, Vermont, and New Hampshire, more than 15 percent of all housing units presently in those States are second homes. Therefore, the economic implications of events affecting those States (as well as many others) would be severe (table 3). The second consideration is the actual number of second homes within the State. New York leads with 201,000, followed by Michigan with 167,000, California, 117,000, and New Jersey, 105,000. Pennsylvania, Texas, and Florida all have in excess of 80,000 (table 4). The southwest is the most rapidly growing area in the construction of new second homes.

Future of the second-home industry

A comprehensive survey of plans for future ownership of second homes was conducted in 1973. This representative national survey (chart 1) shows the very sizable growth in demand for second homes through 1985. This survey shows that overall second-home ownership is projected to more than double by 1985, given 1973 consumer attitudes and economic conditions. Resort condominium unit ownership will more than quadruple over that same period.

TABLE 1.—DEMAND FOR RECREATIONAL PROPERTIES, BY TYPE OF PROPERTY, UNITED STATES, ESTIMATE FOR 1973 AND PROJECTED FOR 1975, 1980, AND 1985

Type of property	1973	1975	1980	1985
Number of households	67,430,000	70,080,000	77,000,000	84,000,000
Number of households owning recreational properties	5,732,000	7,008,000	8,855,000	11,760,000
Percent of total households	8.5	10.0	11.5	14
Number of households owning vacant recreational lot for speculation/investment	877,000	1,051,000	1,155,000	1,680,000
Percent of total households	1.3	1.5	1.5	2
Number of households owning vacant recreational lot for future building	1,416,000	1,752,000	2,310,000	2,520,000
Percent of total households	2.1	2.5	3.0	3
Number of households owning single family detached leisure home	3,237,000	3,855,000	5,005,000	6,720,000
Percent of total households	4.8	5.5	6.5	8
Number of households owning resort condominium unit	202,000	350,000	385,000	840,000
Percent of total households	.3	.5	.5	1

Source: Recreational properties, May 1974, R. L. Ragatz Associates, a study conducted for the President's Council on Environmental Quality in association with HUD and the Appalachian Regional Commission.

TABLE 2.—DURATION OF LEISURE HOME OCCUPANCY, BY REGION, UNITED STATES, 1966

Duration of occupancy	Percent of leisure homes				
	United States	Northeast	North-central	South	West
Less than 30 days	28.3	23.7	31.4	36.1	26.1
30 to 59 days	29.0	26.8	29.2	18.8	42.5
60 to 89 days	17.9	24.3	16.5	9.4	13.3
90 to 179 days	19.3	18.7	21.0	20.9	16.1
180 days or longer	5.5	6.5	1.9	14.8	2.0
Median days occupancy	53.0	59.0	49.0	52.0	47.0
	1,496,000	542,000	474,000	245,000	235,000

Source: U.S. Department of Commerce, Bureau of the Census, "Second Homes in the United States" (Washington: Government Printing Office, 1969), Current Housing Reports, Series H-121, No. 16.

TABLE 3.—*Percent leisure homes*[1] *are of total housing units, States ranked by percent of total, United States, 1970*

State	Percent	State	Percent
1. Maine	18.5	26. Virginia	3.1
2. Vermont	16.5	27. Rhode Island	3.1
3. New Hampshire	15.6	28. Iowa	3.1
4. Alaska	7.6	29. Oklahoma	3.0
5. Wisconsin	6.8	30. Alabama	2.9
6. South Dakota	6.7	31. New York	2.9
7. Montana	6.6	32. Oregon	2.8
8. Minnesota	6.6	33. Arizona	2.8
9. Michigan	6.4	34. Massachusetts	2.7
10. Idaho	6.3	35. Louisiana	2.6
11. North Dakota	5.6	36. Kansas	2.6
12. Wyoming	4.9	37. Indiana	2.6
13. Colorado	4.7	38. New Jersey	2.6
14. Delaware	4.5	39. Tennessee	2.5
15. New Mexico	4.5	40. Utah	2.5
16. South Carolina	4.5	41. Nevada	2.5
17. West Virginia	4.4	42. Pennsylvania	2.4
18. Arkansas	4.1	43. Georgia	2.3
19. North Carolina	4.1	44. Maryland	2.2
20. Mississippi	4.1	45. Florida	1.7
21. Missouri	3.8	46. Connecticut	1.6
22. Washington	3.7	47. Hawaii	1.4
23. Nebraska	3.6	48. Ohio	1.4
24. Texas	3.4	49. California	1.4
25. Kentucky	3.1	50. Illinois	1.1

[1] "Leisure homes" are enumerated by combining the U.S. Bureau of the Census categories "rural seasonal vacant" and "other rural vacant." This combination basically includes housing units which are intended for occupancy during only certain seasons of the year.

Source: Derived from U.S. Department of Commerce, Bureau of the Census, "U.S. Census of Housing, 1970, Detailed Housing Characteristics" (Washington: Government Printing Office, 1972), Final Report HC(1)-B1-52, table 32.

TABLE 4.—ESTIMATED NUMBER OF VACATION HOMES IN UNITED STATES

[Units held for occasional use plus seasonal units minus units held for migratory workers; States ranked by number and percent of total, 1970]

State	Total vacation homes	Percent of total vacation homes
United States	1,645,400	100.0
1. New York	200,636	12.1
2. Michigan	167,243	10.2
3. California	116,843	7.1
4. New Jersey	104,988	6.4
5. Pennsylvania	81,839	5.0
6. Texas	80,475	4.9
7. Florida	80,415	4.9
8. Wisconsin	68,922	4.2
9. Maine	65,854	4.0
10. Massachusetts	65,435	4.0
11. Minnesota	62,671	3.8
12. New Hampshire	36,851	2.2
13. Ohio	36,606	2.2
14. North Carolina	35,063	2.1
15. Indiana	34,189	2.1
16. Illinois	29,771	1.8
17. Virginia	26,681	1.6
18. Washington	22,116	1.3
19. Maryland	20,913	1.2
20. Connecticut	19,499	1.2
21. Kentucky	18,461	1.1
22. South Carolina	18,390	1.1
23. Vermont	18,376	1.1
24. Missouri	17,675	1.1
25. Colorado	17,564	1.1
26. Alabama	16,735	1.0
27. Georgia	14,825	.9
28. Iowa	12,411	.8
29. Louisiana	11,631	.7
30. Rhode Island	11,568	.7
31. Tennessee	11,399	.7
32. West Virginia	11,305	.7
33. Oregon	9,445	.6
34. Mississippi	9,052	.6
35. Montana	8,629	.5
36. Arizona	8,472	.5
37. Idaho	8,119	.5
38. New Mexico	7,060	.4
39. Oklahoma	6,815	.4
40. Delaware	6,204	.4
41. Arkansas	6,099	.4
42. South Dakota	5,508	.3
43. North Dakota	5,346	.3
44. Nebraska	5,013	.3
45. Kansas	4,915	.3
46. Alaska	4,750	.3
47. Utah	4,663	.3
48. Wyoming	2,717	.2
49. Nevada	2,393	.1
50. Hawaii	1,726	.1
51. District of Columbia	1,052	.1

Source: Derived from: U.S. Department of Commerce, Bureau of the Census, "U.S. Census of Housing, 1970, General Housing Characteristics" (Washington: Government Printing Office, 1971), Final Report HC(1)-A1-52, table 2.

Statement of Dr. Joseph Duffey, General Secretary, the American Association of University Professors

I am pleased to submit this statement on behalf of the 80,000 members of the American Association of University Professors as well as many other members of the academic profession. We have been authorized by the American Political Science Association to inform the committee that the association supports our position on the issue which is the subject of this statement.

Our statement focuses on section 601 of H.R. 10612, which relates to the deduction for expenses attributable to the business use of homes. As presently proposed in section 601, the home office deduction would no longer be available to faculty members currently and prospectively employed at colleges and universities. Because they are employees and their taxable income is obtained primarily as a result of their status as employees, section 601 would effectively prohibit their expenses incurred in the use of a home office.

We regard section 601 as both discriminatory and inequitable, and we respectfully request the committee to revise it. Two well-established principles serve as the basis for our request. The deduction currently permits faculty members to establish a more accurate computation of their taxable income. Furthermore, the expenses of a home office are directly attributable to the customary duties of faculty members.

It is important to put the home office deduction in its historical context. In 1963 the Internal Revenue Service issued revenue ruling 63–275 and in 1964 issued revenue ruling 64–272. In the background of the former ruling was a series of decisions on the deductibility of a professor's research expenses dating back to 1922. The immediate catalyst was Harold H. Davis, which was before the tax court in 1962 and the U.S. Court of Appeals for the Ninth Circuit in 1963. The primary issue in Davis was whether the expenses incurred in research were deductible under section 162(a) of the Internal Revenue Code as "ordinary and necessary" business expenses. The Commissioner disallowed the deduction and the tax court sustained him. However, while the case was on appeal to the Ninth Circuit, the Commissioner joined in a stipulation to vacate and remand the case to the tax court for entry of "no deficiency." Among the issues in Davis was whether Professor Davis could deduct the expenses incurred in maintaining a study in his home for the purposes of research and writing. As a result of the stipulation, Professor Davis was entitled to deduct the expenses of his home study.

Revenue ruling 63–275, which was issued at approximately the same time of the disposition of Davis, recognized the deductibility of research expenses incurred by professors as "ordinary and necessary" business expenses under the Internal Revenue Code. Of particular significance is the recognition in the ruling that the duties of a professor encompass not only lecturing and teaching but also communication and advancement of knowledge through research and publication; that appointments to faculties are made with the expectation that independent research will be carried out; and that it is necessary for professors to engage in research.

In 1964, in order to further clarify the issue of a professor's home study, revenue ruling 64–272 was issued. Professor A at X College had duties which included research and publication. His institution provided inadequate space and facilities to carry on such research; therefore Professor A used a home office and was able to establish the pro rata portion of the depreciation and expenses for maintaining his residence which is properly attributable to such use. The ruling provided that such expenses were deductible under section 162 and section 167

of the Internal Revenue Code in computing a professor's taxable income.

Three current and compelling factors serve as the basis for retention of the home office deduction for faculty members. We respectfully urge the committee to consider these factors in its analysis of section 601:

First.—Faculty members tend to purchase homes which have sufficient space for a home office or studio. In many instances, they have remodeled or enlarged their homes in order to provide for such a facility. Removal of the deduction for legitimate use of such space would create a significant financial hardship on such faculty members.

Second.—Faculty offices on the campuses of colleges and universities are not normally designed to provide adequate space or facilities for the research and writing in which professors engage. Frequently, two or more faculty members share an office which is limited in size and usually not conducive to concentration on research materials or the preparation of scholarly works. In a home office or home studio, a faculty member normally maintains a research library, documents, notes, a typewriter, and other necessary equipment purchased or obtained specifically for the purpose of research.

Third.—Within recent years, and particularly since the advent of the energy crisis, faculty offices on the campuses have been inaccessible to faculty members as a result of substantial efforts by institutions to conserve energy and sharply reduce expenses. Formerly, campus offices were adequately heated at all times, and campus buildings in which faculty offices are located were always accessible. Neither of these situations is true on most campuses at the present time. The amount of heat available during nonclass hours has been sharply reduced; concern about security has required institutions to lock buildings which are not required for student use. In the evenings, on weekends, and during student holidays and vacations, when faculty members are frequently accustomed to working in their campus offices, the offices generally are unavailable to them. As a result, an increasing number of faculty members have established home offices in order that they may continue to carry out their customary duties of employment. We believe that neither faculty members nor the institutions at which they are employed should be penalized because of their efforts to conserve energy.

We recognize the potential for abuse of this and other deductions, and we fully support the effort to stop the present abuse by individuals whose job descriptions do not require work at home. However, the elimination of the home office deduction for faculty members is harsher than is necessary in order to stop any abuses of the deduction. We believe that legitimate criteria can be established which will permit faculty members to use their home offices for the performance of their customary duties. We respectfully urge the committee to consider such criteria as it proceeds to analyze section 601.

We shall be pleased to respond to any inquiries from members of the committee.

REVENUE RULING 63–275

SECTION 162.—TRADE OR BUSINESS EXPENSES

26 CFR 1.162–1: Business expenses. Rev. Rul. 63–275
(Also Section 274; 1.274–4, 1.274–5.)

Treatment of research and related expenses incurred by college and university professors.

Advice has been requested concerning the deductibility for Federal income tax purposes of research expenses, including traveling expenses, incurred by college and university professors in their capacity as educators.

The facts presented are that the duties of a professor, with or without tenure, encompass not only the usual lecture and teaching duties but also the communication and advancement of knowledge through research and publication. Appointments are commonly made to college and university faculties with the expectation that the individuals involved will carry on independent research in their fields of competence and will put that research to use in advancing the body of learning in that area by teaching, lecturing and writing. It is customary, therefore, for professors to engage in research for the above purposes. Where the research is undertaken with a view to scholarly publication, the expenses for such purposes can not usually be considered to have been incurred for the purpose of producing a specific income-producing asset.

Section 162(a) of the Internal Revenue Code of 1954 provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Among the items representing business expenses are traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

Section 1.162–1(a) of the "Income Tax Regulations" provides with certain exceptions not here material, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. See, however, section 274(c) of the code and section 1.274–4 of the regulations which impose certain restrictions on the deductibility of travel expenses incurred by an individual who, while traveling away from home in the pursuit of trade or business, engages in substantial personal activity not attributable to such trade or business. See also section 274(d) of the code and section 1.27A–5 of the regulations for the rules with respect to the substantiation of traveling expenses.

Based on the facts presented, it is held that research expenses, including traveling expenses properly allocable thereto, incurred by a professor for the purpose of teaching, lecturing, or writing and publishing in his area of competence, as a means of carrying out the duties expected of him in his capacity as a professor and without expectation of profit apart from salary, represent ordinary and necessary business expenses incurred in that capacity and are, therefore, deductible under section162(a) of the code. Stenographic and other expenses incurred

in preparing a manuscript for this purpose and its publication costs are likewise deductible as business expenses under section 162(a) of the code. See, however, G.C.M. 11654, C.B. XII-1,250 (1933), with respect to capital expenditures connected with such research. The responsibility rests with each professor to show that the amounts claimed are reasonable in relation to the research performed and that the research is in his area of competence: that is, that the research is directly related to the general field in which the professor is performing services as an educator.

In the event income results directly from teaching, lecturing, or writing based upon research the cost of which has already been deducted, such cost may not again be taken into account in determining the income to be reported for Federal income tax purposes.

See revenue ruling 55-385, C.B. 1955-1, 100, with respect to the treatment of royalty and other income from writing as self-employment income.

This ruling does not cover the situation where a professor's activities may bear some similarity to those described above but are such as to constitute a separate trade or business.

Advice has been requested concerning the deductibility for Federal income tax purposes, of the cost of maintaining an office in the home by a college professor in his capacity as an educator.

A, a professor at X college, has certain duties which encompass not only the usual lecture and teaching duties but also the communication and advancement of knowledge through research and publication. It is necessary, therefore, for A to engage in research for the above purposes. The college does not furnish adequate space and facilities necessary to carry on such independent research. Thus, it is necessary for A to furnish his own space and facilities. A regularly uses a part of his personal residence for that purpose and can establish the pro rata portion of the depreciation and expenses for maintaining his residence which is property attributable to such use.

Revenue ruling 63-275, C.B. 1963-2, 85, provides that research expenses incurred by a professor with or without tenure, for the purpose of teaching, lecturing, or writing and publishing in his area of competence, as a means of carrying out the duties expected of him in his capacity as a professor and without expectation of profit apart from salary, represent ordinary and necessary business expenses in that capacity and are, therefore, deductible under section 162 of the Internal Revenue Code of 1954.

Revenue ruling 62-180, C.B. 1962-2, 52, provides that an employee who, as a condition of his employment, is required to provide his own space and facilities for performance of his duties and who regularly uses a portion of his personal residence for that purpose may deduct a pro rata portion of the expenses of maintenance and depreciation on his residence.

Based on the facts presented, it is held that a pro rata portion of the depreciation and other expenses of maintaining his residence incurred by A in his capacity as a professor are deductible under section 162 and section 167 of the code.

In the absence of a reimbursement or other expense allowance arrangement with his employer to cover the office expenses here involved,

such expenses are deductible by A only in computing taxable income and only provided the standard deduction is not claimed or the tax computed from the optional tax table.

CORCORAN GALLERY OF ART,
Washington, D.C., April 23, 1976.

Hon. RUSSELL LONG,
Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: This letter represents my views concerning section 601 of H.R. 10612 which I understand the Senate Finance Committee is now considering. Although the remarks below are my personal opinion, I am currently director of the Corcoran Gallery of Art and dean of the Corcoran School of Art in Washington, D.C. In addition, I have been a practicing artist for 20 years and have lectured widely here and abroad. Therefore, I believe I have some insight into the effect of this provision on the artistic profession which may not have been available previously to the committee.

Let me preface my views with an acknowledgement of the difficulty of the committee's task in revising the Internal Revenue Code so that it is equitable for all taxpayers. Let me also assure you that it is not my purpose to carve out a felicitous exception to the code for the artistic community, nor to suggest that artists should be subsidized through the tax structure, but rather to bring to the committee's attention aspects of the proposed amendment which would have a discriminatory effect on artists, photographers, and other creative individuals.

The question of deducting expenses attributable to the business use of a home is a difficult one, further complicated by several recent Tax Court decisions. Thus, in the face of uncertainty, it is fully appropriate that the Congress act to clarify the matter. As I am sure you realize, the substantive problem in this area involves the proper standard to apply in determining when the use of one's home for a business purpose should be deductible. This is a particularly difficult determination when one's home is merely an adjunct to ordinary business premises, particularly as the Tax Court has applied an "appropriate and helpful" criterion to determine its necessity to the taxpayer. Consequently, I concur in the view that the dwelling unit must be the principal place of business for the taxpayer and must be used for business purposes on a regular basis if it is to be deductible. In the case of employees, I also concur that the use must be for the convenience of the employer. By eliminating the supplementary use of a home for business purposes, I believe you will avoid a great many abuses which have undoubtedly occurred.

My concern with the provision lies in the case of artists and other individuals who either cannot afford separate business premises or who must have their facilities at hand at all times for creative or other reasons. In particular, two aspects of the provision appear to work an unjustified hardship.

The first element which I feel is discriminatory relates to the proposed limitations on deductions (Sec. 280(c)(4)). Under this provi-

sion, the amount which may be deducted (assuming other criteria are met) is limited to the gross income associated with the use of the facility. While some businesses generate sales on a regular basis, this is not true for artists and other creative individuals. A beginning artist may work for 5 years before he or she receives his first one-man show (the major sales vehicle for artists). Even then, as in my case, one-man shows may still only be held every 2 or 3 years as the amount and quality of work justifies an exhibition. The same is true of authors and composers whose creative work may be years in the making. Further, application of this limitation runs counter to the other provisions of the tax code without any articulated justification. Procedures such as income-averaging acknowledge and deal with the problem of irregular income production. More importantly, the "five-year presumption" is urgently applied to determine the legitimacy of the deductibility of all business expenses. Should this legislation be enacted, the deduction associated with utilization of one's home would be the only deduction at variance with this test.

A second problem inherent in section 280(c)(4) deals with the proper allocation of income to the home unit. A sculptor might maintain a home studio for the creation of models, but execute a darkroom at home while photographing elsewhere. Allocation of income to the home facility, no matter how essential it is, may well be disallowed by the IRS.

It might be argued that eliminating this limitation on deduction would allow major abuse. I disagree. The most effective tool for determining the legitimacy of any business deductions is the 5-year presumption, and an exception to this standard should not be thrust forward without conclusive justification. Consequently, it is my strong recommendation that section 280(c)(4) be deleted and that the section 183 5-year presumption be controlling for determining the deductibility of home-use business expenses.

An additional problem I have with H.R. 10612 deals with the section 280(c)(1) requirement that the home space be exclusively used for the business purpose. While this requirement works a hardship on a smaller group of creative artists (those who need to use part of their studio for other purposes), I am sure the committee wishes to be fair to all if it can be accomplished within its basic tax reform mandate. There are many artists who, to save expenses, literally live in their studio. This is most prevalent in New York where special legislation has been enacted to allow artists to occupy loft space which would ordinarily only be available for commercial use. In other instances, a photographer will use a bathroom or kitchen as his darkroom because of the great expense of installing plumbing. Under the current provision, no deduction would be allowed irrespective of the amount of income these facilities generated.

I realize that it could be argued that these are normal living expenses which the artist would ordinarily have to bear. As a practical matter, artists who are unable to afford separate facilities would choose a different (and perhaps less expensive) space should they be merely interested in a dwelling unit. I realize that to allow joint use may lead to abuse in the proper allocation of personal versus business use. However, I also believe the retention of the provision will be equally sus-

ceptible to abuse. Consequently, I would recommend the deletion of the word "exclusively" in section 280(c)(1).

Let me also raise a third point which I believe should be clarified in the committee report. Section 280(c)(1)(a) applies to the taxpayer's "principal place of business". It is my assumption that this relates to the business whose income is being taxed and not to the major source of income of the individual.

In summary, I support fully the basic purpose of the committee to define the limitations on deductibility of home-business expenses. Likewise, I concur that the deduction should only be available in a narrow context. Nonetheless, I am certain the committee would not want to discriminate against artists and other creative individuals whose income, because of the nature of the creative process, is not as regularly produced as that of a salesman or manufacturer. It is my sincere hope that the committee will act favorably on my recommendations. The potential for abuse if my suggested amendments are adopted is almost negligible, but the hardship for artists and other creative individuals is most severe if relief is not granted by the committee.

Sincerely,

ROY SLADE.

AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS,
Washington, D.C., April 26, 1976.

DEAR SENATOR: In preparation for the markup of H.R. 10612, I wish to bring to your attention the enclosed information and documents pertaining to the question of the home office deduction for faculty members. If approved in its present form, section 601 of H.R. 10612 would eliminate the present home office deduction for faculty members. We are very much opposed, of course, to such action, and we have encouraged faculty members to write to you and your colleagues on the Senate Finance Committee about the impact of the proposal.

The enclosed materials include:

(1) Section 601 of H.R. 10612.

(2) Statement by General Secretary Joseph Duffey and accompanying Revenue Rulings 63-275 and 64-272.

(3) A letter from General Secretary Joseph Duffey, dated December 10, 1975, to Senator Russell B. Long detailing the historical background of the home office deduction for faculty members and responding to the report of the House Ways and Means Committee.

(4) Senator Long's response to General Secretary Joseph Duffey, dated January 23, 1976.

(5) Senator Ribicoff's response to General Secretary Joseph Duffey, dated January 14, 1976.

(6) Three articles on the home office deduction from AAUP Legislative News issues of September and November 1975 and January 1976.

(7) The AAUP Legislative News of March 16, 1976, which includes an article on the home office deduction on page 5.

(8) A resolution adopted by the National Council on the Arts, adopted in February 1976.

(9) A statement which appeared in the American Historical Association Newsletter of March 1976.

We would be most pleased to supply additional data or to respond to any inquiries about the home office deduction.

Sincerely,

ALFRED D. SUMBERG,
Director of Government Relations.

Enclosures.

TITLE VI—BUSINESS RELATED INDIVIDUAL INCOME TAX PROVISIONS

SEC. 601. DEDUCTIONS FOR EXPENSES ATTRIBUTABLE TO BUSINESS USE OF HOMES, RENTAL OF VACATION HOMES, ETC.

(a) NONDEDUCTIBILITY OF CERTAIN EXPENSES.—Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding at the end thereof the following new section:

"SEC. 208. DISALLOWANCE OF CERTAIN EXPENSES IN CONNECTION WITH BUSINESS USE OF HOME, RENTAL OF VACATION HOMES, ETC.

"(a) GENERAL RULE.—Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an electing small business corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

"(b) EXCEPTION FOR INTEREST, TAXES, CASUALTY LOSSES, ETC.—Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

"(c) EXCEPTIONS FOR CERTAIN BUSINESS OR RENTAL USE; LIMITATION ON DEDUCTIONS FOR SUCH USE.—

"(1) CERTAIN BUSINESS USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis as—

"(A) the taxpayer's principal place of business, or

(B) a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

"(2) CERTAIN STORAGE USE.—Subsection (a) shall not apply to any item to the extent such item is allocable to space within the dwelling unit which is used on a regular basis as a storage unit for the invention of the taxpayer held for use in the taxpayer's trade or business of selling products at retail, but only if the dwelling unit is the sole fixed location of such trade or business.

AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS,
Washington, D.C., December 10, 1975.

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

DEAR SENATOR LONG: I wish to bring to your attention a matter of considerable urgency involving H.R. 10612 (Tax Reform Act of 1975), which the House passed last week and which your committee is now considering.

Included among the proposed revisions of the Internal Revenue Code is section 601 of H.R. 10612. This section relates to home office deductions, and as presently written in the legislation, it adversely

affects faculty members engaged primarily in research and publication. We are strongly opposed to its enactment.

The home office deduction is a means by which college and university professors engaged in research and publication have been able to establish a more accurate computation of their taxable income. The application of this deduction to professors was clearly established in the 1960's.

In 1963, the Internal Revenue Service issued Revenue Ruling 63-275 and in 1964 issued Revenue Ruling 64-272. In the background of Revenue Ruling 63-275 was a series of decisions on the deductibility of a professor's research expenses dating back to 1922. The immediate catalyst was the *Harold H. Davis* case, which was before the Tax Court in 1962 and the U.S. Court of Appeals for the Ninth Circuit in 1963. The primary issue in the *Davis* case was whether the expenses incurred in research were deductible under section 162(a) of the Internal Revenue Code as "ordinary and necessary" business expenses. The Commissioner disallowed the deduction, and the Tax Court sustained him. However, while the case was on appeal to the ninth circuit, the Commissioner joined in a stipulation to vacate and remand the case to the Tax Court for entry of "no deficiency."

Revenue Ruling 63-275, which was issued at approximately the same time of the disposition of the *Davis* case, recognized the deductibility of research expenses incurred by professors as "ordinary and necessary" business expenses under the Internal Revenue Code. Of particular significance is the recognition in the ruling that the duties of a professor encompass not only lecturing and teaching but also communication and advancement of knowledge through research and publication, that appointments are made to faculties with the expectation that independent research will be carried out, and that it is customary for professors to engage in research.

Among the issues in the *Davis* case was whether Professor Davis could deduct the expenses incurred in maintaining a study in his home for the purposes of research and writing. Although the home study issue was not discussed in Revenue Ruling 63-275, the principle underlying the ruling controlled it, and it was conceded by the Tax Division of the Department of Justice in the *Davis* appeal. Professor Davis was entitled to deduct the expenses of his home study.

In 1964, in order to clarify the issue of a professor's home study, Revenue Ruling 64-272 was issued. Professor A at X College had duties which included research and publication. His institution provided inadequate space and facilities to carry on such research, and therefore Professor A used a home office and was able to establish the pro rata portion of the depreciation and expenses for maintaining his residence which is properly attributable to such use. The ruling provided that such expenses were deductible under sections 162 and 167 of the Internal Revenue Code in computing a professor's taxable income.

In its report accompanying H.R. 10612, the Ways and Means Committee specifically points to the university professor's use of the home office deduction as an example of the "appropriate and helpful" standard, to which the committee objects. But in the example cited by the committee, it speaks of the university professor using "a den or some other room in his residence for the purpose of grading papers, pre-

paring examinations, or preparing classroom notes." The example completely ignores the fact that from the very outset the home office deduction was designed primarily to permit the professor involved in research and publication, which are recognized by the Internal Revenue Service as appropriate employment functions of the college or university professor, to establish an accurate computation of his or her taxable income. A review of the *Davis* case and the two revenue rulings clearly establishes the rational basis for the current interpretation of the applicability of the home office deduction to the professor engaged in research and publication.

In a statement we sent to the Ways and Means Committee on July 21, 1975, we pointed out the detrimental impact which the proposed change would have on professors with home offices who are currently engaged in research and publication. We pointed out that the committee's proposal would create a situation in which professors would be incurring costs of performing some of their employment functions at home without being able to net or deduct those costs against the gross income which their employment produces. We also said in our statement that "this is harsher than is necessary to stop the present abuse by individuals whose job description does not require work at home."

We would strongly recommend, as we did in our statement of July 21, that no change be made in this deduction, particularly in view of the inconsistency of the committee's report on the use which university professors make of their home offices with the established interpretation of the Internal Revenue Code under the principles of the two revenue rulings and the *Davis* case. We believe that the removal of this deduction would add further to the erosion of real income which faculties have undergone in recent years.

Sincerely,

JOSEPH DUFFEY.

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., January 23, 1976.

Dr. JOSEPH DUFFEY,
General Secretary, American Association of University Professors,
Washington, D.C.

DEAR DR. DUFFEY: This is in response to your letter objecting to legislation recently reported by the House Ways and Means Committee and approved by the House of Representatives that would limit the deductibility of a home office for Federal income tax purposes.

The House report prepared in connection with that bill, indicates a need for tighter rules to govern the deductibility of expenses attributable to the maintenance of a home office in order to restrict this deduction to business expenditures as opposed to those of a personal or family nature.

The proposed provision distinguishes between an employee and a self-employed individual who deals with patients, clients or customers in his home in the normal course of his trade or business, because the latter use is believed to be distinguishable as an income-producing activity. The incremental expenses of such home use may be deducted only to the extent of the incremental income produced by that use.

The use of a home office by an employee cannot generally be similarly related to incremental income. Where an income-producing secondary occupation is conducted in the home office, such as writing textbooks, painting, giving private music lessons, et cetera, a deduction to the extent of the income produced by the activity would be allowed.

It may indeed be that this provision, in attempting to limit a certain type of abuse, has worked a real inequity on teachers who must do a significant part of their work-related activities in their homes and who have bought larger homes or added on studios, music rooms or dens specifically to accommodate those activities.

Please be assured that when the Senate Finance Committee considers the House-passed tax legislation, this provision will be studied very carefully to insure that we do not unfairly discriminate against any particular group of taxpayers.

With every good wish, I am

Sincerely,

RUSSELL LONG, *Chairman.*

UNITED STATES SENATE,
COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C., January 14, 1976.

Mr. JOSEPH DUFFEY,
American Association of University Professors,
Washington, D.C.

DEAR JOE: Thank you for your letter regarding section 601 of H.R. 10612, the Tax Reform Act of 1975, which revises the deduction for expenses attributable to the business or professional use of homes.

I am sympathetic to your concern that section 601 as presently written may affect college teachers inequitably. Many teachers do a significant part of their work at home, where conditions may be more favorable for reading and writing. Many colleges quite laudably are attempting to reduce expenses for heat, lighting, etc. in office buildings; our tax laws must recognize that such economizing may compel teachers to rely increasingly on their offices at home.

As a member of the Committee on Finance, which shortly will begin consideration of tax revision legislation, I will urge that serious consideration be given to revising section 601 so that college teachers are not treated unfairly by the act. I believe that it is possible to end abuses of the present law without eliminating entirely the deduction of such expenses for college teachers.

Sincerely,

ABE RIBICOFF.

[From AAUP Legislative News, September 1975]

AAUP COMMENTS ON TAX PROPOSALS

The House Ways and Means Committee is currently considering proposals for changes in the Internal Revenue Code, and some of the proposed changes will affect faculty members. On the basis of an invitation to comment on proposals which were under consideration during the previous Congress, AAUP submitted a statement in July to the Ways and Means Committee. The statement was prepared by Prof.

Leo Raskind of the University of Minnesota Law School, who serves as chairman of the AAUP's Subcommittee on Taxation.

AAUP's statement dealt with three proposals which directly affect faculty members: (1) restricted use of home office deductions; (2) a change in the deductions allowable for attending conventions, educational seminars, and meetings outside North America; and (3) the elimination of deductions for certain employee business expenses below a floor of $200.

Between 1958 and 1963 AAUP was actively involved in obtaining a series of Tax Court and Internal Revenue Service rulings recognizing the deductibility of research expenses incurred by professors (see AAUP bulletin, spring 1964, pp. 14–18). In an agreement with the Tax Division of the Department of Justice during the same period, the deduction of home office expenses by a university professor was also allowed. The AAUP's current statement points out the earlier rulings which recognized the distinctive features and requirements of academic employment. The statement recommended that new legislation permit deduction of home office expenses in the case of "any trade or business of a kind customarily using the home for the performance of required duties" and that the committee's report cite as an example the faculty member who uses a home study for class preparation and "preparing and reviewing manuscripts of scholarly work." In the absence of broad-based tax reform, AAUP recommended that no change be made in the current provision for home office deductions.

The committee also had under consideration a proposal which would limit deductions for expenses incurred in attending conventions, educational seminars, or similar meetings outside North America. No deduction would be allowable for foreign travel expenses for an individual with respect to such meetings unless the location is consistent with the activities, purposes and functions of the meeting. In its statement, AAUP noted that the purpose of the proposed change was to supplement the present "test of motive" which operates exclusively at the individual taxpayer level with an additional showing at the convention level of the compelling reasons for holding the convention outside North America. "This new provision," the AAUP statement said, "would have a constraining effect on members of the higher education community." The statement cited several examples, including teachers of modern languages and law professors, who would be restricted under the proposal, and recommended inclusion of descriptive language and examples which would recognize the justified or reasonable purposes for holding a convention, seminar, or meeting outside North America.

AAUP's statement strongly opposed the enactment of any provision eliminating deductions of employee business expenses below a floor of $200. The enactment of such a proposed flat floor runs counter to the settled interpretation of the Internal Revenue Code and to the principle of a clear reflection of income, the statement said.

As a follow-up to the submission of the statement to the committee, the committee R staff communicated with chapter presidents in the congressional districts of the members of the Ways and Means Committee. The chapter officers were informed of both the proposals and the AAUP statement. They were asked to contact their Representatives

and to discuss the proposed changes with them within the context of the AAUP statement. They were also asked to inform their faculty colleagues of the committee's work.

On September 23 the Ways and Means Committee discussed the home office deduction. It tentatively agreed to provide definitive rules for permitting deduction of expenses for home offices and sharply reduced the instances in which such deductions would be allowed. The committee provided for two situations in which home office deductions would be permitted. Deductions would be permitted with respect to the portion of the home that is used exclusively on a regular basis as: (1) The taxpayer's principal place of business, or (2) a place of business which is used for patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business. Under these two exceptions, the deduction for allowable expenses may not exceed the income generated by the business activities of the taxpayer in his or her home. In the case of an employee, the business use must be for the convenience of the employer.

On the following day, September 24, the committee concluded its discussion of the proposal relating to the deductibility of expenses of attending conventions, educational seminars, or meetings outside North America. The committee rejected the proposed test of relevancy of the convention or meeting and instead tentatively agreed that deductions would be allowed for expenses incurred in attending nor more than two conventions per year which are held outside the United States. Further, the amount of the deduction for transportation expenses may not exceed the cost of airfare based on coach or economy class, and the amount of the deduction for expenses other than transportation expenses cannot exceed the fixed amount of per diem allowed to government employees at the location where the convention, seminar, or meeting is held.

The committee has not yet considered the third proposal. All of the committee's decisions, it should be emphasized, are tentative. During the week of October 20 the committee will review its tentative decisions and decide whether it wishes to proceed with the introduction of a bill. Even if it decides to sponsor a bill, there would be further hearings before a bill was sent to the floor for debate.

The opportunity for further contacts with Members of Congress about the proposals and tentative decisions of the Ways and Means Committee exists. The House will be in recess twice in October—October 9–20 and October 23–28. The recesses will permit faculty members to visit with Representatives in their district offices. Written comments should be directed to the Representative's office in Washington. Copies of the AAUP statement to the Ways and Means Committee are available from Associate Secretary Sumberg.

[From AAUP Legislative News, November 1975]

House Ways and Means Committee Introduces H.R. 10612

When we last reported on the tax reform activities of the House Ways and Means Committee, we said that the committee's decisions of September 23–24 concerning the home office deduction and the deduction for expenses incurred in attending educational meetings

abroad were tentative. Those tentative decisions have now been given final approval by the committee and are included in the Tax Reform Act of 1975 (H.R. 10612), which Chairman Al Ullman introduced on November 6. Action on the bill is expected shortly after Congress reconvenes on December 1.

The committee did not act on a third proposal which would have affected faculty members. That proposal, which was designed to eliminate deductions for certain employee business expenses below a floor of $200, would have resulted in a loss of deductions for dues paid to disciplinary societies and professional organizations as well as for books and supplies.

Under section 601 of H.R. 10612, the only instances in which deductions for home offices will be allowed are when such offices are "exclusively used on a regular basis" as (1) the taxpayer's principal place of business, or (2) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or (3) as a storage unit for the inventory of the taxpayer held for use in the taxpayer's trade or business of selling products at retail.

In a 476-page report which accompanied the bill, the committee challenged recent Tax Court decisions that permitted deduction of expenses attributable to a home office if the maintenance of the office is "appropriate and helpful" to the employee's business. The report pointed out that in at least the fourth judicial circuit, the court of appeals had held that such expenses were nondeductible personal expenses, and that it was therefore unnecessary to decide if maintenance of the home office was appropriate and helpful in carrying on a person's business. In order to obtain a deduction, the court said that an employee would have to show that the office provided by the employer is not available at the times the employee uses the office in his or her residence or that the employer's office is not suitable for the purposes for which the taxpayer is using his or her home office. In its report, the committee said that the determination of allowing a deduction under the "appropriate and helpful" standard was necessarily subjective. According to the committee, the standard creates inherent administrative problems and permits deductions of personal, living, and family expenses which are not allowed under the current law. Pointing directly to the university professor as an example of the current use of the "appropriate and helpful" standard, the committee said: "If a university professor, who is provided an office by his employer, uses a den or some other room in his residence for the purpose of grading papers, preparing examinations, or preparing classroom notes, an allocable portion of certain expenses might be claimed as a deduction even though only minor incremental expenses were incurred in order to perform these activities." H.R. 10612 provides that the new provision would become effective on December 31, 1975.

In its statement of July 21 to the Ways and Means Committee, AAUP argued that the committee's proposal to restrict severely the use of the home office deduction would "cause a distortion in the computation of taxable income of university professors." Professors would be incurring costs of performing some of their employment functions at home without being able to net or deduct those costs against the gross

income which their employment produces. "We think this is harsher than is necessary to stop the present abuse by individuals whose job description does not require work at home." The statement pointed out that home offices are used by faculty members primarily for research and writing or grading examinations. In 1963, the Internal Revenue Service recognized in a revenue ruling the distinctive nature of academic employment and permitted deductions for research expenses. "The proposed change," the statement pointed out, "would effectively distort and discriminate against this class of employees whose job requirements impose on them the obligations of research and writing."

Section 602 of H.R. 10612 restricts deduction for expenses incurred in attending foreign conventions, including educational meetings. The committee rejected an earlier proposal for a test of relevancy of the convention to the taxpayer. Instead, it restricted deductions to two foreign meetings per year, required deductions for transportation expenses to be no greater than the lowest coach or economy rate, and determined that the transportation expense deduction was valid only if the person devotes more than one-half of the total days of the trip to business-related activities, and the subsistence expense deduction was valid only if the person attends two-thirds of the daily business activities. In no case may the subsistence expense deduction exceed the per diem rate permitted to U.S. civil servants.

AAUP's primary concern in its statement of July 21 was the proposed shift from the present test of motive of the individual taxpayer to a new test of relevancy of the convention to the taxpayer. AAUP had rejected the new proposal because of its "constraining effect on members of the higher education community." The Ways and Means Committee agreed and then turned to finding ways of preventing abuses of the current law.

The Tax Reform Act faces an uncertain future when Congress reconvenues on December 1. It was intended to follow in the tradition of the Tax Reform Act of 1969, the most comprehensive reform of the income tax law since its inception in 1913. As the Ways and Means Committee moved through its deliberations in September, October, and early November, at least two complications developed. The first involved the President's proposal to cut taxes by $28 billion and to hold Federal spending in fiscal year 1977 to $395 billion. The proposal created problems for the committee because it could deal only with the tax reduction while the spending limit fell into the area now covered by the Congressional Budget and Impoundment Control Act of 1974. The majority of the committee favors an extension of the 1975 individual and corporate tax cuts, and such a provision has been included in H.R. 10612. The President has announced that he will veto H.R. 10612 if it fails to include a ceiling on fiscal year 1977 spending. As a result, separate legislation simply extending the 1975 tax cuts has been introduced. Thus, in case Congress rejects H.R. 10612, the separate tax cut bill will be pressed forward, and the tax reform provisions in H.R. 10612 would have to be reconstituted in yet another bill.

A second complication arises from the disappointment of tax reformers on the Ways and Means Committee with the final product represented by H.R. 10612. They believe that several of the most neces-

sary reforms were gutted in the final days prior to approval. As a result, they have pressed for consideration of amendments on the floor of the House. Traditionally, tax bills may not be amended during House debate. However, the House Rules Committee has recommended a modified open rule with 6 hours of debate and consideration during the debate of seven amendments. Tax reformers support five of the seven amendments.

AAUP will express its continuing concern about the home office deduction prior to the House debate. Chapters and members may obtain an update of information by contacting Associate Secretary Sumberg.

[From AAUP Legislative News, January 1976]

AAUP STATEMENTS ON HOME OFFICE DEDUCTION BRING RESPONSE

When Congress reconvened on January 19, the home office deduction issue received new attention. The House passed the Tax Reform Act of 1975 (H.R. 10612) on December 4 by a vote of 257 to 168. The Senate did not take up the bill prior to the congressional adjournment on December 19. The Senate Finance Committee has not yet announced its schedule for hearings on the bill.

In an effort to forestall passage of the restrictive provisions in section 601, which includes severe limitations on use of the home office deduction, General Secretary Joseph Duffey wrote first to Representative Al Ullman (D-Oreg.), chairman of the House Ways and Means Committee, and then to Senator Russell B. Long (D-La.), chairman of the Senate Finance Committee. Copies of the letters were sent to members of the House of Representatives and the Senate.

In his letter to Chairman Ullman, Dr. Duffey expressed the AAUP's "disappointment over the way in which the Ways and Means Committee has handled the home office deduction under the current proposed revisions in the Internal Revenue Code." He told Senator Long that the issue was "a matter of considerable urgency." In both letters, he reviewed the background of the home office deduction, which includes a series of decisions on the deductibility of a professor's research expenses dating back to 1922. He pointed to two Internal Revenue Service rulings: (1) Revenue Ruling 63-275, which recognized the deductibility of research expenses incurred by professors as "ordinary and necessary" business expenses under the Internal Revenue Code. This ruling recognized that the duties of a professor include not only lecturing and teaching but also research and publication, that faculty appointments are made with the expectation that independent research will be carried out, and that it is customary for professors to engage in research. (2) Revenue Ruling 64-272, which clarified the issue of the deductibility of expenses for a home study by a professor engaged in research and publication.

Dr. Duffey recommended that no change be made in the home office deduction for faculty members. He pointed to the serious inconsistency in the report of the House Ways and Means Committee on the use of home offices by professors, and he said that "the removal of this deduction would add further to the erosion of real income which faculties have undergone in recent years."

The rules under which the House considered H.R. 10612 on December 4 precluded any additional amendments which might have led to the elimination of section 601. In response to his letter to Senator Long, copies of which were sent to all Members of the Senate. Dr. Duffey received an encouraging response from Senator Abraham Ribicoff (D-Connecticut). Senator Ribicoff said that he was sympathetic to the AAUP's concern about section 601. "Many teachers," he said, "do a significant part of their work at home, where conditions may be more favorable for reading and writing. Many colleges quite laudably are attempting to reduce expenses for heat, lighting, and so forth, in office buildings; our tax laws must recognize that such economizing may compel teachers to rely increasingly on their offices at home." Senator Ribicoff, who is a ranking member of the Senate Finance Committee, said that he will urge "that serious consideration be given to revising section 601 so that college teachers are not treated unfairly by the act. I believe that it is possible to end abuses of the present law without eliminating entirely the deduction of such expenses for college teachers."

General Secretary Duffey and Associate Secretary Alfred D. Sumberg are currently working with Senator Ribicoff's staff person on recommendations for revision of section 601.

Interested faculty members may wish to express their opinions on the subject to members of the Senate Finance Committee: Senators Russell B. Long, Herman E. Talmadge, Vance Hartke, Abraham Ribicoff, Harry F. Byrd, Jr., Gaylord Nelson, Walter F. Mondale, Mike Gravel, Lloyd Bentsen, William D. Hathaway, Floyd K. Haskell, Carl T. Curtis, Paul J. Fannin, Clifford P. Hansen, Robert Dole, Bob Packwood, William V. Roth, Jr., and Bill Brock. Letters should be addressed care of U.S. Senate, Washington, D.C. 20510. Please send copies of your correspondence to Associate Secretary Sumberg at the Washington office.

[From the AAUP Legislative News]

SENATE FINANCE COMMITTEE TO HOLD HEARINGS ON H.R. 10612

The Senate Finance Committee will begin hearings on the Tax Reform Act of 1975 (H.R. 10612) on Wednesday, March 17. Of particular concern is the committee's consideration of a revision of section 601 related to the home office deduction. AAUP has worked with Senator Abraham Ribicoff (D-Connecticut) in the preparation of an amendment which is designed to protect the legitimate use of home offices by faculty members.

During the past several weeks, there has been a heavy volume of mail directed to members of the Senate by faculty members who use their home offices for research, writing, and preparation of their courses. The responses from Senators have been uniformly sympathetic.

One such response came to General Secretary Joseph Duffey from Senator Russell B. Long (D-Louisiana), chairman of the Senate Finance Committee. Senator Long acknowledged Dr. Duffey's letter of December 10 and expressed concern about the potential impact of section 601 on faculty members. "It may indeed be," he said, "that this

provision, in attempting to limit a certain type of abuse, has worked a real inequity on teachers who must do a significant part of their work-related activities in their homes and who have bought larger homes or added on studios, music rooms, or dens specifically to accommodate those activities." Senator Long assured Dr. Duffey that the Senate Finance Committee will study section 601 very carefully "to insure that we do not unfairly discriminate against any particular group of taxpayers."

In a related development, the American Political Science Association informed Dr. Duffey on February 6 that "in matters relating to the proposed legislation designed to limit the deductibility of a home office for Federal income tax purposes (sec. 601 of H.R. 10612), you are authorized to state that the American Political Science Association supports your association's efforts to prevent passage of the legislation." Associate Secretary Sumberg has been in contact with the constituent societies of the American Council of Learned Societies concerning the current status of the issue.

Faculty members interested in the home office deduction are encouraged to write to their Senators and to members of the Senate Finance Committee: Senators Russell B. Long, Herman E. Talmadge, Vance Hartke, Abraham Ribicoff, Harry F. Byrd, Jr., Gaylord Nelson, Walter F. Mondale, Mike Gravel, Lloyd Bentsen, William D. Hathaway, Floyd K. Haskell, Carl T. Curtis, Paul J. Fannin, Clifford P. Hansen, Robert Dole, Bob Packwood, William V. Roth, Jr., and Bill Brock. Letters should be addressed care of U.S. Senate, Washington, D.C. 20510. Copies of correspondence should be sent to Associate Secretary Sumberg at the Washington office.

FEBRUARY 1976—NATIONAL COUNCIL ON THE ARTS RESOLUTION

Statement on tax reform bill of 1975

The National Council on the Arts notes that the Tax Reform Bill of 1975, currently before the Senate Finance Committee, would amend present tax laws with respect to the deduction of expenses attributable to the use of a taxpayer's home for business purposes. The Council believes that the proposed revision (section 601), as presently drafted, could have discriminatory effects on the Nation's artistic community.

Under present law, expenses incurred in maintaining a residence are deductible if incurred in connection with the taxpayer's trade or business or for the production of income. Therefore, if an artist's, writer's, or composer's dwelling includes a studio or workshop and he or she earns income from the sale of works created there, a portion of the expenses incurred in maintaining his or her residence is deductible from adjusted gross income.

Under the proposed bill, deductions would be permitted only if (1) an exclusive portion of the taxpayer's dwelling is used on a regular basis as his principal place of business, or, (2) as a place where, in the normal course of a business activity, the taxpayer meets or deals with patients, clients, or customers.

Many artists, writers, and composers utilize a portion of their homes exclusively as studios and workshops. Artistic works created there may often result in earned income. However, unlike accountants, doc-

tors, or lawyers whose "principal business" activities or jobs are usually synonymous with their main professional interests, artists, writers, and composers must frequently perform nonart business activities or jobs to provide a basic livelihood for themselves and their families. It is unclear under the proposed legislation whether, when this is the case, a studio or workshop in an artist's home would be considered as his "principal place of business" for income tax purposes and thus qualify for the deduction, even though it is here the creative person performs his professional artistic activity. Also, with respect to the second exception, it is not clear whether, for example, art dealers who sell artists' works, or publishers who distribute writers' works, could be regarded as "clients or customers." Further, it is unclear under the proposed law whether an artist or writer who deals directly with "customers" at his studio or workshop, while being the employee of another for basic livelihood purposes, would qualify under the second exception, since it apparently will be necessary that any such use be for the convenience of his employer—even though such employment is not related to the artist's professional work.

Consequently, the Council is concerned that the section 601 criteria presently contained in the Tax Reform Bill for allowing the deduction of expenses attributable to the business use of homes could have serious discriminatory effects on the Nation's artistically creative community, when considered in light of the tax advantages which would continue to be available to other professionals under the proposed legislation.

Accordingly, the Council requests that a copy of this resolution be communicated to appropriate congressional staff and that endowment staff enter into discussions with congressional staff members in order to achieve necessary clarification or modification of these provisions to ensure that artists, writers, composers, and other creative persons do not suffer discriminatory effects under the provisions of the tax reform bill of 1975, as finally enacted.

[From the American Historical Association Newsletter, March 1976]

AAUP Examines Tax Reform Legislation

The Senate Finance Committee is examining the Tax Reform Act of 1975 (H.R. 10612) which includes severe limitations on the use of the home office deduction by faculty members. The American Association of University Professors has been following the legislation closely, and AAUP General Secretary Joseph Duffey has recommended that no change be made in the home office deduction for faculty members. In letters to the House Ways and Means Committee and the Senate Finance Committee, Mr. Duffey has pointed to the inconsistency in the report of the House Ways and Means Committee on the use of home offices by professors, and he said that "the removal of this deduction would add further to the erosion of real income which faculties have undergone in recent years." The AHA office is lending its support to the effort to retain recognition of the legitimacy of the home office deduction.

The Senate Finance Committee is expected to hold hearings on H.R. 10612 in mid-March. Interested faculty members may wish to express their opinions on the subject to members of the Senate Finance Committee: Senators Russell B. Long, Herman E. Talmadge, Vance Hartke, Abraham Ribicoff, Harry F. Byrd, Jr., Gaylord Nelson, Walter F. Mondale, Mike Gravel, Lloyd Bentsen, William D. Hathway, Floyd Hansen, Robert Dole, Bob Packwood, William V. Roth, Jr., and Bill Brock. Letters should be addressed c/o U.S. Senate, Washington, D.C. 20510. The AAUP requests that copies of such correspondence be sent to Associate Secretary Alfred D. Sumberg at the AAUP office, 1 Dupont Circle, Suite 500, Washington, D.C. 20036.

3234

Industrial Development Bonds

3236

Statement by John H. Noonan, Vice-President, Kidder, Peabody & Co., Inc., New York, N.Y.

ALTERNATIVES TO TAX EXEMPT STATE AND LOCAL BONDS

Introduction

As a vice president in one of the Nation's largest investment banking corporations with indepth expertise concerning State and local financing, I am pleased to have the opportunity to submit this statement concerning the above-cited topic.

Prior to the discussion of alternatives, in general, and H.R. 11214, in particular, a review of the legislative history of section 103(a) (1) of the Internal Revenue Code of 1954 is appropriate.

Legislative History

Section 103(a) (1) has its origin in the Revenue Act of 1913 [1] which was enacted 1 year after the adoption of the 16th amendment to the Constitution. It is substantially identical in language to section 22(b) (4) (A) of the 1939 code and provides, in brief, that interest on the obligations of State and local governments is tax-exempt. Apparently, this concept was adopted by Congress because of the belief that the Constitution prohibits the Federal Government from taking any action which might impair the ability of State and local governments to borrow.[2] Although many legal experts have expressed differing opinions on the constitutionality of the Federal Government's power to tax State and local obligations, for purposes of this statement, it is assumed that within limits Congress has the authority to amend section 103(a) (1)[3] of the code.

---

[1] Act of Oct. 3, 1913, ch. 16, 38 Stat. 168. Sec. II(B) of the 1913 act provided, in relevant part, as follows: "That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof * * *"

[2] See, for example, congressional debates relating to the 1939 act, 84 Congressional Record 7497, 7705–7708; 86 Congressional Record 12185 (1940 act); 88 Congressional Record 6278–6280, 7789–7790, 7798, 77805, 7891–7912, 7920–7949.

[3] It is likely that if the Congress enacts an alternative to local tax-exempt bonds it will be challenged in the Supreme Court. The hearings considering the Tax Reform Act of 1969 are replete with references to the constitutionality or lack thereof of an alternative to tax-exempt obligations. For example, Assistant Secretary Cohen cited the U.S. Supreme Court case of *Pollock* v. *Farmers' Loan Trust Company*, 157 U.S. 429 (1894), which held unconstitutional an income tax on tax-exempt interest. In 1939, the State attorneys general submitted a brief to the Congress indicating that this opinion had not been overruled by the 16th amendment. Note that the National Association of Attorneys General have reaffirmed this brief in both 1969 and 1978. On the other hand, former Congresswoman Martha Griffiths (D., Mich.) introduced a letter from the U.S. Assistant Attorney General, Samuel Clark, Jr., dated Apr. 14, 1942, which concludes that "* * * no objections on constitutional grounds can be successfully raised against the proposal to tax the income . . . received upon outstanding State obligations." That letter had been previously introduced in hearings before the Ways and Means Committee in 1942 by Randolph Paul, a tax adviser to the Treasury Department.

If the issue were to be litigated, the question would be whether intervening decisions of the Supreme Court, as well as the 16th amendment, have overruled the *Pollock* case. Subsidiary issues would be whether the loss of the tax exemption by Federal statute infringed upon the powers of State and local governments and if they may elect to have their obligations taxed by the Federal Government if the Constitution prohibits same.

Since 1913, the Congress and the Treasury have considered various legislative proposals to amend section 103(a) (1) and its predecessors. The legislative history from 1913 to 1968 is set forth in more detail in exhibit A attached hereto. This statement will focus on the legislative history from 1969 to the present.

The Tax Reform Act of 1969, as passed by the House of Representatives, contained a provision [4] allowing State and local governments the option [5] of issuing federally subsidized taxable obligations. If the option were not elected, such governments could continue to issue tax-exempt obligations. If the option [6] were exercised, the Federal Government would make payments on the bonds equal to the average cost of the additional interest payable—the difference between taxable and tax-exempt interest rates) plus, in theory, an additional amount. The fixed percentage subsidy would be paid by the Treasury automatically to the issuer and would be either a specified percentage of the yield rate at which the obligations were issued (25 to 40 percent) or a number of percentage points based upon a similar percentage applied to a relatively current corporate bond yield. Payment of the interest subsidy would be made to the issuer or its paying agent by the same time the issuer was required to make interest payments. Also, the interest subsidy could be paid through the use of dual coupons on the bonds—one for the State or local government and the other to be paid by the Federal Government. The latter feature was considered necessary for those States which have a statutory maximum interest limitation.

The first decision of the Senate Committee on Finance, in its deliberations on the Tax Reform Act of 1969, was to delete this House provision providing a subsidy for taxable State and local bonds. Senator Russell B. Long (D-La.), chairman of the committee, indicated in a press release dated October 9, 1969, that every Governor and most other local officials objected to the House's taxable bond option provision. Because of these objections and Treasury's opposition, the Senate's version deleting the option carried in conference.

However, after 1969 there was a major change in opinion, and by 1972, a position supporting a taxable bond option, under certain prescribed circumstances, was adopted by the National Governor's Conference, the National League of Cities, the National Association of Counties, and the Municipal Finance Officers Association.[7] This explains, in part, the passage of S. 3215 by the Senate Committee on Banking, Housing and Urban Affairs in 1972 which provided for a taxable bond option. S. 3215 was referred to the Senate Finance Committee where no action was taken.

On February 23, 1973, a panel of invited experts testified before the House Committee on Ways and Means on "An Alternative To Tax-Exempt State and Local Bonds." All of the panelists supported a taxable bond option, provided various safeguards were included to in-

---

[4] Secs. 101 and 102.

[5] The optional approach apparently originated in 1941 with Mr. Lawrence Seltzer when he proposed that the Federal Government pay State and local governments some fixed proportion of their annual interest payment if they issued taxable bonds. See National Tax Association, Proceedings (1941), p. 195.

[6] The option was not to be available for arbitrage bonds as defined in sec. 103(d) of the code and certain industrial development bonds as defined in sec. 103(c) of the code. Those industrial development bonds which qualify under sec. 103 (c)(4), (c)(5), and (c) (6) apparently would be eligible for the tax subsidy.

[7] See hearings on S. 3215 (Federal financing authority), Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d sess., 277, May 15–17, 1972.

sure the continuation of the tax-exempt market and the autonomy of the State and local governments in their decisionmaking process.[8]

Following the panel discussions, many of the same witnesses who appeared before the Senate Banking Committee appeared at public hearings, with others, before the House Committee on Ways and Means to testify in favor of a taxable bond option. The major statement in opposition was presented on behalf of the National Association of State Auditors, Comptrollers and Treasurers.[9]

The Department of the Treasury in its 1973 "Proposals for Tax Change," before the Ways and Means Committee, reversed its 1969 opposition to a taxable bond option. It recommended a "Taxable Municipal Bond Act of 1973" which would provide a subsidy equal to 30 percent of the net interest on qualifying State and local obligations if the issuer elected to issue taxable ones. The issuer would be eligible for the subsidy, with certain limited exceptions, if it satisfied Treasury regulations or entered into an agreement with the Secretary. In addition, the 30 percent subsidy would be reduced by Treasury administrative cost, and the issuer would have to report to the Internal Revenue Service the payments of taxable interest to the bondholders. See exhibit B for a more detailed explanation of this Treasury proposal, which was not enacted.

Why had Congress considered alternatives to tax-exempt obligations?

Challenges to the historic condition of tax-exempt treatment for all State and local obligations have been grounded on three arguments—equity, cost, and market.

The equity argument asserts that it is unfair to permit some taxpayers to escape payment of Federal income tax on interest income merely because they invest in State or local obligations. There is a growing feeling among a number of legislators, economic and tax experts, and reform groups that every citizen should pay some Federal income tax. They assert that tax-exempt bonds reduce the effective progressivity of the income tax by virtue of the fact that the tax-exempt bonds are worth more to the taxpayers in the higher tax brackets; therefore, there is a redistributional effect in the sense that a tax burden is borne disproportionately among the population.

The cost argument asserts that the savings generated to State and local governments from the sale of tax-exempt bonds are less than the costs absorbed by the Federal Government by reason of forgone revenues.[10] However, other experts, including myself, believe that it is impossible to determine the loss, if any, to the Treasury as a result of the issuance of tax-exempt obligations. Any revenue estimate must assume a particular effective Federal income tax rate on the part of

---

[8] "Panel Discussions Before the Committee on Ways and Means on Tax Reform," panel No. 8, "An Alternative to Tax-Exempt State and Local Bonds," Feb. 28, 1973.

[9] "Public Hearings Before the Committee on Ways and Means on the Subject of General Tax Reform," pt. 10 (Apr. 2, 1973), pp. 4297–4488.

[10] See Congressional Record, S22556, Dec. 17, 1975. "The ratio of yields varied in response to the general availability of credit, the demand for credit, and the proportionate demand by State and local governments to the total market demand for credit. As a result, high-income individuals and institutions otherwise subject to high tax rates who constitute a major portion of the market for tax-exempt State and local securities, have been receiving significantly larger tax benefits than needed to bring them into the market. Recent estimates place the annual savings in interest charges to State and local governments at $1.3 billion, but the annual revenue loss to the Federal Government has been estimated at $1.8 billion." See H. Rept. 91–413, 91st Cong., 1st sess., pt. 1, p. 173 (Aug. 2, 1969) for an estimate of the total cost to the Treasury in 1969 in the amount of $500 million.

the purchaser and a particular savings on the part of the issuers. Therefore, the alleged loss fluctuates depending upon the assumptions used.

Regarding market, reform proponents point to evidence indicating that the tax-exempt market may not be large enough to support the capital requirements of State and local governments at reasonable rates. A growing body of experts believe that State and local governments must have available new markets to raise sufficient capital at low interest rates in order to perform their civic functions. It should be pointed out that their comments are directed to the costs of borrowing and not to funds available since the largest sales volume of long-term State and local obligations occurred in 1975. It is clear that State and local governments have an adequate market for their obligations at some rate of interest.

The costs of governmental functions (such as education, health, housing, crime, and pollution control) are growing as the Nation's population increases and the urbanization process continues. However, State and local governments have not had a source of revenue that grows proportionately. Accordingly, those who challenge tax-exempt obligations argue that the Federal Government has some degree of responsibility to insure that State and local governments have available to them another means of raising capital. In other words, they believe that the present tax-exempt market may not provide a sufficient means to raise the needed capital.

Assuming that your committee accepts any of the foregoing arguments, what are the alternatives that it should consider?

ALTERNATIVES TO TAX-EXEMPT OBLIGATIONS

Before listing the five most considered alternatives and discussing them, it should be made clear that, if any alternative is adopted, it must be in the form of an option on the part of the issuer. This would insure State and local governments that their existing market would remain viable, and would also provide an additional market for their capital formation. Further, an alternative system would be acceptable to State and local governments only if they are convinced that they will continue to be free from Federal review of the merits of a project or their financial stability.[11]

Prior to a detailed discussion, in brief, the five alternatives which have been most widely discussed are:

1. The direct subsidy: Examples would be the Tax Reform Act of 1969 as passed by the House of Representatives, S. 3215 as passed by the Senate Committee on Banking in 1972; and H.R. 11214 as proposed by Congressman Henry Reuss (D-Wisc.).

2. A Federal "urbank" which would sell taxable securities of its own and then either buy tax-exempt obligations from State and local governments or loan funds directly to them. In form, this would follow previously established "urbanks" for other special programs.

---

[11] David J. and Attiat F. Ott, "The Tax Subsidy Through Exemption of State and Local Bond Interest," a compendium of papers submitted to the Joint Economic Committee, July 15, 1972, p. 305.

3. A Federal subsidy to existing tax-exempt institutions (such as pension and profit-sharing trusts, private foundations, universities, etc.) whenever they buy tax-exempt obligations.

4. The creation of a revolving fund, outside the annual appropriations process which would remit to the State and local governments the taxes that the Federal Government collected in any case wherein those local governments sold taxable obligations.

5. Amendment of section 14(b) of the Federal Reserve Act to allow the Federal Reserve to purchase State and local obligations.

1. Direct subsidy

a. In general.—If this concept is adopted, it is recommended that the committee combine the best features of both the 1969 House and the 1973 Treasury proposals. In other words, adopt the unfettered option rules of 1969 along with the set percentage concept (or statutory percent with no discretion on the part of the Secretary to vary it) of 1973. (In no way should the restrictive rules, as set forth in the 1973 proposals, vesting too much authority in the Secretary, be adopted.) The opposite or unfettered approach appears to be set forth in the Reuss bill, H.R. 11214.

b. Discussion of Reuss bill.—The Reuss type of bill could accomplish two goals: One, assure State and local governments that the Federal Government would not review a project either for its social desirability or economic viability; and two, give State and local governments stability through a fixed subsidy which they could rely upon in their long-term planning.

There are several other aspects of H.R. 11214 that should be discussed at this juncture; namely, the lack of specifics and the creation of a Municipal Finance Assistance Office within HUD.

(i) The need for more specificity in the Reuss bill can be illustrated by the following examples:

(*a*) Definition of interest cost.—If the committee adopts a fixed percentage, it must define the term "net interest cost per annum" as used in section 4(b)(1) of the bill. The problem is the bill does not indicate how premiums and discounts and multiple interest coupons contained in most municipal issues should be treated. For example, it could mean net interest costs as that term is used in awarding municipal bonds at competitive sale; that is, a weighted average interest cost per year which gives effect to underwriters discount or premium.

(*b*) Subsidy guarantee.—The bill should make clear the Federal Government's obligation with respect to interest payments in the event of default by the State or local government.

(*c*) Date election is made.—The bill should provide that State and local governments are not required to make the election until the date the bonds are delivered. The bill must not require its election in advance of delivery, because the market conditions do not remain constant.

(*d*) Dual coupon bonds.—There are some States whose constitutions or statutes provide for maximum interest rates, and therefore the bill should provide for dual coupons.

(ii) Creation of Municipal Finance Assistance Office. The creation of any assistance office is unnecessary and will detract from the un-

fettered concept. While such an entity's purpose is laudible, it could ultimately provide the vehicle for Federal controls and supervision of both taxable and tax-exempt obligations. In addition to the concern that the original purpose of this entity could be subverted, this office is not needed because State and local governments have financial expertise available to them. Moreover, if the option operates properly, the assistance office would have no function.

c. Subsidy percentage.—One of the key issues is the rate of subsidy. Proposals have ranged from 25 percent to 50 percent.[12] The arguments are that too low a rate would not be effective because State and local governments would continue to use the tax-exempt market. On the other hand, a high rate of subsidy would result in most obligations moving to the taxable market.

In this connection, Mr. John F. Fogarty, chairman, Public Finance Council of Securities Industry Association in previous testimony before your committee has suggested a subsidy of 33⅓ percent. He subsequently justified this as follows:

> We proposed a maximum subsidy of 33⅓ percent to try and "peg" the market at somewhere around its traditional ratio. Then, in times of crunch, volume of taxables would climb releasing pressure on the tax-exempt market which would automatically cycle ratios back down and preserve an existing market that has performed. Such a maximum subsidy also would reduce demands on the Treasury and reduce probabilities of eventual federal control of local governmental financing.[13]

Joseph H. Crown, Counsel to Tenzer, Greenblott, Fallon & Kaplan, New York, New York, on the other hand calls for a 50 percent subsidy:

> I advocated a 50 percent subsidy because studies have indicated that a 33.3 percent subsidy would supplant only about 10–15 percent of new issues; that a 40 percent subsidy would give a higher degree of substitution but still leave a quite large volume of tax-exempt securities to be issued; while a 50 percent subsidy would probably result in taxable bonds almost entirely displacing tax-exempt issues.
>
> The Senate Banking Committee, in reporting favorably in 1972 on a 33.3 percent subsidy, was seemingly influenced in fixing such a low rate by concerns over the "cost to the Treasury" of a higher rate and hoped thereby to overcome the Treasury's then generally negative attitude. But this factor of net cost to the Treasury is hardly a valid criticism of the proposal, or an obstacle. In an era in which the federal government is providing billions of grants to state and local governments and in which there is widespread support for massive revenue-sharing with no strings tied, the level of a federal interest subsidy should not be determined upon the basis of a narrowly conceived break-even point for the U.S. Treasury.[14]

Whatever percentage this committee decides is appropriate, it should be pointed out that in the final analysis it is highly unlikely that there will be a net revenue gain to the Treasury. Thus, the real

---

[12] Sec. 101 of the Tax Reform Act of 1969 provided for a rate from 25 to 40 percent. However, the Treasury announced through Chairman Mills that it would recommend to the Senate a flat 40-percent subsidy. See Congressional Record, pp. H7088 and H7105 (Aug. 6, 1969). Senator McGovern, on Nov. 25, 1969, made the following remarks: "In my judgment, an equitable solution to this difficulty is to offer a Federal interest subsidy of sufficient size that local governmental bodies will realize that it is to their best advantage to accept this subsidy in return for the issuance of taxable bonds. The House of Representatives accepted this approach in theory but failed to enact an interest subsidy large enough to be attractive to States and localities. The Senate deleted the provision entirely. In my judgment, if the Congress were to provide for a 50-percent interest subsidy and declare that the Federal Government will offer this subsidy for all bonds without judging their merits, it will have established the necessary preconditions for the gradual and voluntary elimination of the tax-exempt bond problem." See Congressional Record, pp. H7088 and H7105 (Aug. 25, 1969).

[13] Tax Notes, ed., James S. Byrne, vol. IV, No. 2, Monday, Jan. 12, 1976, p. 11.

[14] Ibid., note 14, pp. 13, 32.

issue is not the merits of one percentage level over another but of the effect of different subsidy levels on the market. For example, at 40 percent there is no question that some State and local governments will elect the option but others will not.

d. Conclusion.—It should once more be emphasized that the "direct subsidy" alternative is meritorious only with the proviso that it is optional, continuous, has no Federal strings attached, and provides for a sufficiently high subsidy. In brief, the committee should not reverse its 1969 position that there must be no usurpation of State and local government autonomy in making the decision to proceed with a project.

2. Urban Development Bank

This proposal requires the establishment of an Urban Development Bank [15] which would be authorized to provide loans to State and local governments or to purchase their obligations. The difference between the Bank's yield and the interest received on the loans would be provided either by Congressional appropriations or the Treasury would be authorized to purchase the Bank's obligations.

This concept is not nearly as sound an alternative as a fixed direct subsidy. The commitee should not enact such a proposal because it has the potential for allowing State and local governments to borrow beyond their means. This assumes no Federal restrictions. If this assumption is incorrect, then the proposal suffers from the earlier objection to any alternative which alters the current Federal-State relationship. In any event the adoption of this proposal would mandate the creation of a new Federal bureaucracy—the last thing that is needed to aid State and local governments. Finally, it should be pointed out that urbank removes the checks and balances that exist in the marketplace and would have the tendency to increase the cost of other Federal financings which obviously would result in higher interest costs for all taxable obligations.

3. Subsidy to tax-exempt entities

In lieu of or in conjunction with a direct Federal interest subsidy, a subsidy could be paid to tax-exempt entities (under section 501 of the Code), which purchase tax-exempt obligations. Such a program would have the dual advantage of insuring no Federal intervention and broadening the market for State and local obligations. This alternative would be beneficial assuming that the balance of the safeguards suggested under the direct subsidy are also adopted.

In substance, the concept is the same as a direct subsidy but on a smaller scale. It is subject to criticism because it has the potential for altering the Federal Government's relationship with tax-exempt entities.

4. Revolving fund

The Congress could create a special account to be funded by the Treasury with the proceeds collected by the Federal Government from taxable State and local bonds. This is somewhat like a direct subsidy

[15] A similar proposal would be multiurbanks, i.e., a system under which State and local governments borrowings would be handled by a local urbank; or, in the alternative, a series of urbanks for different problems, such as a school urbank, a highway urbank, and so forth. This concept would cause administrative confusion and therefore lacks merit.

scheme, but the amount paid to the State and local governments would be limited to the exact amount of the Federally collected tax dollars.

In order for the plan to be equitable, the administrative costs would probably be excessive. In all likelihood, local governments would object to its enactment because the "refunds" would be payed to the State governments which in turn would redistribute the funds. From an investment banker's viewpoint, the proposal would not provide a stable market upon which State and local governments could rely. For example, no issuer would know at the time of issuance the amount of refund it would receive from the fund. Thus, this proposal would not be as effective as a direct subsidy.

5. Amendment to section 14(b) of the Federal Reserve Act

Under this plan, the Federal Reserve would be authorized to buy State and local obligations. The theoretical advantage of this scheme is that the Federal Reserve is experienced in bond purchase programs and has reserves to manage such programs.

The principal benefits of this program are that, one, the rights of the State and local governments to issue tax-exempt bonds would not be impaired; two, it requires no new appropriations; and three, it provides a new purchaser for State and local bonds. However, it is doubtful that the Federal Reserve would be a constant purchaser unless mandated to do so by Congress.

Advantages and disadvantages of an alternative to tax-exempt obligations

Having considered the various alternative proposals to section 103 (a)(1) of the code, from which the committee might choose, the substantive effects associated with adopting any one of them should be explored.

In this connection, no judgment as to the constitutionality of taxing interest paid on State and local governmental obligations will be made. In addition, it is recognized that it is easy to advise the committee not to distort the existing Federal-State relationship but admit that there is no way of measuring the impact of any alternative prior to its adoption. Finally, the "pros" and "cons" which are set forth below do not take into consideration the difficulties that might be faced in marketing any new type of security.

Advantages

It has been argued by some legislators, economic and tax experts, and reform groups that an alternative taxable bond system for State and local obligations should be adopted because:

(1) The Treasury has estimated a revenue loss to the Federal government resulting from the sale of tax-exempt obligations which it projects to be greater than the amount of interest saved by State and local governments. The Treasury, in 1969, testified before the Senate Finance Committee, that a subsidy would save both the Treasury and State and local governments money. Assuming a 30 percent subsidy and a tax-exempt obligation selling within 75 percent of a taxable 8 percent corporate bond, the results are as follows: the Treasury would pay out 2.4 percent which is less than the 3 percent loss derived from not taxing a 6 percent tax-exempt obligation (assumed tax savings if

a taxpayer is in the 50 percent bracket), and the State saves .4 percent (30 percent of 8 percent=5.6 percent effective rate) by issuing a taxable obligation instead of a 6 percent tax-exempt obligation.

However, Senator Williams responded to the foregoing logic as follows: "As one who has never yet seen a subsidy that we ever started and came out ahead making money paying it out * * *".[16] In addition to the fact that a subsidy can result in a revenue loss, note that the example illustrates the new Treasury position so long as the taxpayer is in at least a 40 percent bracket. If the taxpayer's bracket is less, the example undermines the Treasury contention that it will not lose money with a 30 percent subsidy. This would probably be the case with taxable obligations since pension funds and other exempt organizations might be the greatest purchasers of such obligations.

(2) The result of a new option would be to expand the capital market for muncipal obligations since there would be new customers such as moderate income individuals, tax-exempt entities, and life insurance companies.

(3) State and local governments can still issue tax-exempt obligations; the determination to issue them will be made at the option of the community or the State.

(4) An alternative will reduce the amount of tax-exempt obligations that are issued. This will decrease a tax inequity, i.e., the exemption produces inequality in the Federal tax system by reducing the progressivity of the individual income tax and creating a different tax treatment of persons with the same income depending upon whether or not interest income is taxable or tax-exempt. The combination of the Federal subsidy and the decrease in the amount of tax-exempt obligations issued will force the remaining tax-exempt obligations to bear less interest which will decrease the inequity.

(5) It has been argued theoretically, that a taxable alternative might have countercyclical effects on interest rate movements.[17] However, it remains to be seen whether or not this result would occur.

Disadvantages

While there are obviously some compelling reasons for adopting an alternative option to section 103(a)(1), there are sound arguments indicating that this would be to the detriment of State and local governments:

(1) The lure of a direct subsidy from the Federal Government would alter the classic and time tested method of financing for State and local governments. This could result in greater dependence on Washington than at present.

(2) A change would, in substance, be a modification of the existing balance of power between the Federal, State and local governments. This added "power of the purse" in the Federal Government could discourage or impede local financings and thereby discourage their normal operations.

[16] Hearings on general tax reform before the Committee on Finance, p. 634 (1969).

[17] One current problem in the operation of monetary policy over the cycle is that State and local governments tend to bear a disproportionate share of the burden of credit stringency. This is reflected in the fact that as interest rates in general rise, tax-exempt rates rise more rapidly than do taxable rates. Since a fixed subsidy ties the tax-exempt rate, or equivalently the taxable municipal rate net of subsidy, to the general taxable rate, this cyclical tendency for municipal bond rates to rise and fall relative to the taxable rates would be eliminated.

(3) The State and local governments and the purchasers of their obligations would become dependent upon the Federal Government fairly administering the subsidy at adequate levels without market disrupting amendments. Any future discontinuance of all or a part of the subsidy could be disastrous to either the purchasers or State and local governments.

(4) Should the alternative effectively eliminate the tax-exempt market, State and local governments would be compromised if the Federal Government subsequently withdrew the subsidy. This is true because it would take a substantial period of time to reestablish the tax-exempt market.

(5) Treasury revenue estimates are incorrect. The cost of administering the program plus the cost of the subsidy will more than offset the increased Federal revenue derived from the issuance of taxable bonds.

(6) Even if the bond market ultimately adjusts to new conditions, the period of adjustment would cause needless increases in cost to many vital public projects.

(7) Investors in tax-exempt obligations pay an indirect tax by holding securirties which bear a lower rate of interest than conventional securities. Accordingly, an alternative is not a tax reform since the tax inequity argument is incorrect.

(8) If the subsidy rate is high enough to force local governments to abandon the present system entirely, the costs to the Federal Government could exceed the alleged loss it currently sustains.

(9) It is likely that some taxable municipals would have to be sold at a higher rate than commercial obligations to attract investors. For example, a low-rated community could not compete with a high-rated corporation.

(10) Assuming initial guarantees that the Federal Government would not review the project or the fiscal soundness of the issuer, it is likely that the Federal Government ultimately would impose restrictions.[18] For example, the 1973 Treasury proposal could have required closing agreements between State and local governments and the Federal Government; the Reuss bill would create a new Federal agency to "aid" State and local governments. In addition, it is conceivable that future administrations would judge this program on the basis of Federal economic fiscal policy. Accordingly, the subsidy could be withdrawn or modified prospectively after State and local governments have commenced relying upon it.

(11) The total effect on taxable bond markets could be disastrous. For example, there could be billions of dollars of additional taxable obligations per annum. This would result in an increase in borrowing costs for both the public and private sectors. Obviously, this would be an additional revenue cost to the Federal Government.

CURRENT SITUATION

In general

As of today, it appears that the market for State and local bonds is not slackening and that the present psychology of investors is that the Federal Government should not tamper with tax-exempt interest rates.

---

[18] Hearings on general tax reform, Senate Finance Committee, p. 670 (1969). Secretary of the Treasury Kennedy, in response to a question from Senator Fannin commented: "And I would want to be sure that an obligation was sound if we were putting our name on it. So there is that feature that at least the Secretary of the Treasury would be concerned about. Default on an obligation that had some subsidy by the Federal Government would be quite a thing."

However, this would not preclude the Federal Government from issuing or having State and local governments issue taxable obligations for State projects. In fact, many of the objectors to the alternative in 1969 have modified their position. In addition, Congress has recently passed a number of provisions which may require State and local governments to issue taxable securities in order to receive a subsidy for specific projects (e.g. certain loan programs under Farmers Home Administration, Hill-Burton, and Housing and Urban Development).

Reuss bill, H.R. 11214

H.R. 11214 takes into account most of the safeguards which were discussed previously, but as set forth earlier, it too needs modifications. Under that bill, the Federal Government automatically provides a fixed 40 percent subsidy to issuers electing to issue taxable obligations. It corrects many of the flaws contained in the Treasury's 1973 proposal. But the provision calling for the creation of a Municipal Finance Assistance Office should be deleted to prevent such an office from reviewing the State and local projects in the future.

As to the Reuss bill using HUD instead of the Treasury, since the enactment of a subsidy would involve billions of dollars, it should be administered, if at all, by the Treasury which is the agency with debt management experience.

CONCLUSION

The Reuss bill is appropriate provided the safeguards previously discussed are also adopted. Finally, it should be clear that I favor improvement in the market situation for State and local governments but am concerned at what cost.

In summary, assuming that your committee can adopt an option as an alternative in lieu of the elimination of section 103(a) [19] so that State and local governments are given a choice and so that (1) the market is not disrupted, (2) no new Federal bureaucracy is created either to review the projects themselves or the financial capabilities of the issuer, (3) the cost of the new program is not excessive, (4) the financial mechanism offers at least as good an advantage as that offered by the present tax-exempt market, and (5) the financial mechanism is automatic and irrevocable; then, I believe that the Congress may provide State and local governments with an additional economic tool to deal with the problems they face.

EXHIBIT A.—LEGISLATIVE HISTORY OF SECTION 103(a)(1) OF THE INTERNAL REVENUE CODE OF 1954 AND ITS PREDECESSORS FROM 1913 TO 1968

The Income Tax Law of 1894 (which was part of the Tariff Act of 1894), provided no exemption for interest on State and Municipal Bonds. *Pollock* v. *Farmers' Loan & Trust Company*, 157 U.S. 429, aff'd *on rehearing*, 158 U.S. 601 (1895), held that the income tax provision was unconstitutional on two grounds: (1) it was a direct tax without apportionment, and (2) interest on State and municipal bonds was constitutionally exempt from tax.

[19] Any alternative system must be in the form of an option. As Senator Gore in 1969 commented: "But in any event, it is clear that tax exemption cannot and should not be ended in any way until there is a trustworthy alternative that offers greater advantages to State and local governments than does tax exemption. The essence and efficacy of our system of Government depend [sic] upon effective local self-government," Senate Report No. 91-552, 91st Cong., 1st sess., p. 330 (Nov. 21, 1969).

The 16th amendment was ratified in 1913 and provides that,

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census of enumeration.

The 16th amendment cleared the way for the Revenue Act of 1913 which was approved on October 3 of that year and made effective November 1. Section II(B) of that act provided, in relevant part, as follows:

> That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof * * *.

The exemption from tax provided for interest on State and municipal bonds has resulted in continuous controversy almost since enactment. Since 1918 there have been numerous attempts to remove or modify it. Such attempts have reached various stages in the legislative process, but none resulted in final legislation.

In the Revenue Act of 1918, the Ways and Means Committee approved and the House passed legislation which would have eliminated all exemptions for interest on State and municipal bonds except for those issued prior to the effective date of the act, and except for bonds held which did not exceed in the aggregate $5,000 in principal.[1] The committee report states that, while there is doubt as to the constitutionality of taxing such interest, justice requires its taxation, at least in times of war. The Treasury Department supported this provision as a means of protecting the market for Liberty Bonds during wartime.[2] The Senate Finance Committee, however, rejected it, noting that, apart from constitutional questions, it seemed unwise to impose a tax on the interest from State and local obligations as long as the States were not free to similarly tax interest on Federal obligations.[3] The House receded in conference.[4]

Secretary of the Treasury, Glass, in his 1919 report, recognized that the problem of exempt securities was aggravated because the surtax rates reached 70 percent during the wartime.[5] His report stated that the exemption coupled with high tax rates was causing a diversion of needed capital from taxable into tax exempt securities. As a solution, he proposed a reduction in the surtax rates with an increase in the normal rates. He also proposed inclusion of the interest on tax exempt securities for the purpose of computing the income tax without specifically taxing the income on such securities. This would have resulted in otherwise taxable income being taxed at higher rates. In 1920, the Treasury Secretary again espoused the view that lower surtax rates would remove the incentive for wealthy individuals to invest in tax-exempt bonds.[6] No action was taken by Congress in 1919 or 1920.

A joint resolution (H.J. Res. 102) was submitted on May 3, 1921. It would have amended the Constitution to remove the tax-exempt status of State and local bonds. It was thought at that time that a constitutional amendment was necessary to remove the exemption

---

[1] H. Rept. 767, 65th Cong., 2d sess.
[2] Lent, The Origin and Survival of Tax Exempt Securities, 12 National Tax Journal 301, 304 (1959).
[3] S. Rept. 617, 65th Cong., 3d sess.
[4] H. Rept. 1037, 65th Cong., 3d sess.
[5] Annual report of the Secretary of Treasury, 1919, p. 24.
[6] Annual report of the Secretary of Treasury, 1920, p. 37.

because of the Supreme Court's decision in *Evans* v. *Gore*, 253 U.S. 245 (1920) where the Court stated, in dictum, that the 16th amendment did not entitle the Federal Government to tax State and municipal bonds. The Treasury Secretary supported the proposed amendment, but suggested modifications to House Joint Resolution 102 to remove retroactive features with respect to outstanding issues and to grant reciprocal privileges to the States to tax interest on Federal obligations.[7]

Because the problem continued to exist, the President's address to Congress on December 6, 1921, asked Congress to consider a constitutional amendment to remove the exemption.[8] The Secretary of the Treasury, in his 1922 report, proposed either a constitutional amendment or a reduction in the surtax rates.[9] Hearings were held by Ways and Means in 1922.[10]

Following the hearings, Representative Green introduced a joint resolution along the lines suggested by the Treasury Secretary (H.J. Res. 314, 67th Cong., 4th sess.). The House passed the resolution on January 23, 1923, by the necessary two-thirds vote (223 yea, 101 no).[11] The Senate Committee on the Judiciary held hearings on the resolution but did not report it. On January 10, 1924, Congressman Green reintroduced his resolution.[12] The Ways and Means Committee again endorsed the resolution, but this time the House failed to give the necessary two-thirds approval.

Largely in response to the failure of Congress to approve a constitutional amendment removing the exemption, the Treasury proposed lowering the maximum surtax rate to 25 percent with a normal tax rate of 6 percent. It was believed that a maximum rate of 31 percent would discourage investment in tax-exempt securities.[13] Congress reduced the maximum surtax rates to 40 percent in 1924 and 20 percent in 1926. The legislative history makes it clear that the problem of tax-exempt securities was a major force behind the reduction in surtax rates.

With the lowering of surtax rates in 1926, the furor over tax-exempt securities subsided through 1932. Between 1932 and 1937, 80 resolutions were introduced calling for constitutional amendment to end or curtail the exemption.[14]

In 1933, Senator Clarke introduced an amendment to the National Industry Recovery Act to tax interest on all State and local bonds. The Senate approved the measure (45 to 37).[15] The measure was dropped, however, by the conference committee apparently, in part, due to its retroactive feature.[16]

In January of 1934, Senator Ashworth introduced a resolution, Senate Joint Resolution 7, to amend the Constitution, which was similar to the Green resolutions of 1922 and 1924. The resolution was

[7] Letter of Sept. 23, 1921. annual report of Secretary of the Treasury, 1921, pp. 379–380.

[8] Letter of the Secretary of the Treasury relative to tax-exempt securities, Jan. 16, 1922; annual report of the Secretary of the Treasury, 1922, p. 318.

[9] Ibid., p. 320.

[10] Hearings on tax-exempt securities, H.J. Res. 102, 211, 231, 232, 67th Cong., 4th sess.

[11] 64 Congressional Record 2284 (67th Cong., 4th sess.).

[12] H.J. Res. 136, 68th Cong., 1st sess.

[13] Annual report of the Secretary of the Treasury, 1923, pp. 6–11.

[14] Lent, supra, 309.

[15] 77 Congressional Record 5420–5421.

[16] Ibid., 5857.

reported by the Senate Judiciary Committee (S. Rept. 738), but was never considered on the Senate floor.[17]

President Roosevelt, in a special message to Congress on June 19, 1935, asked for an amendment to the Constitution to remove the exemption.[18]

Again on April 25, 1938, President Roosevelt presented a message to Congress asking for legislation to eliminate the tax exemption for interest on State and local bonds.

In response to the President's second message, the Senate established a special committee comprised of three members from the Judiciary Committee and three from the Finance Committee. That committee held extensive hearings in 1939.[19] The majority report of the special Senate committee recommended elimination of the exemption while offering reciprocal privileges to the States to tax interest on Federal securities.[20] The minority report by two members opposed removal on the grounds that it was economically unsound and unconstitutional.[21]

A House floor amendment offered in 1939 would have removed the exemption for State and local securities while allowing a 100-percent tax credit computed on the basis that exempt income from such securities constituted all of the taxpayer's taxable income. The effect of this amendment would have been to tax otherwise taxable income at higher tax rates. The House rejected the amendment.[22]

In 1940, Senator Brown, chairman of the special committee, offered a floor amendment to eliminate the exemption while offering reciprocal privileges to the States to tax interest on Federal securities. After lengthy debate, his amendment was rejected.[23]

World War II brought higher tax rates, and Treasury Secretary Morgenthau in 1942 proposed that the exemption for State and local obligations be removed for outstanding and new issues. His position was that owners of bonds bought during periods of lower tax rates received a windfall caused by higher tax rates.[24] The House took no action on the Secretary's recommendation, but the Senate Finance Committee added an amendment to the Revenue Act of 1942 eliminating the exemption for bonds issued after January 1, 1943. The Finance Committee amendment also offered reciprocal privileges to the States. The amendment was defeated on the Senate floor.[25]

From 1942 through 1950, no major congressional activity occurred regarding the elimination of State and local tax-exempt bonds. In 1951, Treasury Secretary Snyder proposed removal of the tax exemption on future issues. He stated that other alternatives could be developed

[17] Lent, supra, 809.

[18] H. Doc. 229, 74th Cong., 1st sess., p. 5.

[19] The Treasury Department supported removal of the exemption, while most States opposed removal. U.S. Senate, Special Committee on Taxation of Government Securities and Salaries, hearings on S. Res. 303 (75th Cong.), 1939. During this same period, the Ways and Means Committee held similar hearings. Committee on Ways and Means, hearings on proposed legislation relating to tax-exempt securities, 75th Cong., 1st sess. (1939).

[20] S. Rept. 2140, 76th Cong., 3d sess. (1940).

[21] Ibid., pt. II.

[22] 84 Congressional Record 7497. It should be noted that such a provision would have little effect where all or substantially all of a taxpayer's income is comprised of tax-exempt interest.

[23] 86 Congressional Record 12804.

[24] Statement of Secretary Morgenthau before the Committee on Ways and Means, Mar. 3, 1942, hearings on Revenue Act of 1942. p. 8.

[25] 88th Congressional Record 7949.

to compensate the States for the loss of their tax exemption. Presumably, the alternative means would have been a Federal subsidy to the States.[26] The proposal was not adopted.

In 1954, the Treasury proposed the taxation of interest on future issues of local housing authority bonds.[27] The Ways and Means Committee first announced tentative approval of this proposal but later reversed itself.[28]

Sentiment for removal of the exemption next was evidenced at extensive hearings on the subject before the Ways and Means Committee during 1958 and 1959.[29] No serious consideration was given to this topic until the Tax Reform Act of 1969.[30]

Exhibit B.—Summary of "Proposals for Tax Change, Department of the Treasury", April 30, 1973

The Treasury reversed its 1969 position on the grounds that one, the proposal would provide a more stable market in municipal bonds by allowing them to compete more effectively with corporate obligations, especially when market rates are high; two, municipals would be more attractive to pension trusts and other exempt organizations; and three, it would tend to reduce the supply of exempt obligations thereby also reducing interest rates on exempt obligations issued in the future.

All obligations exempt under section 103(a)(1) would be eligible with the following exceptions:

1. Interest is unrealistically high.
2. Short term (less than 1 year) obligations.
3. Bonds held by congressionally established entities such as Housing and Urban Development or Health, Education and Welfare or owned by the United States or by another State or local government.

Initially, there would be a 10 percent limitation on the maximum interest rate on which the subsidy would be paid. This could be modified by the Secretary. Thus, for example, unless the Secretary modified the maximum interest rate, if a 12 percent bond were to be issued, the 30 percent subsidy would be computed only on the basis of 10 percent interest.

The issuer must either enter into an agreement with the Secretary or meet his regulations in order to receive the Federal subsidy. Once the bonds are issued, the subsidy may not be revoked, and would be paid by a permanent appropriation from Congress. The 30 percent subsidy would be reduced by the Treasury's administrative cost and would be adjusted to reflect any discount or premium. The proposal includes in the subsidy base the amounts paid to intermediaries (such as underwriters and paying agents) in the course of issuing the obli-

---

[26] Hearings on revenue revision of 1951, pt. I, before the Committee on Ways and Means, 82d Cong., 1st sess. (1951), pp. 13–14, 88–94.

[27] The Treasury first proposed this concept in 1949. See S. 138, 81st Cong., 1st sess., sec. 505.

[28] Lent, supra, 814.

[29] Statement of Stanley Surrey, hearings on general revision before the Committee on Ways and Means, 85th Cong., 1st sess., p. 2283 (1958); tax revision compendium of panel discussions on broadening the tax base before the House Committee on Ways and Means, 86th Cong., 1st sess., pp. 679–791 (1959); panel discussions on income tax revision before the House Committee on Ways and Means, 86th Cong., 1st sess., pp. 389–402 (1959).

[30] This excludes the enactment of sec. 103(c) in 1968 relating to industrial development bonds.

gation and the day-to-day servicing of the issue. However, normal administrative costs incurred by the issuer would not be eligible.

Prior to payment of the subsidy, a verification that interest was still due and payable would be required from the State. The issuer would report to the Internal Revenue Service the taxable interest paid to holders. The bond would be required to contain a notification of the taxability of interest payments.

Regulations would be issued providing alternative sets of standards, which if met, would eliminate the necessity for an advance agreement. Upon appropriate certification from the issuer that it has met the applicable set of standards, the subsidy becomes automatic. The intent of the regulation would be to, one, limit negotiated agreements to unusual cases; two, provide assurance to the public; and three, prevent unnecessary Federal review of State and local decisions. They would also set forth, (1) the time and manner of making an election; (2) when the Secretary would pay the subsidy; (3) the limitations on the general exceptions in the eligibility rules; (4) definitions of net interest expense, administrative costs, and issuer; (5) the notation to appear on the face of the obligation with respect to taxability; (6) the subsidy eligibility rules; (7) information reporting; and (8) provisions for bond premiums and discounts.

The Treasury estimated the cost of the subsidy to the $180 million annually, which would be offset by increased tax receipts so that there would be little or no net gain or loss to the Treasury. As to how the subsidy would operate in the future, the Treasury stated that experience under the program would be required in order to evaluate the need for more or fewer restrictions on eligibility.

ARENT, FOX, KINTNER, PLOTKIN & KAHN,
Washington, D.C., April 23, 1976.

Hon. MICHAEL STERN,
Staff Director, Senate Committee on Finance,
Washington, D.C.

DEAR MR. STERN: Enclosed please find five copies of the statement of Humana, Inc. relating to the funding of hospital facilities through the medium of tax free industrial development bonds. The testimony suggests certain changes to section 103 of the Internal Revenue Code.

Humana, Inc. is located at One Riverfront Place, Post Office Box 1438, Louisville, Ky. 40201. Any correspondence relating to this testimony should be addressed to Mr. William C. Ballard, Jr., vice president of Humana, Inc., with a copy to the undersigned.

Very truly yours,

JOHN L. BURKE, JR.

Enclosure.

STATEMENT OF HUMANA, INC.

I. INTEREST OF HUMANA, INC.

Humana, Inc. ("Humana") is a Delaware corporation, headquartered in Louisville, Ky., whose stock is traded on the New York Stock Exchange. Humana is involved in the health care field as a provider

of hospital services. It designs, supervises the construction of, and owns and operates short-term, acute-care community hospitals. At present, Humana is operating 62 hospitals located in 15 States, has 4 hospitals under construction (which will add 2 additional States) and ranks second among investor-owned hospital service companies in the number of licensed hospital beds (8,275).

Our statement to this committee sets forth our concern that the provisions of the Internal Revenue Code relating to industrial development bonds are too restrictive in the context of present economic realities, and, unless amended, will foreclose the use of such bonds as a vehicle for the construction of investor-owned hospitals. As more than two-thirds of Humana's present patient capacity has been constructed since 1969, with 10 hospitals being financed through the issuance of industrial development bonds, Humana believes it is well qualified to address itself to this concern.

II. STATEMENT OF POSITION

A. Present state of the law

As this Committee is well aware, section 103 of the Internal Revenue Code makes subject to Federal income tax the interest income from industrial development bonds, unless such bonds (i) are issued to assist a trade or business carried on by an "exempt person" as defined by § 103(c)(3);[1] (ii) provide revenues for certain "exempt activities" within the meaning of § 103(c)(4); or (iii) are issued within the scope of the "small issue" exemption described in § 103(c)(6).

The term "exempt person" is defined to include (i) a governmental unit or (ii) an organization described in code § 501(c)(3) and exempt from Federal income tax. Thus, hospitals which are owned and operated by a State or local governmental unit or by a charitable entity may be financed by tax-exempt municipal bonds, without regard to the aggregate face amount of such bonds or the total cost of the project being financed.

The term "exempt activities" means the providing of any of seven specific types of facilities, including (i) sports facilities, (ii) convention or trade show facilities and (iii) air or water pollution control facilities. Thus, any person or entity, whether nonprofit or profit-oriented, may receive funding for such projects through the vehicle of tax-exempt industrial bonds, without regard to the aggregate face amount of such bonds or the total cost of the project being financed. A good example, is the sports promoter/team owner whose sports facility is made possible through the issuance of municipal bonds.

The term "small issue" exemption describes the third method of funding community projects through tax-exempt municipal bonds, and the only method which is currently available to an investor-owned provider of hospital facilities, such as Humana. It would not be productive to develop the intricacies of this exemption in this statement. Suffice it to say that no bond issue pursuant to this exemption may exceed $5 million in face value and the project being funded may not exceed $5

---

[1] Technically, of course, a bond issuance, the major portion of the proceeds of which are used in the trade or business of an "exempt person" is not included in the definition of an "industrial development bond." Sec. 103(c)(2).

million in cost (determined over a 6-year period). If the $5 million limitation is exceeded, the entire bond issue fails to qualify for Federal tax exemption. In essence, no project which has a projected cost of more than $5 million may be funded by tax-exempt municipal bonds.[2]

B. Suggested changes in the law

For the reasons set forth herein, Humana suggests the code section 103 be amended to permit the funding of tax-free municipal bonds for the construction and renovation of all hospital facilities, no matter by whom constructed and regardless of the total cost of constructing or renovating such facilities. The specific method of achieving this result is by amending section 103(c)(4), dealing with exempt activities, to add thereto a new subparagraph (H) to read: "hospital facilities."[3] Thus, placed in context, section 103(c)(4)(H) would exempt from Federal income tax the interest income from: * * * any objection which is issued as part of an issue substantially all of the proceeds of which are used to provide hospital facilities.

In the absence of such an amendment, Humana suggests that this committee amend that portion of section 103 which deals with the small issue exemption and the $5 million limitation thereon. That limitation should be substantially raised. We suggest a ceiling of $15 million, which would be simply effectuated by amending section 103(c)(6)(D) to insert "$15 million" in the two places where the figure "$5 million" now appears.

III. REASONS NECESSITATING THE CHANGE IN THE LAW

A. Background and developments in the field of hospital services

When the industrial development bond provisions of the Internal Revenue Code were enacted in 1968,[4] investor-owned hospital service companies were virtually unknown. In fact, at the end of 1967, there were 5,850 community hospitals in the United States and only five hospitals were operated by investor-owned, multiple-unit hospital service corporations. In 1968, the vast majority of the hospital facilities in this country — and this is still the case today — were owned and operated by local governmental entities or charities (including religious groups).[5] As stated earlier, when owned by such "exempt persons," these hospital facilities may be financed in full by tax-exempt municipal bonds, regardless of total cost, pursuant to code section 103(c)(3).

We believe that this provision of section 103 helps accomplish a very important and laudable social objective — the construction and operation of needed hospital facilities. However, we believe that the very same assistance should be available when hospital facilities are constructed and operated by investor-owned entities. It is the objective of

---

[2] It should be noted that $1 million in tax exempt bonds may be issued for any project, regardless of the total cost. Sec. 103(c)(6)(A).

[3] Senator Bentsen of this committee has introduced a bill, S. 3241, which would achieve this objective.

[4] Public Law 90-364 (June 28, 1968) and Public Law 90-634 (Oct. 24, 1968). Certain amendments with respect to water control facilities (sec. 103(c)(4)(G)) and "unforeseen expenditures" (sec. 103(c)(6)(F)) were made by the Revenue Act of 1971, Public Law 92-178.

[5] In 1974, there were 5,977 non-Federal hospitals in this country. Of this number, 5,202 (or more than 87 percent) were owned by State and local governmental entities (1,821) or nonprofit organizations (3,381). See, 1974 Annual Survey of the American Hospital Association.

providing health care facilities that should be encouraged and the fact that such facilities may be provided by an investor-owned entity rather than a charitable corporation or governmental unit should be irrelevant.

It may well be that, because of the very minor role played in the hospital industry in 1968 by investor-owned companies, Congress believed it had fully accomplished this objective when it enacted the present provisions of section 103 dealing with "exempt persons." What other justification could there be for specifically exempting from tax those bonds which are issued to provide sports facilities, convention facilities and similar facilities and not those which are used to finance hospital facilities? Surely, the providing of hospitals must rank as high as the providing of sports and convention facilities in the scheme of relative social benefits that should be encouraged by tax incentives.

With respect to the value of investor-owned hospital service companies in providing hospital services, it is our experience that these companies can provide quality hospital facilities and care at least as efficiently and economically as any other entity currently providing such care and facilities. A for-profit entity, such as Humana, must be highly responsive to the values and needs of patients and physicians — the greatest need being the efficient delivery of the highest quality health care to the ultimate consumer, the patient. The quality of health care provided by Humana is second to none. But while the quality of care cannot be statistically proven, efficiency in providing that care can be. Efficiency is best gauged by reviewing two vital areas of productivity, productivity of capital and productivity of labor.

In the area of productivity of capital, the average per bed cost of hospital construction in 1974 was estimated, by Blue Cross and Blue Shield Plans, at $67,000; the average per bed cost of the 14 hospitals constructed by Humana in 1974 was $34,028, or about half the national average.[6] The design and construction of a new hospital facility is a large undertaking which requires substantial expertise and effective administrative capabilities in order to prevent rising construction costs without a commensurate rise in quality. Humana's project costs benefit from the expertise in design and construction it has gained in the completion, to date, of nearly 40 new hospitals.

In the area of productivity of labor, the better training and organization provided to its employees by Humana has resulted in a superior level of service quality for each patient at an average of 2.2 employees per patient. In contrast, the average number of workers per patient in all similar hospitals is more than 3.2[7]

The point to be made is that an investor-owned hospital service company is certainly one of the best vehicles available for constructing and operating hospitals efficiently. This is vitally important as there presently exists a tremendous need for hospital construction. Of the 5,977 nonfederal hospitals in this country, approximately 2,400, or 40 percent, do not presently conform to modern day safety or technical standards.[8] If private industry is not encouraged to replace these hospitals, the Government may well be faced with this

[6] This figure includes the cost of land, buildings, equipment, interest during construction, and all the other expenditures necessary for a first-quality hospital.
[7] Statistics from the 1974 Annual Survey of the American Hospital Association.
[8] 1974 Annual Survey of the American Hospital Association.

monumental task. Perhaps this would require a massive grant program such as previously administered pursuant to the Hill-Burton Act.

We believe that Federal involvement could be kept to a minimum by providing local municipalities with the ability to finance private construction or renovation of hospitals through tax-exempt bonds without regard to an overall cost limitation. As will be discussed in more detail, the present $5 million limitation is simply no longer realistic.

B. The Louisa, Ky. experience

We would like to provide this committee with just one example of the importance of tax-exempt municipal bonds to a local community, or region, with respect to obtaining quality hospital care facilities.

Hospital services might be totally absent today in Louisa, Ky., without the financing help of hospital revenue bonds issued by the city of Louisa in 1973. The city, which is the county seat of Lawrence County in the extreme eastern part of Kentucky on the West Virginia border, had lost one of its two hospitals and was on the verge of losing the other one. The 40-bed Riverview Hospital, built in 1906, was forced to close in 1972 because it did not meet medicare standards. The other hospital, the 41-bed Louisa General Hospital, built in 1930, did not meet certain standards on fire safety and also faced loss of its medicare certification, which would have led to its being closed.

Seven years before the Riverview closing, the Lawrence County Medical Society, the Greater Louisa Community Hospital Association and local community leaders realized the need to replace the two hospitals and had begun efforts to obtain a new hospital. Over a 3-year period, four applications for Hill-Burton funds were submitted to the Federal Government. Because of competing requests for a diminishing supply of Hill-Burton funds, the Louisa applications were denied.

Moving in a new direction, the community entered into an agreement with Humana in June 1972 to develop a new 90-bed hospital. The city issued $4,200,000 of hospital revenue bonds to finance the project. Humana was the guarantor of the bond issue and a subsidiary of Humana operates the hospital under a 15-year lease. A certificate of need was granted in 1972, construction was started in January 1973, and the new hospital began accepting patients in November 1974. Louisa General Hospital, which had obtained a temporary extension of its medicare certification during the construction period, closed when the new hospital opened.

As a result of the financing arrangement worked out between the city of Louisa and Humana, first-quality hospital care is available for the more than 58,000 people of Lawrence and Morton Counties in Kentucky and Wayne County in West Virginia. The new hospital, Louisa Community Hospital, has a coronary care unit and an intensive care unit, both fully monitored with electronic equipment; two operating rooms; obstetrical facilities, including labor and delivery rooms and a nursery; X-ray rooms; a cystoscopic procedures room, and other facilities for full medical/surgical care.

In short, the new hospital makes it possible for residents of the Louisa area to receive emergency medical care in a modern hospital

without the time-consuming, long-distance travel that would have been necessary if this hospital had not been constructed.

C. Limitations of the $5 million exemption

As exemplified by the Louisa experience, the goal of Humana is to provide new hospitals in communities which need replacement of obsolete facilities or where there is a shortage of facilities.[9] Since 1968, Humana has been able to finance the construction of 10 hospitals, including the Louisa Community Hospital, through the issuance of tax exempt municipal bonds. This means that the total cost of constructing each hospital did not exceed $5 million.

However, over the last 5 years, construction costs in the hospital industry for labor and materials have increased by approximately 66.2 percent. As a result, it is fair to state that none of the 10 hospitals constructed by Humana which were financed through the issuance of tax exempt bonds would qualify for such financing if built today. In essence, inflation has rendered the $5 million limit unrealistic.[10]

Thus, tax exempt municipal bonds are no longer a viable method of financing the construction of investor-owned hospital facilities. This is an unfortunate situation for communities, especially smaller communities, badly in need of new or renovated hospital facilities. Such communities may not have the expertise to economically design, and supervise the construction of, a new hospital facility. An investor-owned company, such as Humana, may not be able to obtain conventional financing for the project—or the financing may be too expensive to permit Humana's involvement.

Tax exempt bonds provide cheaper and quicker financing, and a larger percentage of financing, than conventional financing. The availability of such financing may well be the determinative factor in the involvement of a company such as Humana in a particular community—and it may well be the deciding factor in that community's ability to provide its residents with quality health care (or any kind of health care at all) at a reasonable price.

D. Effect of expensive financing on Government reimbursement programs and the ultimate consumer

All of Humana's general and acute-care hospitals meet medicare certification requirements. The medicare and medicaid cost reimbursement programs provide for the cash reimbursement to participating hospitals of certain allowable costs. Interest on debt utilized to provide a hospital facility is a proper allowable cost.[11] Consequently, the greater the cost of financing a hospital facility, the greater will be the ultimate reimbursement cost paid to the hospital by the Federal Government. Financing obtained through tax-exempt municipal bonds is invariably less expensive than more conventional financing and will result in a lower annual reimbursement cost to the Federal Government.

In the same manner, reducing the cost of hospital financing will reduce the total cost of health care to the ultimate consumer, whether

---

[9] Attached to this testimony is a listing of the hospitals owned and operated by Humana.

[10] In apparent recognition of this fact, the following bills have been previously introduced to raise the $5 million limitation to $10 million: H.R. 5640 (Congressman Duncan, Tenn.), S. 1949 (Senator Curtis); H.R. 7543 (Congressman Waggonner), S. 1977 (Senator Bartlett); H.R. 7596 (Congressman Conable).

[11] See reimbursement of reasonable cost provisions of sec. 1861V(1)(A) of the Social Security Act Amendments of 1972.

that consumer pays such costs directly or indirectly through an insurance carrier. Congress has evidenced a growing concern with the soaring costs of health care and health care insurance. Providing a less costly method of financing hospital facilities, through tax exempt bonds, is a positive step in the direction of keeping those costs within reasonable bounds.

IV. SUMMARY

This committee should be aware that investor-owned companies have become a significant and important force in the area of health care and the providing of health care facilities. This is a recent and, we believe, positive development. Reducing health care costs to the ultimate consumer necessitates constructing hospital facilities at the lowest possible cost. Tax-exempt municipal bonds provide the cheapest, and best, method of financing such hospitals. We strongly believe the goal we advocate accomplishes important social objectives which the Congress may well have intended to fully support in 1968, when it retained the availability of such financing for hospitals (and other ventures) owned and operated by governmental units and charities.

Regardless, the fact remains that investor-owned hospital service companies, which today account for perhaps 40 percent of new hospital construction in this country,[12] are being shut out from the tax exempt municipal bond market. For the reasons we have enunciated herein, we do not believe that this is a result that is beneficial to our society or a situation that Congress should permit to continue.

We urge this committee to amend section 103 to provide for the financing of all hospital facilities, without regard to the total cost of each facility or the identity of the entity responsible for constructing and operating that hospital facility.

EXHIBIT I

Humana Hospitals, November 1, 1975

	Beds
Region I Central:	
Illinois: Springfield, Springfield Community Hospital[1]	200
Kentucky:	
Louisa, Louisa Community Hospital	90
Louisville, St. Joseph Infirmary	509
Louisville, Suburban Hospital	380
Tennessee:	
East Ridge, East Ridge Community Hospital	128
Hohenwald, Lewis County Hospital	32
Lebanon, The McFarland Hospital[2]	137
Morristown, Doctors Hospital	135
Trenton, Gibson General Hospital	65
Waverly, Nautilus Memorial Hospital	52
Region II Eastern:	
Georgia: Louisville, Jefferson Hospital	101
North Carolina: Hickory, Hickory Memorial Hospital	85

[1] Opened after Aug. 31, 1975.
[2] 29 beds added after Aug. 31, 1975.

[12] This percentage is based on the increase, over the last 4 years, in hospitals of over 100 beds owned by investor-owned hospital service companies. It is assumed that this increase is principally due to new construction or renovation.

Region II Eastern—Continued	Beds
South Carolina:	
Darlington, Coleman-Aimar Hospital	27
Marion, Palmetto General Hospital	50
Virginia:	
Pennington Gap, Lee General Hospital	74
Richmond, St. Lukes's Hospital	200
Virginia Beach, Bayside Hospital	250
West Virginia:	
Bluefield, St. Luke's Hospital	72
Ronceverte, Greenbrier Valley Hospital	122
Daytona Beach, Daytona Community Hospital	214
Oakdale, Oakdale General Hospital	61
Tampa, Women's Hospital	124
Orange Park, Greater Orange Park Community Hospital	196
Florence, Colonial Manor Hospital	100
Many, Many Clinic and Hospital	34
Richmond, St. Luke's Hospital	200
Sheffield, Shoals Hospital	138
Russellville, North Alabama Hospital	100
Bluefield, St. Luke Hospital	72
Sarasota, Sarasota Palms Hospital	60
Georgia: Louisville, Jefferson Hospital	101
Lebanon, The McFarland Hospital [1]	137
Marion, Palmetto General Hospital	50
Trenton, Gibson General Hospital	65
Region III Southeastern:	
Florida:	
Dade City, Community General Hospital	65
Daytona Beach, Daytona Community Hospital	214
Fort Lauderdale, Bennett Community Hospital	204
Fort Walton Beach, General Hospital of Fort Walton Beach	236
Kissimmee, Community Hospital	122
Orange Park, Greater Orange Park Community Hospital	196
Orlando, Lucerne General Hospital	267
St. Petersburg, St. Petersburg General Hospital	221
Sarasota, Sarasota Palms Hospital	68
Tampa, Tampa Heights Hospital	146
Tampa, Women's Hospital	124
Region IV Mid-South:	
Alabama:	
Enterprise, Coffee General Hospital	135
Florence, Colonial Manor Hospital	100
Hartselle, Pineview Hospital	172
Huntsville, Medical Center Hospital	294
Prattville, Prattville General Hospital	68
Russellville, North Alabama Hospital	100
Satsuma, Suburban Hospital	34
Sheffield, Shoals Hospital	138
Region V Delta:	
Louisiana:	
Erath, Erath Memorial Hospital	37
Many, Many Clinic and Hospital	34
Marksville, Marksville General Hospital	29
Oakdale, Oakdale General Hospital	61
Shreveport, Brentwood Hospital	126
Springhill, Community Hospital	80
Ville Platte, Ville Platte General Hospital	124
Winnfield, Winnfield General Hospital	103
Mississippi:	
Jackson, Doctors Hospital of Jackson	150
Natchez, Natchez Community Hospital	101

[1] 29 beds added after Aug. 31, 1975.

Region VI Southwest:

Texas:	*Beds*
Abilene, West Texas Medical Center	115
Baytown, Baytown Medical Center Hospital	191
Beaumont, Beaumont Medical Surgical Hospital [3]	250
Bryan, Bryan Hospital	65
Center, Memorial Hospital of Center	60
Kaufman, Kaufman Hospital	36
Killeen, Hillandale Memorial Hospital	35
New Boston, New Boston General Hospital	63
Region VII Western:	
Colorado: Aurora, Aurora Community Hospital	200
New Mexico: Hobbs, Llano Estacado Medical Center	180
Texas:	
Andrews, Community General Hospital	60
Dallas, Bristol General Hospital	67
Dallas, Medical City Dallas Hospital	367
Garland, Garland Community Hospital	128
62 Hospitals	8,275

[3] Opened after Aug. 31, 1975.

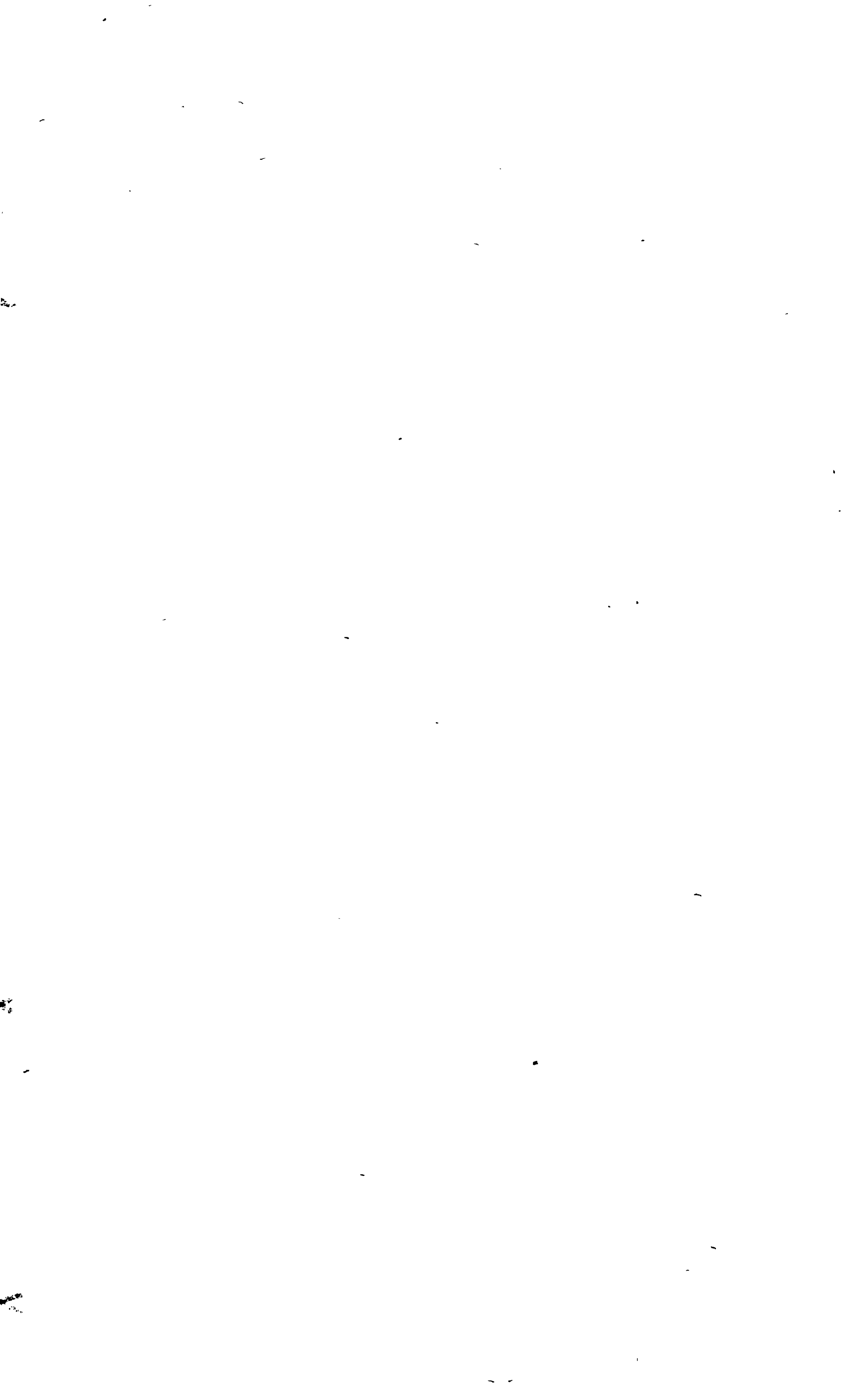
HOSPITAL CONSTRUCTION IN PROGRESS, NOV. 1, 1975

	Size of project	Net additional beds
Region I—Central: Somerset, Ky., Lake Cumberland Medical Center, new hospital	175	175
Region IV—Mid-South: Florence, Ala., Colonial Manor Hospital, addition	55	55
Region VII—Western:		
Dodge City, Kans., new hospital	110	110
Layton, Utah, Davis North Medical Center, new hospital (building designed for 125 beds; space shelled in for 25)	100	100
Total	440	440

Note: Size after completion of this construction: 65 hospitals; 8,715 beds.

Charitable Organizations Influencing Legislation

31.61



Statement of Elvis J. Stahr, President of the National Audubon Society and Chairman of the Coalition of Concerned Charities

This statement is submitted as a result of a request made by the Coalition of Concerned Charities to testify at the hearings of the Finance Committee which commenced on March 17, 1976. We were advised that shortage of time precluded the possibility of oral testimony before the committee, but that the committee would be pleased to receive a written statement.

This statement is made in support of S. 2832, which was introduced on December 19, 1975, and has been sponsored by 47 Senators, including 11 members of this committee. I shall also refer to and support a revised version of this bill which I believe will soon be introduced.

This statement will be divided into four parts:

1. The need for legislation amending section 501(c)(3) insofar as it relates to the legislative activities of the operating charities which are duly qualified under it.
2. The tortuous 7-year history of the efforts of those, both in and out of Congress, to arrive at an appropriate piece of legislation which would satisfy that need without making it possible for organizations whose primary interest is in influencing legislation (usually qualified under sec. 501(c)(4) of the code) to qualify under section 501(c)(3) and thus to be able to receive tax-deductible contributions.
3. A description of S. 2832, its companion, H.R. 8021, and of the proposed bill, which we believe will accomplish these objectives.
4. An argument in support of S. 2832 and its proposed revision.

1. THE NEED FOR LEGISLATION

Under section 501(c)(3) of the Internal Revenue Code of 1954, publicly supported charitable, educational, religious, and similar organizations are granted tax exemption provided, among other requirements, that no substantial part of their activities consists of the carrying on of propaganda or otherwise attempting to influence legislation. Many arguments support the need for corrective legislation.

a. Uncertainty of present law should be corrected

Although the present law has been in effect for approximately 40 years, neither the courts nor the Service has been able to derive a universally acceptable definition of "substantial." The Service has refused to take a position on the meaning of "substantial" in quantitative terms, such as what percentage of expenditures or time devoted to lobbying activities would be deemed insubstantial. Moreover, the Service has at times attempted to view the term "substantial," not only in undefined quantitative terms, but in undefined qualitative terms as well. A "facts and circumstances" test, apparently called for by the regulations, takes the bewildered charities out of definable areas, such

as specific financial expenditures and allocations of stafftime, and into completely uncharted areas, including not only time of volunteers, but importance of the effort, and very possibly other factors.

In addition, the Service, as a result of the vague regulations, inevitably interprets the law differently from district to district and even from revenue agent to revenue agent, resulting in even greater confusion to the charities. As former Commissioner Mortimer Caplin pointed out in testimony before the Ways and Means Committee in 1972, revenue agents are normally experts in accounting, not ideology: this, combined with the vagueness of the tests used, inevitably results in widely varying applications of the rule, and in subjective rather than objective determinations. All this is unconscionable in a nation which believes in fair play. Surely, all the very least, a charitable or educational organization is entitled to a clear statement of "the rules of the game."

When a charity's exemption is revoked, no matter how tenuous or unfounded the grounds, it takes a considerable period of time to get the action reversed, whether by administrative or court action. During this period, the charity cannot assure contributors that their contributions will be deductible, and the normal programs of the charity inevitably suffer drastically. In many instances, loss of contributions will result in severe crippling and even total and permanent cessation of the organization's charitable activities. In either case, the eventual finding that the revocation of exemption was itself mistaken and illegal cannot repair the damage. In a nation whose basic traditions include strong reliance on and encouragement of voluntary citizen service and activity, this is indeed an ironic situation.

b. Governmental bodies often wish to receive the ideas and information of public charities

Legislative bodies are often desirous of receiving ideas and information from charitable organizations, particularly in view of the fact that Federal and State Governments have taken an increasingly active role in fields that were previously the almost exclusive domain of charitable organizations, such as health, welfare, education, and environmental matters. Examples of desirability of charities contributing their ideas and information to legislative bodies are numerous. In considering the budgeting, structuring, and priorities of a health program, Congress would almost surely want the benefit of the expertise of the staffs and the opinions of the executives of leading health agencies, even though (and perhaps particularly because) they would frequently be in conflict. In considering pollution laws, a State legislature would probably wish to weigh the arguments and supporting facts of businesses that would be affected and also of any 501(c)(3) groups which had studied the situation. By having such information, legislators will be better able to make informed decisions more responsive to the needs of all their constituents.

c. Charities should also be allowed to volunteer information and suggestions to governmental bodies

Responding to specific requests by governmental bodies is far from a complete solution to the basic problem: too often bills can slip through or other governmental action can be taken without the recog-

nition of possible drawbacks or problems that informed charities could identify. For example, a committee concerned with improving water transportation in Florida by building a cross-peninsular canal may be unaware of the ecological consequences such a canal would have on waterflow patterns and the underground aquifer on which numbers of Florida communities depend for fresh water. Unless concerned conservation groups are allowed to approach the committee with their information describing the problem, legislative action may be taken that could have consequences wholly unintended. Such a threat might be avoided if interested charitable organizations are permitted to provide legislators with the benefit of the information they have available on the problem.

For any public charity, legislative activity, direct or indirect, is a relatively minor part of the reason for its existence; yet, though minor, it can nonetheless be important. The major purpose of a university is education: yet members of its board of trustees and faculty boards should be allowed to comment on legislation affecting higher education. The amount of time or money relative to the entire operation of the organization might and probably would be small, but it is nonetheless important, both to the charities and the governmental body, that the views be heard.

d. The right to communicate with members is critical to the proper functioning of most charities

The fuzziness of present law brings into sharp relief the problems encountered by charities with respect to communications with their members. For the charity to be representative of its membership, there must be freedom of exchange of views—by correspondence, published magazines, and orally at meetings. The members must and are entitled to know what the directors, officers, and staff are thinking with respect to issues of special concern to the particular charity, and vice versa. The issues may involve matters that are or could be the subject of legislation or other governmental action. The vital exchange of information within an organization is the very lifeblood of its existence and permits it to state when taking a position on a matter of legislative concern that it is in fact a public charity nurtured by citizen involvement and subject to citizen control. If such communications are considered to be "attempts to influence legislation," it could leave a carefully administered organization in a real straitjacket.

e. Charities should be allowed many of the same rights as trade associations

S. 2832 attempts to redress a serious inequity in present law. In 1962, Congress enacted section 162(e) of the Internal Revenue Code, extending to businesses and the organizations which represent them the right to conduct legislative efforts with tax-deductible funds. The Senate Finance Committee explained the grounds for that action in these words:

> It is also desirable that taxpayers who have information bearing on the impact of present laws or proposed legislation on their trade or business not be discouraged in making the information available to the members of the Congress or legislators in other levels of Government. The presentation of such information to the legislators is necessary to a proper evaluation on their part of the impact of present or proposed legislation.

The reasoning applies with equal force to public charities.

It is almost inconceivable that Congress would wish to hear the views of business organizations, but not those of charities. Likewise, it is inconsistent to permit charities to present their views to an administrative agency charged with the duty of drafting interpretive regulations, such as the Environmental Protection Agency, yet deny charities the opportunity to present such views to Congress.

As Congress properly recognized in 1962, the legislative process works best when it is open to the free and full expression of views by all concerned individuals and groups. The present restriction found in section 501(c)(3) of the Internal Revenue Code effectively limits a broad, diverse and important class of organizations from participation in the legislative process.

2. HISTORY OF S. 2832

The great-grandfather of S. 2832 might well be the American Bar Association, which in 1969 passed a resolution calling upon Congress to restore the balance in legislative influence between public charities and the business community. In the same year an amendment was introduced by Senator John Sherman Cooper (R-Ky.) with the same purpose in mind. In 1971, legislation based on the ABA resolution was introduced by Senator Edmund S. Muskie (D-Maine) and Congressman James W. Symington (D-Mont.) (S. 1408 and H.R. 8420). These bills also followed the characteristics of section 162(e).

Although there was broad support for the Muskie-Symington bill, there was some concern that it was too broad and that it might be interpreted to permit a public charity to concentrate on legislative activities rather than normal operations. As a result, Senator Muskie with Senator Hugh Scott (R-Pa.) introduced a new bill (S. 3063) on January 24, 1972 which had the same fundamental purpose but somewhat limited the legislative activities in which charities might engage.

Further compromise and refinement led to the introduction on March 9, 1972 of a bill (H.R. 13720) by Congressman Al Ullman (Democratic, Oregon) and Herman Schneebeli (Republican, Pennsylvania). Hearings on this bill were held in May 1972. The testimony was overwhelmingly favorable with respect to the principles of the bill but questions were raised, particularly by the Treasury Department, about many of the specific provisions.

Up to this point some charitable organizations had been supporting the various bills but the efforts had been mainly on an individual basis, there being no cohesive organization. It became obvious that better organization was required. Discussions among the section 501(c)(3) organizations led to formation of the Coalition of Concerned Charities early in 1973. The coalition was created for the sole purpose of finding a suitable substitute for the restrictive and vague language of section 501(c)(3). A Steering Committee was elected, counsel was selected and we tried, for the first time, to coordinate our efforts. A list of our members is attached to this statement.

In response to the questions raised during the 1972 hearings and after further study, Congressmen Ullman and Schneebeli introduced another bill (H.R. 5095) on March 1, 1973. The day before Senators Muskie, Hugh Scott, Robert J. Dole (Republican, Kansas) and Gay-

lord A. Nelson (Democratic, Wisconsin) along with 31 other Senators had introduced a bill (S. 1036) similar to the bill introduced the year before by Ullman and Schneebeli. Shortly after the introduction of these bills another set of hearings was held by the Ways and Means Committee and I had the privilege of testifying at that time. I supported the first Ullman-Schneebeli bill but objected to certain features of the second Ullman-Schneebeli bill.

Still further discussions were held after these hearings with the result that on December 19, 1973, Congressman Barber B. Conable (Republican, New York) introduced another bill (H.R. 12037). This bill was reintroduced in 1974 by Congressman Conable with other members of the Ways and Means Committee as sponsors, and in August the committee tentatively adopted this bill with three amendments. When the bill was drafted in final form, however, several changes of format and substance were made, causing serious concern among the charities. In the frantic rush at the close of that session there was no time to resolve these problems. Congress Conable accordingly asked that the bill be withdrawn.

In this Congress, Congressman Conable and Senator Muskie again introduced identical bills, H.R. 8021 which had 23 sponsors from the Ways and Means Committee, and S. 2832 with 47 sponsors from the Senate, including 11 members of this committee. Since the introduction of these bills a great deal of work has been done by the staff of the Joint Committee on Internal Revenue Taxation, by representatives of the Treasury Department and by representatives of our Coalition of Concerned Charities. As a result of this work a new bill has been prepared which I believe will shortly be introduced.

Between the introduction of H.R. 8021 in June and S. 2832 in December 1975, the Commission on Private Philanthropy and Public Needs (known as the Filler Commission) after more than 2 years of exhaustive study covering the entire area of charitable organizations, published its report called "Giving in America—Toward a Stronger Voluntary Section." This report was submitted to the Secretary of the Treasury, the chairman of the Ways and Means Committee and the chairman of this committee. The conclusion of the distinguished persons comprising this Commission was that operating charitable organizations should be given much greater latitude with respect to their rights to influence legislation than is envisioned in S. 2832. I do not mention this in order to suggest that this committee should go beyond the provisions of S. 2832 or its revision, but to note that there is indeed a strong and considered feeling toward much more liberal rules than those for which I am arguing in this statement.

The viewpoint expressed in the Filer Commission report also received support in the House in H.R. 9256 introduced in 1975 by Congressman Richard L. Ottinger (Democratic, New York) and sponsored by 14 other Members of the House of Representatives.

3. BRIEF DESCRIPTION OF S. 2832, WITH PROPOSED REVISIONS

The proposed revision of S. 2832 is the result of all these years of discussion, negotiation and compromise. Its most important feature is that it replaces the vague subjective tests of section 501(c)(3) with an objective test, namely, dollar expenditures. The bill would establish a

reverse graduation feature so that the larger the charity's budget, the smaller the percentage it could spend on legislation. For example:

If a charity's total expenditures excluding certain fund raising items are:	Its allowable lobbying expenditures are:
$500,000	$100,000 (20 percent).
$1,000,000	$175,000 ($100,000 plus 15 percent of everything over $500,000).
$1,500,000	$225,000 ($175,000 plus 10 percent of everything over $1,000,000).
$5,000,000	$400,000 ($225,000 plus 5 percent of everything over $1,000,000).
$10,000,000	$650,000 ($225,000 plus 5 percent of everything over $1,000,000).
$15,000,000	$900,000 ($225,000 plus 5 percent of everything over $1,000,000).
Over $17,000,000	$1,000,000 maximum.

It readily can be seen that the rules are more liberal for smaller organizations than for larger ones. Indeed, the cutoff point of a million dollars means that an organization with expenditures in excess of $17 million has zero allowable expenditures for anything over that figure.

With such a "reverse graduation" provision it was deemed necessary to have an affiliation provision which would prevent an organization which has control over the legislative policy of another organization from being able to use the favorable figure of the lower bracket more than once. Such a provision is found in the bill.

Moreover, so-called grassroots efforts (those involving appeals to the general public either directly or indirectly), are, by the proposed revision, limited to 25 percent of the allowable lobbying expenditures. Violation of the grassroots limitation results in penalties even though the overall limits have not been violated.

An important feature of the proposed bill, which is not found in earlier bills, is the provision of a "cushion." Violation of the allowable expenditure limits results, in the first instance, in a "tax" which is really a type of penalty for exceeding the limits: this tax is in the amount of 25 percent of the excess expenditures and is assessed on an annual basis. Only when the charity "normally exceeds 150 percent of the allowable limits does it lose its exemption. We understand that "normally" will be defined as a 4-year average.

With very few exceptions section 501(c)(3) organizations do not pay taxes. We do not like the idea of being considered taxpayers but we see the merit of this cushion. It tends to dispose of the problem of overkill where a charity which innocently or negligently exceeds its limit in 1 year, but not by a great deal, is pulled up short, as it were, and made to pay for the transgression by way of total loss of exemption which injures the charity, its contributors and the general public. This also, as a practical matter, allows room for a charity to engage in reasonable negotiations with the Internal Revenue Service about matters that are properly disputable without there necessarily being the spectre of complete death if the dispute be lost.

If, however, the violation is continuing with resultant loss of exemption, there is a stringent penalty in addition to the loss of exemption: a charity cannot become a 501(c)(4) organization, and the Treasury Department is given broad latitude to prevent evasion of this provision.

Expenditures for certain activities will be excluded from the expenditure limitations. A charity may make available results of nonpartisan analysis, study or research; it may provide technical advice to governmental bodies in response to a written request; it may communicate concerning issues of direct concern to its own existence or tax exempt status. These three privileges are believed to be declaratory of present law.

One area in which present law may be ambiguous is that of communication with the executive branch. Under S. 2832 such communications are excluded from the definition of "influencing legislation"; under the revision these communications are excluded except when their principal purpose is to influence legislation.

I have stated that communication with our own members is of the utmost importance to us. Such communications would not be considered lobbying under S. 2832; the revision makes an exception for cases in which we directly encourage our members to influence legislation. In these situations the expenditures are counted against the over-all lobbying limits. If we go further and encourage our members to encourage others to influence legislation, this is considered "grass-roots" lobbying.

4. ARGUMENT IN SUPPORT OF S. 2832 AND ITS PROPOSED REVISION

As is evident from the history described earlier in this statement, this bill represents the culmination of many years of give and take and of pure hard work, all in a sincere effort to arrive at the best possible piece of legislation. In a very real way, it can be said that it represents the legislative process at its best: All parties, including interested members of the Congress from both Houses, members of their staffs, members of the staff of the Joint Committee on Internal Revenue Taxation, the executive branch represented by the Treasury Department, an outside Commission composed of leading citizens and advised by competent specialists, and our own organizations, have all made important contributions, with the revision of S. 2832 and H.R. 8021 as the end product. It is this, we believe, which has caused the sponsorship of the two bills to be so impressive. It is this, we submit, which should allow this committee and the Committee on Ways and Means to be able firmly to fix the label "Non-Controversial" on this final effort.

In another way, it can be said with a certain amount of justification that the plodding history of this meritorious legislation represents our legislative process at its worst: Why has it taken 5 years, principally of detail work, instead of 2? Actually, the answer is easy enough to find: This legislation, important though it be, was never classified as a high priority item when contrasted with many other critical matters relating to the revenue or the economy.

We submit, however, that it now does deserve priority. It is critical to the charitable community, it is important to the legislative process, and the bugs have finally been worked out.

I do not mean to imply by the last statement that the charities for whom I now speak regard these bills as the perfect answer to their problems. As in any such give and take process, we have compromised in many areas though we sincerely felt that such compromise should be unnecessary. Examples of this are numerous:

(A) The expenditure limitations themselves—we believe they could properly be higher, though we share the opinion that they should not be limitless.

(B) Freedom to communicate with the executive branch without it being "charged" to our allowable expenditures—we accepted an exception to the provision which we had suggested.

(C) Freedom to communicate with members without a similar "charge." Again, we accepted an exception.

(D) Freedom to appear before committees of Congress on any matters of direct interest to the particular charity without such a "charge"—in the spirit of compromise, we abandoned this position entirely.

(E) Acceptance of a penalty clause for loss of exemption resulting from violation of the provisions of this bill. We did not really see the need for any such clause, holding that loss of exemption was itself sufficient penalty: However, we are happy that it is much less stringent than that found in earlier drafts.

(F) Acceptance of an affiliation provision (some such provision being necessitated by the "reverse graduation" feature of the bill) that is more stringent than our original suggestion.

(G) Acceptance of separate restrictions on grassroots lobbying.

(H) Acceptance of exclusion from total expenditures, which acts as the denominator of the operative fraction, certain fund-raising expenses.

What we have not done, in my opinion, is compromise any of the fundamental principles for which we have struggled so long. In this connection, I would like to point out that the representatives of the legislative and executive branches with whom we have been working have not asked us to abandon any of these principles. It is also appropriate at this point to thank them for the considerable amount of time they have devoted to our problems and for their unfailing courtesy in giving us the opportunity to present our viewpoint.

Why is this a good bill? First, it solves the major problem existing under present law: That of uncertainty. In addition, this bill introduces a new concept often discussed but never before found in a bill actually introduced: A "cushion," causing a charity which violates the basic limits of the bill to be penalized by a tax, but not providing the severe sanction of loss of exemption except for greater violation over a longer period of time. This eliminates, for most of us at least, the problem of "overkill"—the punishment being too great for the crime.

The bill allows us, with some limitations, to communicate freely with our members; it also allows us to discuss administrative matters with the executive branch "free of charge." It should (and we hope it will) allow the Internal Revenue Service to adopt specific tests for the guidance of its revenue agents and to have a consistent policy from district to district. It does not put us on an equivalent status with businesses and trade associations, but it does place us closer to that equilibrium—and we understand that the problems are not, and thus the solutions should not necessarily be, exactly the same.

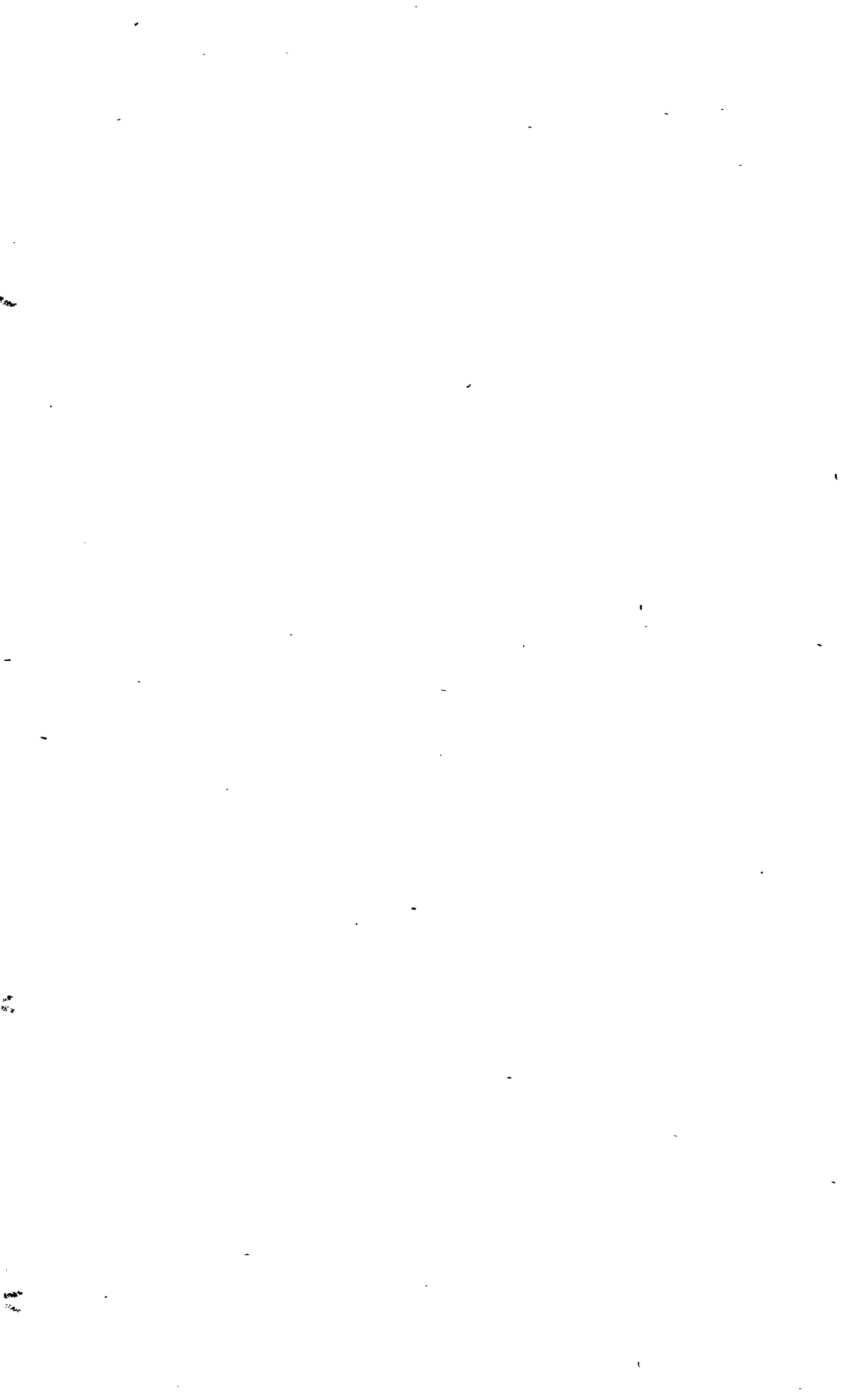
The bill will result in freer communication between government representatives (at all levels) and representatives of operating charities, who, as I have pointed out previously, are primarily interested in

their basic charitable operations and are interested in legislative matters only when they pertain to the basic purposes of the organization. The bill will do this, moreover, without allowing those organizations whose principal purpose is influencing legislation to be able to attain section 501(c)(3) status and thereby gain the important attribute of tax deductibility of contributions to them. Incidentally, the bill has no effect one way or the other on private foundations.

I respectfully and urgently request that the proposed revision of S. 2832 be placed high on the agenda of this committee for consideration and approval.

MEMBERS OF THE COALITION OF CONCERNED CHARITIES

American Association of Blood Banks.
American Association for Respiratory Therapy.
American Cancer Society.
American College Health Association.
American College of Preventive Medicine.
American Diabetes Association.
American Heart Association.
American Jewish Committee.
American Jewish Congress.
American Littoral Society.
American Lung Association.
American Medical Technologists.
American Public Health Association.
American Society of Allied Health Professions.
Association for Voluntary Sterilization, Inc.
Arthritis Foundation.
Association of Schools of Public Health.
Association of American Law Schools.
Audubon Naturalists Society of the Central Atlantic States, Inc.
Big Brothers of America.
Camp Fire Girls, Inc.
Center for Community Change.
Child Welfare League of America.
College & University Personnel Association.
Community Council of Greater New York.
Community Services of Pennsylvania.
Community Service Society of New York.
Council for Advancement & Support of Education.
Council for Financial Aid to Education.
Defenders of Wildlife.
Environmental Defense Fund.
Epilepsy Foundation of America.
Family Service Association of America.
Garden Club of America.
Florida Audubon Society.
Goodwill Industries of America.
Involvement, Inc.
Massachusetts Audubon Society.
Muscular Dystrophy Association of America.
National Assembly of Voluntary Health and Social Welfare Organizations.
National Association for Mental Health.
National Association of Social Workers.
National Audubon Society.
National Cancer Foundation, Inc.
National Center for Voluntary Action.
National Council on the Aging.
National Council on Alcoholism.
National Council for Homemaker-Home Health Aide Services, Inc.
National Council of Jewish Women.
National Council of State Garden Club.
National Council of Women, U.S.A.
National Cystic Fibrosis Foundation.
National Easter Seal Society for Crippled Children and Adults.
National Environmental Health Association.
National Federation of Settlements and Neighborhood Centers.
National Foundation March of Dimes.
National Health Council.
National Hemophilia Foundation.
National Kidney Foundation.
National League for Nursing.
National Medical Association.
National Multiple Sclerosis Society.
National Safety Council.
National Society for Autistic Children, Inc.
National Society for the Prevention of Blindness.
National Wildlife Federation.
Nature Conservancy.
New Jersey Association on Correction.
New Jersey Association for Children with Learning Disabilities.
State Communities Aid Association.
Student American Medical Association.
Travelers Aid International Social Service of America.
United Cerebral Palcy Association.
United Service Organizations, Inc.
United Way of America.
United Way of Delaware.
Washington International College.
Wilderness Society.
Wildlife Management Institute.
World Wildlife Fund.
Y.W.C.A. of the U.S.A.



Carryforward and Carryback of Net Operating Losses

3274

Statement of Kurt M. Swenson, Executive Vice President, The John Swenson Granite Co., Inc., Concord, N.H.

Mr. Chairman, members of the committee, My name is Kurt M. Swenson, of Hopkinton, N.H., and I submit this statement in my capacity as the executive vice president of The John Swenson Granite Co., Inc. of Concord, N.H. With your indulgence, I would like to briefly outline for you the history of our company and then explain our strong support for a bill similar to that reported out favorably by this committee in 1975. We seek a bill to extend the loss carryback provisions of the Internal Revenue Code to permit small businesses to carry back losses 10 years for all tax years beginning after December 31, 1969. We strongly recommend that the bill be restricted to small business either by limiting the amount of the refund or by using an appropriate definition of a qualifying small business.

HISTORY OF THE JOHN SWENSON GRANITE CO., INC.

1. Early history

The John Swenson Granite Co., Inc. is a small business located in Concord, N.H. It was founded by my great grandfather, John Swenson, in 1883 in Concord. The business began as a granite polishing operation which polished granite for use in the monumental business. By 1900, John Swenson had bought a gray granite quarry and a manufacturing plant at the company's current location in Concord. The company quarried and manufactured gray granite for use in the monumental industry.

By 1915, John Swenson's only three sons, John, Guy, and Omer, had joined him in the business and it began to expand. After John Swenson's death in 1918, the three sons continued the business as a partnership. Primarily because two of the sons had college backgrounds in architecture, the company began to expand its manufacturing capacity into the manufacture of finished granite for use in buildings. The company successfully survived the Depression and in the 1930's, provided the granite for the Waldorf Astoria in New York and other buildings in New York, Philadelphia, and Washington. As the company's expansion continued, it phased completely out of the monumental business and concentrated in the business of manufacturing finished granite for use in buildings.

During the Second World War, the company converted its entire productive capacity to the production of antisubmarine nets and to the reconditioning of rockets for the war effort. All of the Swensons who were physically able joined the Armed Forces.

2. Postwar history

After the Second World War, the company incorporated and the sons of the three owners, the third generation of Swensons, began to

enter the firm. Both John and Omer Swenson's only sons became active in the business in the 1940's, and two of Guy Swenson's three sons joined the business in the 1950's.

During the post war period and through the early 1960's, the company grew and prospered. It became the second largest supplier of building granite in the United States. It quarried and/or fabricated the granite for the CBS Building and the Seagrams Plaza in New York, the Dupont-Brandywine Building in Wilmington, Del., the Pittsburgh National Bank, the Michigan Bell Telephone Headquarters, and hundreds of other buildings throughout the United States. In Washington, our granite can be found in numerous places and applications, including the Rayburn Office Building, the Hirshhorn Museum, and the Tomb of the Unknown Soldier. From 1945 to 1965, the company never lost money and paid millions of dollars of taxes to the U.S. Government. In the company's 3 most profitable years in the 1960's, the company paid the U.S. Government approximately $800,000 in Federal income taxes for those years alone.

The company bought additional quarries in the postwar period and now owns seven different granite quarries in the States of Maine, New Hampshire, and Vermont, representing six different colors of granite ranging from gray to black. In terms of the Concord area, the company was one of the top employers in the Concord area, employing between 100 and 170 employees during the 1960's. The company was one of the largest city, State and Federal taxpayers in the city of Concord, N.H.

3. Current history—1965–75

As a result of the Kennedy round tariff reductions, the impact of competition from imported building granite began to severely erode the company's earnings beginning in 1965. Many of the building granite manufacturers in the United States have gone bankrupt or withdrawn from the building granite business from 1965 through 1975. Despite what was, for a company of our size, a massive investment from 1965 through 1972 of over $1 million to install and update machinery and equipment to meet this competition, and despite diversification into the granite curb business and reentry into the monumental business, the company suffered staggering losses from 1966 through 1974 which brought it to the brink of bankruptcy in late 1973.

When I became chief executive officer of the corporation late in 1973, I was forced to lay off over one-half of the employees of the company, including over one-half of the management personnel, and shut down the company's operation in order to preserve cash. For those employees in the building granite division, this was a permanent layoff and shutdown of plant facilities. While the impact of laying off 40 to 50 people may be minimal by national standards, it is not minimal by community standards in Concord, N.H. Moreover, unlike an executive in a large corporation laying off 5,000 or 10,000 employees, the employees laid off were 10- to 20-year employees of the company who the management knew on a first-name basis.

Ultimately, in February of 1974, the company entered into a purchase and sale agreement for the sale of its building granite division for a fire sale price, and on the closing of that agreement in the spring

of 1975, lost over $100,000 on a book value basis, not even considering the fair market value of the land, building, and equipment involved.

The company now has an employment level of approximately 40, including both management and union members, and sales of about $1 million, a level of approximately 25 percent of those in the early 1960's. We have retained our quarries and now sell our granites primarily to monumental manufacturers and as granite curb and other quarry products. We sell some rough granite blocks to the purchaser of our building granite manufacturing assets.

In the summer of 1974, the company petitioned the then U.S. Tariff Commission for a qualification for trade adjustment assistance under the Trade Expansion Act of 1962. We were successful in the petition and became the first granite company qualified under the 1962 act. I would note that we joined a select few who had qualified under the stringent qualifications of the 1962 act which required our company to show that we were injured "in major part"—as opposed to the less stringent test in the 1974 act)—by increased "quantity"—as opposed to the dollar value of that quantity—of imported products.

I have two purposes for raising the Tariff Commission's decision. The first is to illustrate that the predicament of the John Swenson Granite Co., Inc. was not brought about by mismanagement, but by circumstances over which a small company like the John Swenson Granite Co., Inc., had no control. The company and our industry did not participate in or fight the Kennedy round tariff reductions in the rate on imported granite. The dramatic increase in imports to almost 50 percent of our market was a circumstance not foreseen by our company nor any other company in the building granite business. Perhaps some would say the company stayed in the building granite business too long, but I attribute this to the transmission of tradition in the Swenson family that quality, hard work, perseverance, and honesty can overcome any economic setback. The company had managed to overcome depressions and world wars in its over 80 years of business, and assumed that it could overcome the imports. It could not.

The second reason that I raise the issue of the Tariff Commission is that, pursuant to the decision of the Tariff Commission, we submitted a trade adjustment assistance proposal to the Commerce Department for assistance. The management, management consultants, and our accountants, determined very carefully the amount of dollars that were necessary to get the company back where management and its consultants thought the company should be, and the total dollars required was in the vicinity of $900,000. Since the Commerce Department can provide only debt financing, debt financing in that amount had a substantial adverse impact on the level of indebtedness of the company and raised substantial problems with management in determining whether it could be repaid. With considerable trepidation, however, management submitted a request of $900,000 in debt financing on the basis that we should at least honestly show what we believed to be necessary in terms of actual dollars to revitalize the company from the blow suffered at the hands of imports.

Suffice it to say that at the present time, management has received a loan from the Commerce Department in the amount of $250,000. This obviously does not obviate the need for additional capital. We would

have no objection whatsoever if the bill extending the period for carrying back losses required a repayment of any direct or guaranteed loans from the U.S. Government. Our company's loan from the Government under the Trade Act of 1974 has an interest rate in excess of 10 percent. The Italians, whose imports nearly put us out of business, have received loans at 6 percent. This is a fine example of Congress' support of small business.

4. The company's current situation

The company today faces a high demand for its granite, a development that we are delighted with. We had a small profit in 1975—less than $25,000—and demand in 1976 appears better than 1975. We have survived a very difficult 5-year period and have a good market for our product in the future. We are, therefore, viable, and the demand for our product is growing. However, years of operating losses have seriously hurt our cash position and our payables are badly out of line, creating unusually high demands on our cash by trade creditors. Our machinery and equipment badly needs updating, maintenance, repair, or replacement. Our quarries need development if we are to continue to supply our customers with granite to meet their current needs, as well as to meet the expanding demand in the future. All of this requires capital—capital we do not have and do not have access to.

THE NEED FOR EXTENSION OF THE LOSS CARRYBACK PERIOD

1. The need for capital

There has been substantial testimony before Congress and extensive treatment in the media of the need for a substantial influx of capital into business in order to permit it to survive and grow. I know our company doesn't need any additional debt, and we can't obtain it from conventional sources in any event. We have plenty of debt as it is. What we need is an influx of capital. The question that the John Swenson Granite Co., Inc., faces is, how do we get the capital?

In 1975, I testified before the House Ways and Means Committee on a similar bill. The panel I testified with included executives and representatives of very large businesses. I am sure that the magnitude of the refunds requested by those large businesses were a substantial factor in the congressional decision not to enact an extension of the loss carryback period. I am also sure that payments made to foreign officials by some of these companies were another negative factor.

It is unfortunate that the ability of small business to obtain needed legislation is so inextricably bound to the needs of big business. It is the power of, or the abuses by, big business that garner headlines and result in legislation passing or being defeated. We don't have money to pay lobbyists, and we don't have money to contribute to Congressmen or Senators. Most of the time, we provide no input into important bills and may not even know that an important bill is pending. Yet every piece of legislation pertaining to business affects us. More and more, I have come to believe that small business and its problems have been overlooked by Congress. If Government bureaucracy is difficult for big business, I can assure you from personal experience that the Government bureaucracy is almost an insurmountable hurdle for small business.

I can honestly say that I think I have learned a great deal about small business in the approximate one and one-half years since I took a leave of absence from the practice of corporate law to become chief executive officer of The John Swenson Granite Co., Inc. The magnitude of the problems faced by small business is staggering if my experience is any reflection of the actual situation. In the past decade, I think it is safe to say that hundreds of thousands of small businesses have been swallowed up by large businesses, or been forced into bankruptcy as a result of markets over which they have no control. Imports have raised havoc with small business. I invite you to review the transcripts of testimony before the International Tariff Commission in 1975 concerning tariff reductions. Hundreds of small businessmen testified at those hearings which were held all over the country. I was amazed and even shocked at the number of businesses and industries, ranging from a sardine business in Maine to a handkerchief manufacturer, that faced staggering losses at the hands of imports and were going out of business. These are not new businesses but well-established small businesses. It is safe to say, I think, that small business cannot either control its market or adjust to changes in its market as quickly as big business can, primarly as a result of the fact that it does not have adequate capital. All business must in the end rely on earnings for capital expenditures. It is often considered vogue to use percentages in measuring business performance, but from a practical point of view, the difference between $50 million in net after-tax profit and $50,000 in net after-tax profit, is tremendous in terms of investment ability.

Recent media articles concerning capital shortages for big business should magnify for you the problems faced by small business. Big business has traditionally utilized the bond markets, secondary issues of its common stock, or merger with cash-rich financial partners to obtain capital. If these markets are either not available to big business or unattractive to big business, imagine the effect on a small business. A small closely held corporation essentially has access to none of these capital markets or financial partners anyway, particularly a small business that has been dealt a crushing blow and is attempting to regain its feet. Where does a small business go to get capital after bank sources have been exhausted. What investor is going to invest in The John Swenson Granite Co., Inc. at this stage of the game when the return on other investments is considerably more attractive at equal, or more likely, lower risk. In simplistic terms, the only source of capital for the small business is its earnings.

2. Justification for the extension of the tax carryback period

The points raised in the foregoing section, I believe, illustrate for our company the absolute necessity that the net operating loss carryback period be extended to permit not only our company, but other companies in similar situations, to recoup money they have actually paid in Federal taxes. As I indicated previously, we paid $800,000 in taxes for 3 years alone in the midsixties. I ask that you permit us to carry back our losses to recover some or all of our earnings paid to the Treasury as taxes to help us increase our employment, increase our efficiency by capital investment, and increase our profitability.

I suggest that our company will pay back those dollars refunded to us in the form of taxes, as well as additional tax dollars from us and from others. I will leave it to the economists to determine the possible multiplier effect of such a refund, but the impact in terms of investment and return of tax dollars significantly exceeds the amount of the refund.

Some companies may benefit from the tax loss carryforward provisions either because they can shield high profits in succeeding years from taxes, or they can attract a financial partner looking for tax losses to offset profits, assuming they can meet the stringent pooling requirements now in effect. The John Swenson Granite Co., Inc., could not possibly make enough money in the next 10 years, let alone 5 years, to take advantage of its $1 million of tax loss carryforwards. Some $200,000 in available tax loss carryforwards have been lost by our company, and additional amounts expire each year. The prospect of a financial partner, assuming we desire one, is remote, if nonexistent, on any reasonable basis. Probably, our most attractive asset for a financial partner is our tax loss carryforwards.

We would obviously elect to receive the entire refund, and if our projections hold true, in the absence of carryforwards, we would immediately begin paying corporate taxes in the year 1976 and increase withholding taxes as a result of increased employment in the year 1976. Obviously, the effect of a refund would have a significant positive impact in the Concord area in terms of employment, paying of payables, and purchases of machinery and equipment.

3. Absence of relief to the John Swenson Granite Co., Inc., from recent tax reductions

All of the tax reduction items enacted by Congress in the recent past have done our company absolutely no good since we have more tax loss carryforwards than we need. Investment tax credits, depreciation changes, increases of the surtax exemption, and other tax reduction measures do us absolutely no good in the short term. The only way we can be helped is by extending the number of years allowable for the tax loss carryback, thereby permitting us to recover taxes paid to the Treasury in prior years to offset the substantial losses in recent years.

We cannot take advantage of any of the recent tax reductions in effect, nor could we take advantage of any further tax reductions or credits that Congress may enact, at least for the next 3 years. I suggest that this puts our company in an extremely unfair relative position to those companies who have had successful years from 1970 through 1975 and are able to obtain the benefits of these reductions through lesser tax payments.

I know of other companies in New Hampshire in relatively the same position as ours, and certainly a careful analysis would develop hundreds of small businesses like ours who desperately need the positive impact of tax relief but have not obtained any benefits from the recent tax reductions. We think we are at least as deserving of tax relief, and certainly in as much need, as other businesses who enjoy the benefits of the recent tax reductions. An extension of the period for carrying back net operating losses provides a reasonable vehicle for that relief, particularly since Congress has already recognized that a company should be able to carry forward or carry back its losses. What

the John Swenson Granite Co., Inc., seeks is not a radically new proposal, but simply extending the coverage of an existing provision to assist small businesses such as ours in obtaining the necessary capital to return their businesses to normal levels of employment, efficiency, and profitability.

Thank you.

BAKER & MCKENZIE,
Washington, D.C., April 23, 1976.

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

Dear Mr. Chairman: The purpose of this statement is to urge the Senate Finance Committee to adopt as a small business tax reform a proposal which it previously had found acceptable (even on a big business scale), that is, a longer period for carrying back net operating losses if, in exchange, a taxpayer is willing to give up his right to carry losses forward. This could be done very simply: Refunds due to such longer carryback period could be limited to a maximum of $5 million.

A brief review of recent legislative activity pertaining to loss carrybacks will help to put this small business proposal into perspective.

On March 17, 1975, the Senate Finance Committee favorably reported, as section 804 of the tax reduction bill of 1975 (H.R. 2166), a tax reform measure which would have permitted taxpayers who had suffered large net operating losses in taxable years ending after January 1, 1970, to elect to substitute net operating loss carryback years for carryforward years. The effect of this giving up of carryforward years in exchange for a longer carryback period would have been to give taxpayers, particularly hard pressed for working capital, a real financial shot in the arm in the form of a refund of income taxes paid by them in earlier, more profitable years. In substance, the taxpayers receiving those refunds would actually have funded this so-called tax relief themselves.

However, because of the great number of amendments that were added to the committee's bill on the Senate floor, Senator Mansfield moved to have the bill recommitted to the Finance Committee minus a number of committee provisions, including the one dealing with net operating loss carrybacks. Thereafter, a more narrow version of the provision, which would have dealt only with net operating losses arising in 1975 and 1976, and which apparently would have benefited only one very large corporation, was adopted by the Senate. However, because of its narrow scope, this provision was deleted in conference.

As the tax reform bill presently before your committee was being developed by the House Ways and Means Committee, essentially the same net operating loss carryback extension proposal was again considered. This year the Ways and Means Committee went so far as to vote 28 to 9 in favor of an 8-year extended carryback, provided that only 1975 losses were covered; that is, that the bill did not affect losses in prior years. Eventually, the committee moved to defer action on the entire subject of loss carrybacks for 6 months and referred the matter to a special subcommittee for further study. That is where the matter now stands as far as the House of Representatives is concerned.

It is clear to the undersigned that the Ways and Means Committee had no quarrel with the rationality, fairness, and economic good sense of extending the period for carrying back operating losses. This is dramatically evidenced by its 28 to 9 vote in favor of that principle. The two major difficulties the Ways and Means Committee had with the proposal, if it were to be effective with respect to losses suffered in years prior to 1975, was: (1) Its revenue impact, and (2) perhaps more importantly, the fact that it would greatly benefit several very large and highly publicized corporations. Indeed, the proposal became commonly known and frequently referred to in the press as the Lockheed-Chrysler-Pan Am relief bill.

Regardless of the merits of those objections, it is patently clear that they spelled the death knell of the proposal in the House. The unfortunate victims of this big business ramification of the proposal were the small and medium size companies of the United States who had suffered such large losses throughout the first 5 years of the 1970's that they were faced with the extremely serious twofold problem of: (1) Being unable to obtain desperately needed additional working capital from banks, investors, and other traditional credit sources, and (2) even worse, being faced with the likelihood of losing the entire tax benefit of their losses because of their inability to generate sufficient profits in the near future to utilize those losses on a carryforward basis.[1]

In view of the foregoing difficulties which the loss carryback proposal has suffered, it is submitted that its reappraisal in the form of a small business measure should serve to liberate it from its major drawbacks.

Revenue impact

As above discussed, the large immediate revenue effect of an extension of the loss carryback period, if such extension were to apply to all businesses large and small, has been a major obstacle to the proposal's enactment. This one-time (temporary) revenue cost has been estimated by the Joint Committee staff to be about $1.4 billion. The proposed small business approach of limiting the refunds obtainable by reason of a longer loss carryback period to $5 million would, of course, greatly reduce the revenue cost of the measure. For example, the refunds some of the large companies would have received under the original proposal are: Chrysler—$180 million; Lockheed and W. T. Grant—both about $100 million; American Airlines—$50 million; Pan Am—$40 million.

Eliminating these large refunds from the picture of necessity will greatly reduce the revenue effect of the measure. By the same token, the remaining revenue cost will be channeled to the smaller and generally more needy taxpayers.

---

[1] Under such circumstances, many of these small companies chose to "sell" their loss carryforwards at substantial discounts. As a practical matter, they had no alternative; it was either peddle their loss carryforward to salvage something or lose its tax benefit entirely. This practice, a much decried abuse of our tax laws, is commonly referred to as "trafficking in losses" and is discussed further below. Obviously, however, if a taxpayer is permitted to get a refund by carrying his losses backward for a greater number of years, he will do so rather than "sell" his losses at a discount to a stranger. In this way the taxpayer who suffered the loss gets the benefit—not a profitable taxpayer who seeks to shelter his otherwise taxable income at the expense of his less fortunate fellow taxpayer.

One aspect of the so-called revenue cost of the proposal deserves emphasis because it does not appear to have been clearly understood heretofore. Unlike tax rate reductions, investment credit liberalization and depreciation reform, all of which result in a permanent revenue loss, the instant proposal causes only a temporary revenue "loss." It simply shifts the timing of the loss deduction. In other words, the longer carryback, resulting in a present reduction of tax revenues, produces an increase in revenues next year (and thereafter) because no loss carryforward is available to reduce the taxable income of future years. It is quite probable that the permanent revenue effect of shifting the carryforward years to carryback years will be a neutral one. Indeed, by foreclosing the trafficking in loss carryforwards (discussed below), the proposal could have a positive effect on the ultimate revenues.

Finally, in considering the revenue impact of the proposal, the so-called ripple effect should not be disregarded. The refunds obtained will be plowed back into the economy, this will result in more jobs and more business, more jobs and business mean more income, and more income means a greater amount of tax collected by the Federal Government.

A good example of the ripple effect flowing from an extension of loss carrybacks is the so-called American Motors amendment. In 1967 the net operating loss provisions of the Internal Revenue Code were amended specifically to benefit only one taxpayer—American Motors Corp. Because American Motors had suffered extraordinarily large losses and because it was felt that this relatively small American auto manufacturer might go out of business—thus lessening competition in an industry dominated by three giants—Congress voted to extend AMC's loss carryback period 2 extra years, without however, reducing its 5-year carryforward period. As everyone well knows, AMC did not go out of business, but on the contrary, with the refund obtained by reason of the extended loss carryback to help it AMC became quite viable and consequently has contributed much to the Federal revenues.

Retroactivity

Closely tied in with the revenue ramifications of the proposal is the contention that because it would be retroactive it would be improper to extend the carryback period for losses arising in years prior to 1975. It is respectfully submitted that this objection actually is not founded so much on principle as it is on the added revenue cost of including earlier years in any liberalized loss carryback treatment. Most timely and pertinent evidence of this is the fact that the Ways and Means Committee itself in the very same tax reform bill in which it deferred action on retroactive loss carrybacks (the instant bill under discussion) adopted a retroactive provision with respect to loss carry forwards.

Moreover, the degree of retroactivity found acceptable by the committee is precisely that which is being advocated in this statement—losses for 1970 and subsequent years. The Ways and Means Committee's provision, section 1404 of H.R. 10612, would permit regulated investment companies (mutual funds) to carry their 1970 net capital

losses forward for 8 years rather than for the five years permitted under existing law. The fact that carryforwards rather than carrybacks are involved makes no difference as far as the principle of retroactivity is concerned. To repeat, this amendment accepted by the Ways and Means Committee demonstrates in a very dramatic way that the concept of retroactivity in and of itself should present no obstacle to a retroactive expansion of the loss carryback period. The real issue is the substantive merit of the proposal under consideration. Significantly, among the considerations which appeared to influence the Ways and Means Committee to extend such retroactive relief with respect to mutual fund net capital losses was the fact that "Regulated investment companies are a way for relatively small investors to invest in common stocks and other securities." (Emphasis added) H.R. Rept. No. 94-19, 94th Cong., 1st sess., p. 342.

Many small businesses must be provided longer carrybacks of 1970 and later losses if they are to derive any benefit from proposal

It is most important that the committee understand clearly why any liberalization of net operating loss carrybacks for small business must extend at least back to the year 1970. Many small businesses, typical of which are shoe manufacturers and textile companies, must be able to carry their 1970 and later losses back for the proposed extended 8-year carryback if they are to get any benefit from such an amendment. This is due to a number of external and largely governmental factors which occurred in the late sixties and early seventies over which these loss taxpayers had absolutely no control.

The drastic effects on the economy of trade, fiscal, and monetary policies which began in the 1966-67 period had their principal impact beginning in 1970, the first of the modern deep recession or depression periods. Budget expenditures far exceeding revenues because of the Vietnam conflict, tight monetary policies, suspension, reinstitution, repeal and readoption of the investment credit, and other measures all trace back to that period. The economy followed a roller coaster course thereafter. Losses in the late 1960's could be offset against profits within the normal 3-year carryback period, but as the peaks and valleys became more severe in 1970 and thereafter, the normal averaging period became useless for many industries. While these factors affected all businesses, large and small, their impact was far more severe (often fatal) in the case of smaller businesses.

Similarly, beginning in the 1970-71 period, large increases in imported oil at low prices upset our balance of payments drastically, undercut the dollar (then on fixed exchange rates), and thereby further increased imports. Further, the price of oil began to rise relentlessly in 1972 and 1973, with severe adverse impacts on energy users. These developments, together with the roller coaster pattern of the economy, attributable to fiscal and monetary policies already outlined, led to the major "recession" in 1974.

Moreover, as far as the shoe, textile, granite, and other import-competing industries are concerned (a great number of whom are typically small business concerns) the Kennedy round of tariff reductions, which began to take effect in 1968, together with a rigid mone-

tary policy, had a devastating effect. Some of these companies experienced losses for the first time in their long histories after the Kennedy round of tariff reductions. It certainly seems appropriate that the effects of these governmentally imposed policies be ameliorated by permitting the losses generated thereby to offset prior taxable income. If this is not done, these operating losses will be wasted and these companies will be taxed on a return of capital—or, as noted above, will be forced to try to sell their loss carryforwards to unrelated profitable taxpayers who will use such carryforwards to shelter otherwise taxable income.

Only by permitting the extended carryback election for 1970 and subsequent years, can the Congress do equity among all the many small industries that suffered huge losses as a result of various combinations of these factors. While many larger businesses are on a strong recovery course, smaller businesses continue to lag behind. It has simply been more difficult for them to obtain needed capital. That is why it is so appropriate to provide them with the unique source of capital represented by the refunds of taxes paid in better days which an extension of the loss carryback period would produce.

Trafficking in loss carryforwards

As an integral part of a liberalization of loss carryback treatment for small business, your committee could most appropriately enact a major tax reform, which would apply to large and small businesses alike, by eliminating the ability under present law of a taxpayer to sell unused or unusable loss carryforwards to an unrelated taxpayer. As mentioned above, present law permits profitable corporations to purchase losing firms for the purpose of acquiring their net operating loss carryforwards. Thus, for a nominal price, a profitable corporation can shelter millions of dollars of taxable income. Based solely on ads appearing in the Wall Street Journal in 1974, it is estimated that this much decried loophole is responsible for at least $125 million of revenue loss every year and additionally, particularly where smaller and medium size businesses are concerned, is a major factor toward the merger of smaller companies into larger ones, resulting in an undesirable concentration of corporate power.

This particular abuse of existing restrictions on the transfer of net operating losses from one taxpayer to another has become so widespread and open that it is a common phenomenon in the daily trade journals of the country. The following ad appeared in the Wall Street Journal on May 20, 1974:

The foregoing ad is typical of new advertisements for millions of dollars in net operating loss carryforwards which appear almost daily in the Wall Street Journal. During 1974, 224 such Wall Street Journal ads appeared offering for sale and purchase net operating loss carryforwards. Many of the ads contained no mention of the dollar amount of the losses involved. Utilizing only those ads which set forth dollar amounts, the total for 1974 comes to above a quarter of a billion dollars. In addition, it seems conservative to assume that many of these sales of tax losses are carried out without resort to newspaper advertising.

Therefore, it would appear that the $125 million revenue figure is conservative.

This trafficking in loss carryforwards is a strong example of a tax shelter which abuses fundamental concepts on which our Federal tax system is based. If one taxpayer who had medical expenses which he could not deduct were to transfer those deductions, for a price, to another taxpayer who could take advantage of them on his income tax return, it would be a shocking thing. In principle, trafficking in net operating losses is no different.

Accordingly, it would be most appropriate, it is submitted, for a tax amendment designed to aid smaller businesses by giving them more flexibility in the carryback area to close this abuse in the carryforward area, which would not only tend to discourage the merger of smaller businesses into larger ones but would also partially help to make up, on a permanent basis, the temporary revenue loss which would result from an extension of the loss carryback period for smaller business.

General policy considerations supporting an extension of the loss carryback period

When the subject of net operating loss carrybacks was being considered by the Ways and Means Committee, a panel of nine of the country's leading economists, who were appearing before the committee at its invitation, unanimously agreed that an extension of the period for the carryback of net operating losses was the most efficient idea in the entire tax reform package for stimulating the economy. As stated by one of this panel of eminent economists, Robert Nathan, when he was asked whether he would recommend an extension of the loss carryback provision:

> Yes, I would. I think this kind of a measure has a very direct identification with the specific parts of the industry. When you take an industry which has had the worst kind of results—and, sure, some of it might be due to bad management, lack of adaptation to technology and so forth—but, by and large, when you give that kind of so-called relief associated with the greatest need, I think that you have the best chance of getting a bigger bank for the buck. I would certainly recommend a longer averaging and you might even take a longer period and average in each direction. Hearings before Committee on Ways and Means, House of Representatives, 94th Cong., 1st sess., on President's Authority To Adjust Imports of Petroleum; Public Debt Ceiling Increase; and Emergency Tax Proposals, Jan. 22–30, 1975, pp. 650–660.

The sound tax policy ramifications of a longer carryback period were very effectively stated by a member of the Ways and Means Committee in the following extract from that committee's report on the Tax Reduction Act of 1975:

> I offered an amendment in Committee which would have granted businesses an option to carry losses backward for whatever period of years they were willing to surrender the opportunity to carry losses forward. A panel of economists testifying on the problems of the hard-hit industries unanimously attested to the stimulative benefit that this carryback modification would bring to the economy. The amendment would have enabled those businesses most crippled by the recession to receive a prompt infusion of cash in the form of a refund drawn against taxes in profitable years. Pressures on credit would have been reduced and capital availability enhanced by the adoption of this amendment. These

companies would have been able to preserve existing jobs and to provide new opportunities for employment. Simply stated, this optional extension of the loss carryback provision would have brought corporate tax benefit to the point of greatest need. Furthermore, the unique combination of inflationary and recessionary forces with which our economy is now beleaguered cries out for this medication. This is a prescription for recession that would not have been inflationary, because in opting to carry losses backward, companies would have foregone the opportunity to soften future profits by carrying losses forward. In other words, they would have paid greater taxes on future profits, thereby relieving the Federal deficit and dampening inflationing pressures.

I regret that I was unable to convince the Committee to include this provision in the bill. Defeated on a tie vote of 18 to 18, the proposal received the support of 12 Democrats and 6 Republicans. I continue to believe that this emergency tax bill would have been significantly strengthened and its goal better served by the incorporation of this loss carryback provision.—Mr. Vander Jagt, H.R. Rept. No. 94–19, 94th Cong., 1st Sess., pp. 98, 99.

Your views, as chairman of the Senate conferees when the 1975 Tax Reduction Act was being considered by the Senate after conference (during which the extension of the loss carryback period had been deleted as being too narrow in scope) were essentially the same as those expressed in the foregoing extract from the Ways and Means Committee Report:

I am hopeful, Mr. President, that the House will consider in due course and recommend to the Senate a tax reform measure something that will be broader than this and which will help to protect our major employers from going out of business after they have contributed large amounts of taxes to their Government over a period of time. Tax averaging seems to this Senator to be one appropriate way of doing it—Cong. Rec., March 25, 1975, p. S5245.

Small business policy considerations supporting an extension of the loss carryback period

The foregoing policy considerations apply to all business—small and large. Indeed, it is submitted that these policy considerations apply with even greater force and present an even stronger equitable case where smaller businesses are concerned. The capital needs of small businesses, particularly during periods of economic downturn, inherently present more critical problems than in the case of big business. Small business simply does not have the capital reserves, credit standing, and general economic staying power that big business has to weather a financial crisis. By the same token, even if a smaller business survives a crisis, its recovery rate is generally much slower than that of its larger competitors because its sources of capital for rebuilding are much more limited than are those of its large competitors.

That a longer loss carryback period for small business than for big business is justifiable as a matter of tax policy is well stated by Senator Nelson, chairman of the Senate Select Committee on Small Business, in testimony on tax reform before the Ways and Means Committee last July. Senator Nelson stated:

In my view, practical distinctions should be established in economic policy and tax policy between the few thousand corporations which have achieved access to the bond markets, stock markets, and other large-scale aggregations of capital; and the millions of corporations and unincorporated firms which have not.

Otherwise, in spite of protestations of neutrality and equal treatment, the tax code will create discrimination and competitive disadvantage against new, small

and independent businesses.—Hearings before the House Ways and Means Committee on the Subject of Tax Reform, 94th Cong., 1st Sess., July 25, 1975, p. 2952.

Senator Nelson then went on to point out that:

The present tax law has also given us the largest wave of mergers in American history, which reached a peak of about 6,128 combinations in 1969. I submit that as legislators, we know very little about whether this has been a good thing for the economy and for the companies involved. Ibid.

Among the negative ramifications of mergers highlighted by Senator Nelson were the following:

1. Employment of merged companies grows more slowly than their local economy, and often suffers reductions;
2. Merged companies reduce their business not only with local lawyers, accountants and bankers, but also with local suppliers of materials and other services;
3. Merged companies contribute significantly less to the support of local charities—up to one-third less in the case of conglomerates.

In view of the foregoing, Senator Nelson concluded:

At the minimum, I feel the burden of proof should be on those who wish to perpetuate the demonstrated bias in the 1954 Code in favor of bigness. More than this, I urge the Committee, in responding to this Administration's initiative on capital formation, to consider carefully how capital can be formed in new, small, and independent firms in ways that reward risk, effort, innovation and efficiency, rather than merely concentrating tax benefits in large existing firms with no assurance that the economy will reap any corresponding gains in these areas. Ibid.

Also very pertinent to the instant proposal to extend the carryback period for small business are the following statements of Senator Bentsen, chairman of the Senate Financial Markets Subcommittee, included in the Congressional Record for November 11, 1975, at page S–19618, when he introduced S. 2646, entitled "Small Business Tax Reform Act":

Mr. President, I am today introducing legislation to make several changes in our tax laws which will be of particular significance to our Nation's smaller businessmen who play an indispensable role in promoting healthy competition in our economy and creating jobs for our growing work force. This legislation was formulated after comprehensive 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 business.

The bill would make the following changes in our tax laws to help provide a healthier economic climate for the growth of small business.

First, it would allow a new business to carry forward for 10 years any net operating losses incurred during the first 10 years of operation of that new business. These net operating losses would be deductible against profits. This will help new businesses grow and thus promote greater competition in our economy.

* * * * * * *

The legislation I am introducing today, in conjunction with an extension of the 1975 tax cuts for small business, would provide significant tax reform for the crucial small business sector of our economy.

Mr. President, it is not widely known that small businesses and individual entrepreneurs are the largest source of jobs in our economy.

* * * * * * *

The current recession has hit small businesses harder than larger firms.

* * * * * * *

It is important that Congress take constructive action to provide a favorable economic climate in which small business can prosper and grow. Enactment of this small business tax reform legislation would be one step in that direction.

One of the specific recommendations made by Senator Nelson and Senator Bentsen, the Senate Select Committee on Small Business and the Senate Financial Markets Subcommittee to aid small businesses in solving their capital formation problems was to extend the period for carrying forward net operating losses from 5 years to 10 years during the first 10 years of operation of a new business. Since new enterprises are generally more dependent on internally generated capital for growth and 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 carryforward period now permitted. Thus, although well-established companies can usually utilize net operating loss deductions on the combined carryback and carryforward basis of present law, newer enterprises often cannot and the foregoing Senate proposal is aimed at eliminating this inherent inequity.

It can readily be seen that an extension of the period for carrying back net operating losses in the case of smaller businesses very effectively meets both of the foregoing objectives of the Senate Select Committee on Small Business and the Senate Financial Markets Subcommittee. First, one of the frequently used avenues for effecting the merger of smaller business into larger ones is through the buying up by larger companies of the net operating loss carryforwards of smaller companies. By permitting smaller companies to recoup their past taxes out of longer loss carrybacks, this stimulant to undesirable mergers would be automatically reduced. Moreover, the enactment of a more efficient provision prohibiting trafficking in loss carryforwards should completely foreclose this encouragement to corporate mergers.

Second, in the same manner that an extension of loss carryforwards provides a source of capital for a newly formed business to grow and expand after it has begun to generate profits, the extension of the period for carrying back net operating losses will help existing small businesses to remain in business by obtaining an infusion of much needed capital out of previously paid taxes when times were better. It seems correct to observe that an extension of loss carrybacks is an even more meritorious small business approach than an extension of loss carryforwards because it enables hard-pressed businesses to continue to operate, thus preserving existing jobs, preventing a disruption of local economies, and keeping workers off the unemployment compensation rolls—certainly an even more desirable and efficient economic state of affairs than creating new jobs. Of course, to the extent the refunds generated from longer loss carrybacks permit businesses to turn the corner and expand their operations, new jobs will also be created. Again, the case of American Motors provides an excellent example of the critically important role that a longer loss carryback can play in helping to put a company back on its financial feet.

Conclusion and recommendations

In view of the foregoing, we believe that a proposal which would result in modest refunds—when compared to those which would restrict relief to small and medium size businesses—those which have been hardest hit by the liquidity crunch—should be found acceptable

by both the Senate and the House. Many distinctions have been drawn in the Internal Revenue Code based on small business considerations and we respectfully submit that this loss carryback proposal presents a most appropriate situation for doing so again.

Accordingly, we respectfully recommend that your committee amend the net operating loss provisions of the Internal Revenue Code so as to:

1. Permit the period for carrying back net operating losses to be extended by the number of carryforward years surrendered.
2. Be effective with respect to the period 1970 through 1975.
3. Limit the maximum amount of the aggregate refunds attributable to loss carrybacks from those six years to $5 million.
4. Prohibit the trafficking in loss carryforwards.

Respectfully,

MICHAEL WARIS, Jr.

WILLIAMS & JENSEN,
Washington, D.C., April 22, 1976.

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

DEAR MR. CHAIRMAN: As indicated in your February 5, 1976, press release, the Committee on Finance is considering the House-passed tax revision proposals, H.R. 10612.

We respectfully request that the committee adopt an amendment to the House bill which would provide an option to the present net operating loss carryover-carryback provisions. This option would allow the taxpayer to elect, in lieu of the present general rule providing a 3-year carryback-5-year carryover, a 10-year carryover period with no carryback. This proposal would be prospective in its application. It is impotant to note that numerous exceptions to the general rule already exist in the tax law, with no exception dealing with less than an 11-year averaging cycle, the longest being 16 years.

I am enclosing a brief memorandum explaining this proposal in more detail.

Sincerely yours,

DONALD C. EVANS, Jr.

Enclosure.

NET OPERATING LOSS (NOL) CARRYOVER PROPOSAL

Present law provides a general moving 9-year period to average income (5-year carryover—3-year carryback). We propose, as an additional option, an elective 10-year carryover period with no carryback. In considering a proposed change to the general rule, it is important to note the numerous exceptions for certain industries or taxpayers (chart 1) to the general 9-year averaging period. Presently, no ex-

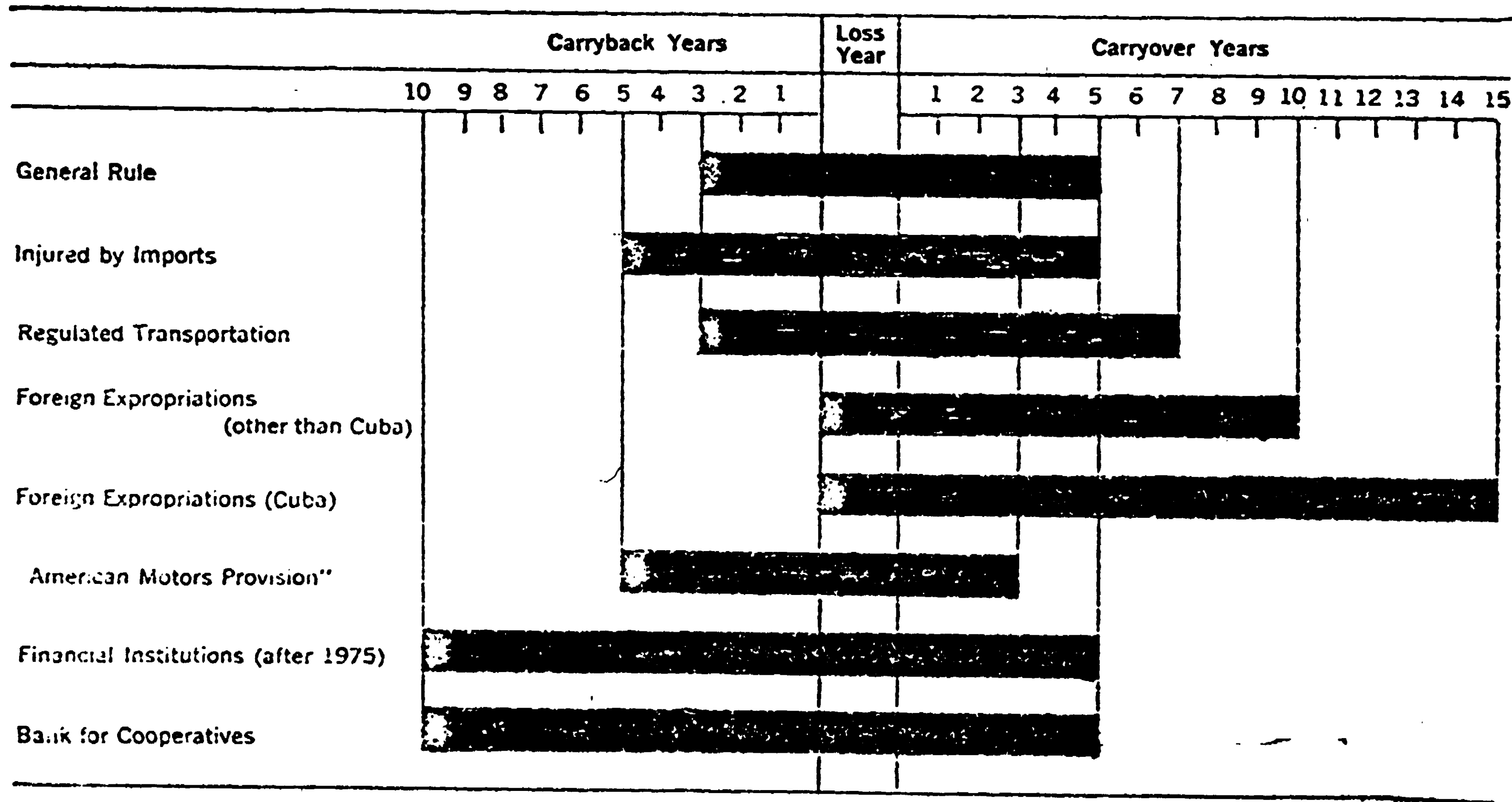
ception deals with less than an 11-year averaging cycle, the longest being 16 years.

Adverse economic conditions have caused many taxpayers subject to the general rule to incur NOLs that exceed total income for the carryback years and also the income anticipated for the 5 carryover years. These taxpayers, unlike others more successful in resisting the economic downturn over the last 6 years, are disadvantaged by being unable to apply losses to income earned during the 9-year cycle. In fact, in order to carryover these losses at all, financial accounting rules require a showing beyond a reasonable doubt that the losses can be used before the limited carryover period expires. Obviously, the larger the loss and the shorter the carryover period, the more difficult this becomes, with a resultant adverse impact on after-tax earnings and borrowing power. The present general rule also deprives a new business of the benefit of 3 years of the averaging cycle since it cannot carry its losses back. Related problems are faced by businesses expanding or promoting new lines and products. There too, the losses generated may greatly exceed prior income. Firms which have sustained losses over a protracted period thus preventing even the use of an expanded carryback provision do not have any real economic income, but because of the present limited carryover provision they may have to pay tax. They are struggling to stay in business, thereby continuing to employ workers at a time when unemployment is unusually high. Additionally, these firms find it difficult, if not impossible, to obtain new financing, if their losses are not allowed by reason of the operation of the accounting rules, or actually expire, because of the present limited carryover period.

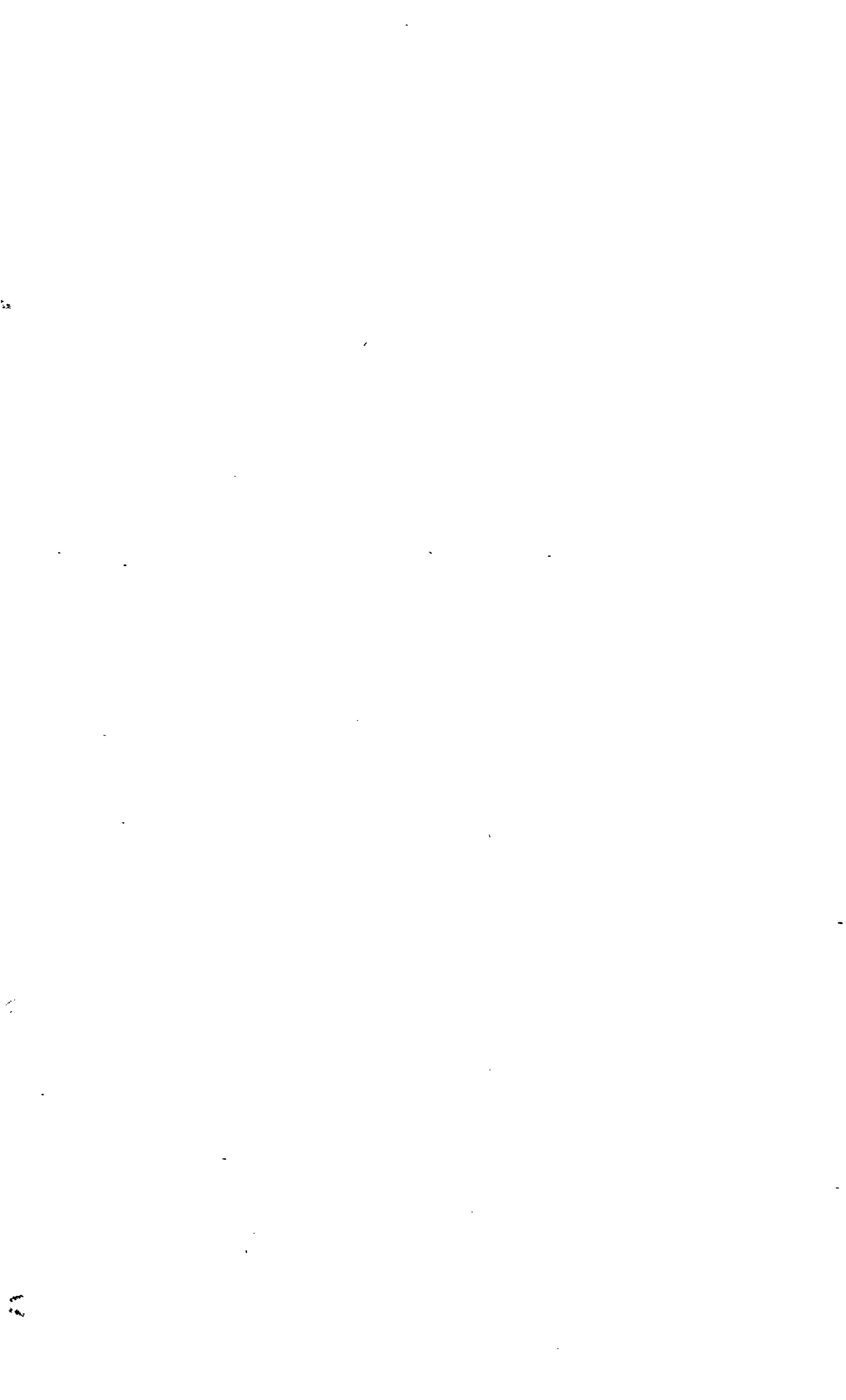
We propose that, since the basic purpose of a carryover-carryback is to average true economic income for equitable taxation, a company be allowed to elect for a particular year, in lieu of the general carryover-carryback period, a 10-year carryover period. This would extend the general 9-year averaging period to 11 years. (As explained above, present law has averaging periods running as high as 16 years.) If the 10-year carryforward period were allowed, no carryback would be allowed. This election would be made for each year and would be binding upon the company.

This proposal helps those firms which have sustained long periods of losses but have managed to stay in business, it helps new businesses, businesses that are materially expanding, and provides an additional stimulus to business investment. A provision under which relief is granted primarily when the business is brought back to a profitable basis, provides a greater incentive to management and investors alike than a provision which allows the losses of the present to be financed by the refund of taxes paid in the past. This proposal also helps competition by allowing viable businesses to stay in existence, and it allows such businesses to obtain or renew borrowings.

CHART 1.—NET OPERATING LOSS CARRYBACK AND CARRYOVER PERIODS FOR DIFFERENT CATEGORIES OF TAXPAYERS



Unrelated Business Income Tax



Statement of the Order of Cistercians of the Strict Observance (The Trappists)

TOPICAL SUMMARY

1. Subject matter

Addition of a modification to section 512 so that, in the computation of the unrelated business income tax, tax exempt organizations will be able to take a reasonable deduction for the value of labor contributed by unpaid volunteers in the conduct of the unrelated trade or business.

2. Position of the Trappists

Such a modification should be added to section 512. Without such a modification, the fundamental purpose of the tax on unrelated business income will be thwarted.

The Order of Cistercians of the Strict Observance, commonly known as the Trappists, operates 17 monasteries in the United States.[1] In addition to the usual religious vows of poverty, chastity and obedience, the Trappists have a rule of "self-support by manual labor." As a result, the Trappists have long engaged in a variety of businesses—since 1098 in Europe and since 1848 in the United States. The businesses are primarily agricultural, but include some processing and manufacturing. The monks themselves do most of the work. The net income from these businesses is the basic support of the monastic communities.

During the last few years the Trappists have conducted a careful study of their business operations to determine whether any of them will be subject to the tax on unrelated business income for tax years beginning after December 31, 1975.[2] On February 6, 1976 the Trappists formally requested rulings from the Internal Revenue Service on two basic questions:

(1) The substantial relatedness of their businesses; and

(2) The applicability of the section 513(a)(1) exception ("substantially all the work * * * without compensation").

During the preparation of these requests for rulings, it became evident that a third question would become extremely important if the Internal Revenue Service ruled adversely on both the "substantial relatedness" and "substantially all the work without compensation" requests.

The third question is concerned with the computation of taxable income. The Tax Reform Act of 1969 clearly intended to put the unrelated business income of exempt organizations in the same taxable status as the business income of commercial, taxpaying organizations.

---

[1] There are 13 monasteries of men and 4 of women. Each monastery is separately incorporated under civil law. The monasteries are located in Arizona, California, Colorado, Georgia, Iowa, Kentucky, Massachusetts, Mississippi, Missouri, New York, Oregon, South Carolina, Utah, and Virginia.

[2] Cf. sec. 512(b)(16) of the Internal Revenue Code.

Accordingly, exempt organizations get the same deductions as commercial businesses. This parity of deductions, however, does not guarantee parity of taxable status for the Trappists and similar monastic organizations. Unlike commercial businesses, which regularly pay wages and salaries to all their employees, the Trappist monasteries always have made substantial use of unpaid workers (the monks and sisters). If a deduction is not allowed for the value of this labor, the Trappists will have to pay far more in taxes on their unrelated business income than a commercial business of comparable size.

Suppose, for example, that a monastery conducts an unrelated trade or business with 35 monks and 15 hired employees. The wages of the 15 hired employees are clearly deductible. But if that is the only deduction for labor that the monastery is entitled to, the monastery will have to pay far more in taxes than a comparable commercial business with 50 employees. Unless the monastery is allowed a reasonable deduction for the value of the work performed by the monks, the unrelated business income tax will not result in parity of taxation.

The monasteries cannot solve this problem simply by paying the monks wages and salaries. First of all, such a practice would be inconsistent with the traditional monastic understanding of the vow of poverty and of the relationship between the monastic community and the individual monks. Secondly, the Internal Revenue Service would almost certainly regard such payments of wages to monks as a "sham," because the monks would immediately return the wages to the monastery. Their vow of poverty prevents the monks from retaining ownership or control over money.

At the present time there is no firm statutory basis in the Internal Revenue Code for an unrelated business income deduction by an exempt organization of the value of labor contributed by unpaid workers in the conduct of an unrelated trade or business. Indeed, such a deduction by a monastic corporation would not seem permissible under existing law. No wages are actually paid to the monks. Moreover, in a somewhat analogous area, it is well settled that an individual taxpayer cannot take a "charitable contribution" deduction for the value of services he contributes to an exempt organization.

Accordingly, the Trappists request the members of the Senate Finance Committee to propose a modification of section 512 of the Internal Revenue Code that will eliminate the disparity of tax treatment outlined in this memorandum. The Trappists do not seek any modification of the section 170 rules with regard to charitable contributions. They seek only a modification of the section 512 rules with respect to the computation of unrelated business income.

Such a modification of section 512 obviously involves many complex and technical questions of detail. Accordingly, the Trappists do not themselves propose any specific language at this time. They would, of course, be happy to cooperate through their counsel, Prof. Charles M. Whelan, S.J., of Fordham Law School, with the staff of the Senate Finance Committee and with the staff of the Joint Committee on Internal Revenue Taxation in drafting appropriate language for the modification of section 512.

In order to help the members of the Senate Finance Committee better understand the religious lifestyle of the Trappists and the implications of their religious rule of "self-support by manual labor," an appendix has been attached to this memorandum. The appendix con-

tains part I of the ruling requests submitted by the Trappists to the Internal Revenue Service on February 6, 1976. If the Senate Finance Committee desires any further information in this area, the Trappists will gladly supply it.

Appendix to the Statement

PART I. LIFESTYLE AND RULES OF THE ORDER OF CISTERCIANS OF THE STRICT OBSERVANCE

The Cistercians form one monastic order with two branches, one of men (the Trappists) and one of women (the Trappistines). The Abbot General, who resides in Rome, is the head of both branches of the order. Founded in France in 1098, the order has enjoyed an uninterrupted existence and maintains houses throughout the world. In the United States the first group of monks was established in Kentucky in 1848, and the first group of nuns was established in Massachusetts in 1949. At present in the United States, there are 13 monasteries of monks and 4 of nuns, established in 14 separate States jurisdictions (Arizona, California, Colorado, Georgia, Iowa, Kentucky, Massachusetts, Mississippi, Missouri, New York, Oregon, South Carolina, Utah, and Virginia).

The Order of Cistercians cf the Strict Observance is an approved monastic order of the Roman Catholic Church and is listed annually in the Annuario Pontificio, an official catalog of Roman Catholic institutions published by the Holy See. The order is also listed in the Official Catholic Directory (the monasteries of men on page 1013 of the 1975 edition, the monasteries of women on page 1038 of the same edition). In addition, each monastery is listed separately in the Official Catholic Directory within the diocese or archdiocese in which the monastery is located.

The following table provides some statistical information on each of the monasteries. The data is based on averages for 1971–73. Where there has been a material change in more recent years, the change is indicated in footnotes.

			Total regularly engaged in the business activities of the monastery	
Name and location	Date of foundation of monastery	Total monks or nuns in community	Monks or nuns	Hired employees (full and part time)
Gethsemani Abbey, Trappist, Ky	1848	100	43	7
New Melleray Abbey, Dubuque, Iowa	1849	66	38	4
St. Joseph's Abbey, Spencer, Mass	1868	89	37	1
Holy Spirit Abbey, Conyers, Ga	1944	58	30	2
Holy Trinity Abbey, Hunstville, Utah	1947	34	29	1
Guadalupe Abbey, Lafayette, Oreg	1947	42	31	[1] 18
Mepkin Abbey, Moncks Corner, S.C	1949	26	23	[2] 5
Holy Cross Abbey, Berryville, Va	1950	25	16	[3] 0
Genesee Abbey, Piffard, N.Y	1951	30	26	4
Assumption Abbey, Ava, Mo	1950	19	15	7
New Clairvaux Abbey, Vina, Calif	1955	27	25	[4] 4
St. Benedict's Monastery, Snowmass, Colo	1956	16	9	2
Brooksville Monastery, Brooksville, Miss	1968	3	3	0
Mount St. Mary's Abbey, Wrentham, Mass	1949	48	34	1
Redwoods Abbey, Whitehorn, Calif	1962	9	9	0
Our Lady of Mississippi Abbey, Dubuque, Iowa	1964	15	14	0
Santa Rita Abbey, Sonoita, Ariz	1972	7	4	0

[1] Reduced to 2 in 1975.
[2] Reduced to 3 in 1975.
[3] Added 2 (part time) in 1975.
[4] No hired employees since the end of 1974.

The Order of Cistercians of the Strict Observance follows the Rule of St. Benedict, which was written in the sixth century. Under this rule, the monastic life is divided into three complementary parts (worship, work, and private prayer or reading) which balance one another in such a way as to gather all the physical and mental activities of the monks and nuns into a harmonious spiritual unity. Each of these three parts is essential to the way of life of the order.

First, there is the Opus Dei, which is religious worship and liturgical praise according to the rites of the Roman Catholic Church.

Second, there is manual labor (4 to 6 hours a day) in the monastery fields or workshops.

Finally, some hours are devoted each day to spiritual reading and private prayer.

As part of the Opus Dei, Mass and the "canonical hours" (vigils, lauds, terce, sext, none, vespers, and compline) are celebrated each day in each monastery. The worship services are basically the same in the men's and women's branches of the order. Visitors and guests at the monasteries may attend all of the liturgical and religious services.

Each monastery follows a similar daily schedule, with minor variations according to local circumstances and the seasons of the year. A representative schedule is as follows:

3:15 a.m.—Rise.
3:30 a.m.—Vigils (common prayer service in the church).
4:30 a.m.—Breakfast; reading, individual prayer and meditation.
6:30 a.m.—Lauds (common prayer service in the church).
7:00 a.m.—Mass.
9:00 a.m.—Terce (common prayer service in the church).
9:15 a.m.—Manual labor.
11:45 a.m.—Sext (common prayer service in the church).
12:00 noon—Dinner.
1:45 a.m.—None (common prayer service in the church).
2:00 p.m.—Manual labor.
4:30 p.m.—Vespers (common prayer service in the church).
5:30 p.m.—Supper.
7:30 p.m.—Compline (common prayer service in the church).
8:00 p.m.—Retire.

Thus the monastic day is carefully arranged to provide time for each of the three components of the Cistercian way of life: worship, work, and private reading or prayer. Under the Rule of St. Benedict, the entire life of the monks and nuns is dedicated to the praise and worship of God. Each member of the monastery shares in the conduct of the worship services and the performance of manual labor according to his abilities and assigned functions.

The religious nature of the worship and prayer performed by the monks and nuns is obvious. The religious nature of the manual labor becomes readily apparent from an analysis of the functions that this labor performs in the Cistercian way of life. Clearly, as in the case of all self-supporting men and women, the labor has an economic function. For the Cistercians, this economic function is itself a religious ideal. The monastic ideal of "poverty" embraces a frugal and austere life, but not a dependency upon the contributions of outsiders. In the

history of Roman Catholic religious orders, some have chosen the ideal of dependency and they are known as the "mendicant orders." Others, however, including the Cistercians, have chosen to imitate the example of laborious self-support given by Jesus Christ, his Apostles and the early leaders of Benedictine monasticism. As St. Benedict says in chapter 48 of his rule: "They are truly monks when they must live by the labor of their hands, as did our Fathers and the Apostles."

Over and above the economic function, however, manual labor plays an indispensable psychological role in the spirituality of Cistercian monks and nuns. St. Benedict also prescribed that they should spend part of each day in manual labor and in spiritual reading because "idleness is the enemy of the soul" (chapter 48 of the rule). St. Benedict's reasoning is carefully explained in the following passage from the Cistercian Spiritual Directory for Religious (pp. 374–75):

> It was a current saying among the ancients that for one demon that tempts the man who works, there are a thousand urging the slothful to evil. Work powerfully conduces to a spiritual life. It subdues the body, moderates the passions, exercises obedience, humility, patience and all the virtues one aims at acquiring. The Rule consequently orders that "the religious should apply themselves to manual labor at stated times because idleness is the enemy of the soul," and because it leads to much evil.
>
> Furthermore the religious is a human being and labor forms a law of his existence. St. Benedict wishes us to observe poverty and yet he does not wish us to be mendicants. We shall correspond to his ideal of a monk if we gain our livelihood by manual labor and moreover be in a position to relieve the needy.
>
> Work is also necessary to ensure fidelity to the regular observances and to render them congenial. When we engage in manual labor we no longer feel the inconvenience of our hard couch, we partake with relish our plain fare, fasting becomes less difficult and we can dispense with the recreation common to other Orders.
>
> Were it not for manual labor, a monk's life would be tedious. He could not pray all day. In the sense in which our Order has understood manual labor, this exercise is very favorable to contemplation. It relaxes the mind and renews its vigor for prayer; or rather the silence which accompanies manual labor permits us to practice almost uninterrupted union with God.
>
> Manual labor is not less in harmony with our life of penance. It is the special penalty and remedy imposed on man after the Fall. Rendered more penitential in our case by fasting and watching, it forms the daily and universal expiation; it is one of the principal penances of the Cistercian. These are additional reasons for esteeming manual labor and becoming zealously attached to this exercise.

This passage from the Directory clearly explains the intrinsically religious nature of manual labor in the Cistercian tradition. For some men work is a curse; for others, a simple necessity; and for still others, a means of self-gratification. For the Cistercian, work is part of the Divine Law, a weapon against spiritual disorders, a penance willingly embraced and, above all, an imitation of Jesus Christ, his Apostles and the saintly founders of Benedictine monasticism.

Like self-support, self-sufficiency is an integral part of the Cistercian religious ideal. Thus, as far as possible, all the tasks incident to monastic life (cooking, cleaning, laundry, sewing, et cetera) are performed by the monks and nuns themselves. Ordinarily, a monk's or nun's life is lived entirely within the boundaries of the monastic property. The monastery provides for all the needs of its members from the time of their entrance until their death.

The first 5 years after joining the monastery are considered a period of formation and education within the community. The new monk is

helped to appreciate and adopt the values and lifestyle of the monastery by an intensive 2-year "novitiate" program of spiritual formation and education. The novitiate is usually followed by an additional 3 years of training in theology, philosophy, the humanities, and practical skills which will enable the new monk to contribute to the functioning of the community. During the period of formation and training, monks and nuns ordinarily perform manual work on a more limited basis than after their training is completed. Monks who become priests receive additional training beyond that provided for all the monks and nuns.

The Monastery also provides care within its own quarters for the sick, aged, and infirm. Trained members of the monastery provide all normal nursing needs. The aged and infirm are considered integral members until their death, and are assisted in continuing to enter into the monastic life to the extent that their age and infirmities permit.

The Cistercian Order does not operate schools or hospitals or administer parishes, but limits itself to living a life of worship, labor, and prayer separate and apart from the way of life of others. By deliberate choice, the monasteries are located in rural settings. To preserve the solitude of the monastery and to permit engagement in agricultural pursuits, reasonably extensive tracts of land are required.

From the very beginning, however, the monasteries have found it necessary to purchase commodities and services from the secular marketplace. Following the Cistercian ideal of self-support, the Order has sought to finance these necessary purchases by making the manual labor of the monks sufficiently productive, in an economic way, to provide the funds needed by the monastery for these purchases. In deliberate self-restraint, the monasteries seek to limit the size and extent of their productive business activities to the amount necessary to provide these funds. The monasteries do not try to use their means of production to the fullest capacity or to maximize the income from their business operations. Indeed, at many of the monasteries the constraints imposed by the monastic life against running the business activities in as efficient and profitable a manner as possible have resulted in the production of far less business income than needed to meet the monastery's ordinary religious expenses.

The monasteries have been careful to engage only in businesses that are compatible with the monastic way of life and in which the essential productive operations can be carried on within the grounds of the monastery. As a result of these policies and of the deliberately rural location of the monasteries, it has been traditional within the order for the monks and nuns to engage in agriculture, horticulture, forestry, and all types of animal husbandry.[8] The closeness to nature which this type of activity engenders is, in itself, an important part of the religious life of the monks and nuns.

The manufacture of food items, such as bread and cheese, has also been a centuries-old practice at Cistercian monasteries, since the volume can be controlled and the work schedule can be coordinated with the prayer and worship schedule of the monasteries. In a few instances, where the monasteries are located in situations unfavorable for agri-

[8] Sec. 99 of the Cistercian Constitutions specifies that agriculture and the raising of cattle are preferred occupations for the Cistercian Order.

culture and food production, th monks have engaged in manufacturing other items needed in the local market. Many of the monasteries engage, at least on a small scale, in the production of items necessary for religious worship and in making religious arts and crafts.

Perhaps the most distinctive feature of the Cistercian monastic businesses is the composition of their work force. It is essential to the religious lifestyle and integrity of a Cistercian monastery that the business be wholly under the control of the monks and that most of the employees be monks. Individuals, however, do not become monks or nuns in order to be employed at a Cistercian monastery. Instead of recruiting workers according to their skills for a preexisting business, the monasteries find their essential work force a "given" in the persons of the monks and nuns who belong to the monastic communities. This factor induces the monasteries to choose and shape their businesses according to the talents of their members. In a very real sense, the business must fit the work force rather than the other way around.

Most of the monasteries do hire a few outside employees. A small amount of such help is often necessary in order to make it possible for the monks and nuns to maintain the scheduled balance of liturgical worship, manual labor, and private prayer and reading. Lay employees, serving as truckdrivers and in other capacities that bring them into daily contact with the secular world, also help to safeguard the monks and nuns from the distractions from the spiritual life that such work involves. When an individual monastery has difficulty in maintaining its income-producing activity owing to the age or fewness of its members, it may temporarily have to hire more workmen than would ordinarily be the case.

Lay employees are compensated with wages and fringe benefits according to the value of their work. All the monks and nuns, however, owing to their vows of poverty, have forsworn any material recompense for their labors. The monks and nuns live what Roman Catholic law calls a common life, in which they share exactly the same food, clothing, lodging, and other features of monastic life without regard to their position of authority in the monastery and without regard to whether they are on the business work force or not. A Cistercian monk or nun owns absolutely nothing in this world and has no claim against the monastery in the event that the monk or nun should leave the community to rejoin the secular world.

The Cistercian Order has existed (sometimes flourishing, sometimes barely surviving) for almost 1,000 years. One of the most traditional manifestations of the religious and apostolic mission of the order is the foundation and care of new monasteries. Because of its austerity and seclusion, the Cistercian way of life is not likely to attract a large percentage of the human race. But in every century a significant number of men and women have felt called to find God in this mode of existence. The order has grown slowly and steadily throughout the world. The established monasteries consider it to be one of their prime functions to help fledgling monasteries achieve a secure foothold. Every Cistercian monastery can trace its parentage directly back to the original foundation at Citeaux in 1098.

Although cloistered and secluded from the secular world, the Cistercian monasteries are far from indifferent to the needs and catas-

trophes of mankind. Normally able to support themselves, they have a tradition of helping to support others, especially those who are poor and needy. In any given year, the Cistercian monasteries receive many requests for such help, and they normally give away more than they receive in contributions.

The apostolic mission of the Cistercian monasteries thus defines itself in two ways: First, in respect to the members of the monasteries, who seek God according to the Cistercian way of life; and second, with respect to the secular world, through the extraordinary spiritual witness that the monasteries give to the world and through the material help that the monasteries provide for the poor and needy. The monasteries are devoted, by prayer, witness, and generosity, to the promotion of the Christian religion throughout the world.

The apostolic mission of the Cistercian way of life also manifests itself, following the rule of St. Benedict, by providing a place for spiritual retreat for those who desire to spend some time away from the ordinary concerns of life and to devote themselves to a period of prayer and reflection. Although the Cistercian monasteries do not operate schools or colleges, they are centers of spiritual learning and experience not only for their own novices and members but for many of the laity and clergy, who come to the monasteries for a few days, a week, or longer.[4] Most monasteries have a "guesthouse" in which visitors may make retreats or other spiritual exercises. Such visitors, like the general public, are free to assist at the liturgical worship of the monastery. These visitors are guests of the monastery, and no charge is ever made for their food and lodging. The simplicity and austerity of the Cistercian way of life have always been matched by its hospitality and generosity.[5]

---

[4] An eminent psychologist has recently described his experience during a half-year visit at a Cistercian monastery: Nouwen, "Genesee Diary" (1976).

[5] For a more complete description of the Cistercian way of life, see Thomas Merton, "The Waters of Siloe" (1949) and "The Silent Life" (1957); Lowrie J. Daly, "Benedictine Monasticism" (1965); Peters (ed.), "Monks, Bishops, and Pagans" (1949; reissued 1975).

Manufacturers Excise Tax

PRIVATE TRUCK COUNCIL OF AMERICA, INC.,
Washington, D.C., April 20, 1976.

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

DEAR MR. CHAIRMAN: These comments are being filed on behalf of the Private Truck Council of America, Inc. (PTCA), the national organization representing interests of more than 1000 nontransportation companies which operate trucks in furtherance of their primary businesses.

The council appreciates the opportunity of submitting for the public record the following statement in support of the repeal of the 10-percent Federal excise tax on new trucks and truck trailers, and the 8-percent tax on truck parts and accessories.

PTCA believes that the long overdue repeal of these excise taxes is fully consistent with and supportive of efforts for achieving greater tax equity, stimulating the economy, bolstering employment, and reducing inflationary cost pressures on the consumer.

Last year such a proposal was approved by the committee and passed by the Senate as part of the Senate version of H.R. 2166. We are convinced that the merits of the case for repeal are even greater in 1976, for which reason we strongly urge that efforts be renewed to achieve its adoption by the entire Congress.

Under present law the only motor vehicles subject to the 10 percent manufacturers excise tax are those in excess of 10,000 pounds gvw. Passenger automobiles and light-duty trucks up to 10,000 pounds were exempted by Congress in 1971.

Prior to this automobile parts were exempted from the 8-percent parts tax. The vast majority of products originally subject to similar "temporary" Federal excises, imposed in wartime and largely to discourage consumption, have long since been exempted. Consequently, these remaining excise taxes would seem to discriminate against one class of products to the relative advantage of others, thus imposing an added burden which ultimately must be passed on to the consumer. Congress should act now to complete the job of ending this system of excise taxation in this area.

While these excises are currently devoted to the highway trust fund, they are really not, unlike other trust fund taxes, user-charge levies. They are based on factory sales of new products and not on the use of these products on our highways.

Furthermore, the vehicles now subject to this rather onerous tax represent less than 20-percent of total new truck sales annually. And yet, it is this relatively small segment of the total truck market that appears to be evidencing the most difficulty in recovering from the double impact of inflation and recession in recent years. As the facts

69-516—76—pt. 7——30

seem to indicate, the decline in retail sales of these taxed trucks has been far greater than the sales of decline of nontaxed trucks during the past 2 years.

This sales decline has naturally resulted in a similar decline in tax revenues from these excises. The Internal Revenue Service reports that the receipts from the 10-percent truck tax declined from $554 million in calendar 1974 to $394 million in calendar 1975, a 40-percent drop. And no doubt there were other peripheral revenue losses such as personal and corporate income taxes, not to speak of other Federal, State, and local revenue losses stemming from the same basic problem.

This decline in tax revenues would have been greater had there not been a sharp increase in the price of these commercial vehicles in recent years. In some cases, the increase has been as much as 50 percent over the cost of medium- and heavy-duty trucks just 5 years ago. This price increase has been due to a combination of sharply rising material and manufacturing costs due to inflation and to increased Federal requirements. These increases have been compounded by the 10-percent excise tax which each time the price of a vehicle increases collects more revenue. It is an unavoidable fact of the economic system that such increases must ultimately be borne by the consuming public. Therefore, we submit that the repeal of these excise taxes would act to measurably ease such inflationary burdens on consumers.

Attached for your further consideration is a copy of a resolution passed by the PTCA board of directors calling for the repeal of these taxes.

Sincerely,

JOHN C. WHITE.

Enclosure.

RESOLUTION TO REPEAL FEDERAL VEHICLE EXCISE TAXES ON TRUCKS, TRUCK TRAILERS, AND ACCESSORIAL ITEMS

Whereas the Private Truck Council of America, Inc., represents businesses and industries which operate their own private trucks as a necessary transportation function in the conduct of their nontransportation businesses, and

Whereas private trucks constitute approximately 85 percent of all trucks registered in America and are owned by a wide spectrum of businessmen ranging from farmers to bakers, bottlers, and tradesmen, and

Whereas a substantial percentage of these trucks are over 10,000 pounds gross vehicle weight and therefore are subject to the manufacturers' Federal vehicle taxes, and

Whereas the total Federal excise taxes on trucks, truck trailers, and accessorial items constitute an annual tax burden of $700 million which must be passed on to shippers, consumers, and users, and

Whereas these costs add to the final price of all consumer goods which must be transported by truck during part of their journey from the producer to the consumer, thereby fanning further the fires of inflation, and

Whereas the prices of trucks and truck trailers have increased substantially in recent years due to inflation, and Government mandated

standards to the point that truck sales have dropped drastically in recent months, thereby causing unemployment in communities where truck manufacturing plants are located, and

Whereas repeal of the said excise taxes would provide an incentive to businesses to purchase new trucks and truck trailers rather than assume increased maintenance costs by operating existing trucks beyond their normal life expectancy, therefore be it

Resolved, That the Private Truck Council of America, Inc., urges the Congress to take immediate steps to repeal Federal vehicle excise taxes on trucks, truck trailers, and accessorial items.

Statement of the Motor & Equipment Manufacturers Association

I. Interest of the Motor & Equipment Manufacturers Association

The Motor & Equipment Manufacturers Association ("MEMA") is composed of approximately 750 manufacturers of automotive and truck parts, equipment, chemicals, accessories, and tools. These manufacturers have plants located throughout the United States and produce virtually every piece of equipment used in, or in connection with, servicing all forms of motor vehicles, off-the-road vehicles, and industrial engines. Some members sell to the aftermarket only, some sell original equipment only, while most sell to both channels.

Aftermarket sales are the sales of replacement parts to warehouse distributors, wholesalers, national accounts and service sales divisions of vehicle manufacturers, fleet specialists, and engine rebuilders. It is the automotive aftermarket sales of truck parts and accessories that would be most affected by the excise tax repeal provision we urge this committee to adopt in connection with its present tax reform considerations.

Original equipment sales are not an immediate concern because, as this committee is aware, such sales to vehicle manufacturers are exempt from excise taxes, provided an exemption certificate is furnished if the part is to be used in the further manufacture of a taxable automotive or truck chassis or body. Further, as a result of the Excise Tax Reduction Act of 1965 (Public Law 89-44), the excise tax on automobile parts (including truck parts interchangeable with automobile parts) has been repealed. Our concern, therefore, is with the sole remaining category of automotive parts which remains subject to tax—those truck parts and accessories, sold in the aftermarket which have no passenger vehicle applications.[1]

II. Statements of Other Automotive Industry Groups

This committee received testimony on April 6, 1976, from several other automotive industry groups: the Motor Vehicle Manufacturers Association, the Truck Body & Equipment Association, and the Truck

---

[1] It should be noted that, prior to the Excise Tax Reduction Act of 1965, there was no distinction made in the taxation of automobile and truck parts. Both were lumped together in sec. 4061(b) by the code as "automobile and truck parts" and subjected to an 8-percent excise tax. That act repealed the tax on automobile parts but retained the tax on truck parts.

Trailer Manufacturers Association. Representatives of these groups stressed the fact that the general economic decline in this country has been perhaps most acutely felt in the automotive industry and that excise tax repeal would provide a strong stimulus for the recovery of this industry. Those representatives urged the repeal of the 10-percent excise tax on new trucks and trailers, as well as the 8-percent tax on replacement truck parts and accessories. MEMA fully supports and endorses the position taken by these industry groups, but in order not to be repetitive of previous testimony, limits its comments in this statement to the tax treatment of truck parts and accessories.

III. BRIEF STATEMENT OF POSITION

At present, section 4061(b)(1) of the Internal Revenue Code imposes an 8-percent excise tax on parts and accessories for trucks, buses, or similar over-the-road vehicles.[2] The excise tax is not imposed on any truck part or accessory which is suitable for use, and ordinarily is used, on or in connection with passenger vehicles. Briefly stated, and for the reasons set forth in more detail hereafter, we urge this committee to repeal this tax or, at the least, extend the exemption to include (and exclude from tax) parts and accessories which are suitable for use, and ordinarily are used, on or in connection with off-highway engines or vehicles. If this committee decides not to repeal the tax in its entirety but to extend the exemption, it could easily do so by amending § 4061(b)(2) to read as follows:

> No tax shall be imposed under this subsection upon any part or accessory which is suitable for use (and ordinarily is used) on or in connection with, or as a component part of, *any off-highway stationary engine, any chassis or body for an off-highway vehicle,* any chassis or body for a passenger automobile, any chassis or body for a trailer or semitrailer suitable for use in connection with a passenger automobile, or a house trailer. (Italic portions indicate the language necessary to effectuate the proposed amendment.)

IV. PRIOR EXCISE TAX REPEAL EFFORTS

Earlier this year, this committee added a provision to its version of H.R. 2166, the Tax Reduction Act of 1975, which would have repealed not only the parts and accessories excise tax, in toto, but also the excise tax on new trucks, buses, and trailers. The Senate voted its approval of this provision, but the provision was subsequently dropped by the conference committee. As stated in the report of the Senate Finance Committee, the repeal provision was adopted "both to provide a stimulus for the purchase of trucks and buses, and because of the additional employment this is expected to create."[3] Thus, the Senate Finance Committee was acutely aware of the serious economic problems in the automotive industry. As indicated by the recent testimony of the industry groups previously referred to, those problems have not diminished.

Under threat of a presidential veto, the act's revenue loss (after it passed the Senate) was minimized in part by eliminating the repeal of the truck tax and tax on parts and accessories.

---

[2] Until enactment of Public Law 92–178, the tax was scheduled to be phased out by Dec. 31, 1981. The law now provides that the rate for parts and accessories will drop to 5 percent on and after Oct. 1, 1977.

[3] S. Rept. 94–36, 94th Cong., 1st sess., Mar. 17, 1975, p. 68.

As a secondary factor for eliminating this repeal provision, the conference committee stated:

> While the conference committee is quite aware of the depressed conditions existing in the truck manufacturing and marketing industry, it felt that the repeal of these excise taxes should more properly be considered in conjunction with the Public Works Committee, at a later date when Congress considers the Federal Highway Act and the Highway Trust Fund of which these taxes are a part. (H. Rept. 94–120, 94th Cong., 1st Sess., March 26, 1975, p. 67.)

Despite the reasons given by the Conference Committee for not including in the Tax Reduction Act of 1975 a total repeal of the excise taxes on motor vehicles and related parts, the Ways and Means Committee saw fit to include in its Energy Conservation legislation, H.R. 6860 (which this committee has before it for consideration), several provisions for the repeal of certain manufacturers excise taxes which form a part of the Highway Trust Fund.

V. EFFECT ON HIGHWAY TRUST FUND

We strongly urge this committee to repeal the entire truck parts and accessories excise tax. A total repeal of the truck parts and accessories tax would reduce the annual revenues of the Highway Trust Fund by about $150 million.[4] The consumer savings from repeal of the tax, as explained in section VI hereof, would equal three to four times that amount. Repealing the tax on only those parts and accessories which are suitable for use, and ordinarily are used, on or in connection with off-highway engines and vehicles would impact even less heavily on those Highway Trust Fund revenues. Further, the committee should recognize that the revenue from the tax on parts that are interchangeable on off-highway engines and vehicles does not belong in the Highway Trust Fund in the first place.

The concept behind the creation of the Highway Trust Fund and consigning to that fund various excise taxes was the "user charge" concept; that is, the attempt to make certain that the chief users of a particular governmental service, in this case the interstate highway system, would pay their fair share of providing that service. While this is a valid principle of taxation, it can readily be seen, by definition, that off-highway vehicles and engines do not use the interstate highway system. We estimate that only one-fourth to one-third of the diesel engines built each year in the United States are used in trucks, with the remainder being used in off-highway vehicles or applications.

The off-highway applications include municipal water pumping stations, peakload electricity generation, emergency electricity generation in hospitals, generation of electricity used in airplanes, pumping oil in oil fields, military service equipment and small ships and landing craft, emergency water supply in case of fire in manufacturing plants and institutions, heavy duty material handling equipment, construction equipment, earth moving equipment, farm tractors, air compressors, marine engines and others. Nevertheless, the majority of the replacement parts for off-highway vehicles and applications are subject to the manufacturers excise tax because independent manufacturers

[4] At present, the excise tax rate is scheduled to drop to 5 percent by Oct. 1, 1977, with revenues reverting to the general treasury. The Federal-aid highway bills (H.R. 8235 and S. 2711) would extend these and all other excises devoted to the Highway Trust Fund, at their present rates, through Sept. 30, 1979.

are simply unable to substantiate to the satisfaction of the Internal Revenue Service that the primary use (the present standard for taxability) of specific replacement parts is in the off-highway category. In imposing the excise tax on truck parts and accessories, it was intended that the actual users help pay for the construction and maintenance of our highways. In actual practice, however, the tax burden falls mainly on the nonhighway users enumerated above.

VI. CONSUMER SAVINGS FROM THE PROPOSED AMENDMENT

In repealing excise taxes, the Congress has consistently expressed an abiding concern that the resulting economic benefits not flow primarily to business at the expense of the consumer, but that the consumer receive the ultimate benefit. In this regard, there is no question that the primary beneficiary of the repeal of the 8 percent excise tax on the trust parts with which we are concerned will be the consumer.

Most product manufacturers, and manufacturers of automotive products are no exception, utilize a three to five step distribution system for marketing their diverse products. The various distribution channels at each step, in computing prices to customers, mark up their total costs including taxes. The 8 percent excise tax on truck parts, since it is based on the manufacturer's selling price, is pyramided through each step of the multichannel distribution process. A multiplier effect is created for the excise tax and the ultimate consumer often ends us paying, as part of the final price, the equivalent of three to four times the original tax.

Thus, for example, the repeal of the automobile parts tax in 1965 cost the Treasury $224 million in revenue but, when multiplied through the automotive aftermarket distribution system, saved consumers of such automotive parts an estimated three quarters of a billion dollars. By the same principle, consumers of truck parts having off-highway uses will save upwards of three times the amount of revenue that will be lost to the Treasury by repeal of this tax. We submit that the benefits to the consumer are well worth the cost to the Government.

VII. CURRENT DIFFICULTIES IN MAKING EXCISE TAX DETERMINATIONS

At present, a part or accessory which is used on over-the-highway trucks as well as on off-highway vehicles or engines is subject to the excise tax unless the manufacturer can prove that the primary design and use of such part is off-highway. Further, the primary use test depends upon the use of a part by the customers of not just an individual manufacturer but of all manufacturers of that part or competitive parts. Thus, even if an individual manufacturer could accurately determine that the aftermarket use of a part it manufactures was entirely on off-highway vehicles, that manufacturer would still be liable for the tax unless it could show that the primary use of such part (or competitive parts), on an industrywide basis, was on off-highway vehicles.

The independent manufacturer, especially the small manufacturer which sells exclusively to the aftermarket, is placed at a competitive disadvantage with respect to making excise tax determinations. The

larger manufacturer which sells to the original equipment market as well as the aftermarket has a better understanding of how the parts it sells are used because it can extrapolate original equipment sales as a measure of its aftermarket sales and approximate its excise tax potential. A replacement parts manufacturer does not have the same ability to make reasonably accurate excise tax determinations and, upon a later audit and retroactive tax assessment, faces an almost impossible burden of proof.

We advocate total repeal of the parts tax. Failing that, we have recommended a new standard of taxation which would remove this extreme burden from parts manufacturers and make excise tax determinations more uniform and much easier to make. This is in large part due to the fact that the definitional standard of taxation ("suitable for use, and ordinarily is used") has been a part of the excise tax statute since 1965 in connection with the exemption for parts and accessories which are interchangeable with passenger vehicles. Several rulings of the Internal Revenue Service, particularly in recent years, have helped define that standard administratively to the point that all manufacturers, regardless of their market, are able to make excise tax determinations with a fair degree of certainty as far as passenger vehicle parts are concerned. Such is presently not the case for parts manufacturers servicing off-highway vehicles for the industrial engine market.

Extending to the manufacturers of interchangeable off-highway parts the same standard of exemption as is available to manufacturers of interchangeable automobile parts will assist greatly in ending existing inequalities among such manufacturers with respect to excise tax determinations and payments.

VIII. RELATIONSHIP OF EXCISE TAX REPEAL TO ENERGY CONSERVATION

In its report accompanying H.R. 6860 (which is under consideration by this committee), the Ways and Means Committee made the observation that:

> There are several excise taxes applied to energy-efficient products which have the effect of discouraging their use by increasing their price. Savings in energy can be achieved in these instances by removal of the tax.—H. Rept. 94-221 at 94-221 at 94th Cong., 1st sess., May 15, 1975, p. 15.

To effectuate its policy of energy-saving, the Ways and Means Committee repealed the 10 percent excise tax on intercity buses (to encourage this more efficient means of mass transportation) and also repealed the 10-cent-per-pound excise tax on radial tires (because such tires improve gas mileage by between 3 and 5 percent). However, replacement parts for those same buses remain taxable.

We suggest to this committee that gas mileage and total fuel efficiency are increased not only by the use of radial tires but also by the proper overall maintenance and repair of the entire vehicle—in particular, the internal combustion engine. In fact, the U.S. Environmental Protection Agency has estimated that a vehicle which is maladjusted or unmaintained (for example, spark plugs misfire, air filters are clogged, carburetor is improperly adjusted) can suffer a fuel economy penalty of 20 percent or more. Although the EPA was referring to automobiles, the same result holds true with any vehicle powered

by an internal combustion engine. An off-highway earthmoving machine or a farm vehicle will run poorly and inefficiently if it is not properly maintained and, because many of such vehicles have a higher consumption of gas per mile than automobiles, the energy loss consequences may be much more severe.

In spite of this, the effect of the current excise tax on certain truck parts and accessories is to increase the price of these items and postpone replacement and repair of engine parts that are essential to fuel-efficient performance. We suggest to this committee that, on an energy-conserving basis alone, the repeal provision we urge should be adopted. A tax on the proper maintenance of motor vehicles does not make any sense in light of today's energy problems and the entire truck parts tax is precisely such a tax.

IX. OTHER FACTORS JUSTIFYING THE REPEAL OF THE EXCISE TAXES IN QUESTION

A. An excise tax is a cost of doing business unrelated to normal competition, to productivity, or profitability of the manufacturer

One of the many negative features of the parts tax is that it constitutes an inflexible "front-end load" on the cost of doing business. Because it does not respond to market impulses as do other costs of doing business, it discourages capital investment in equipment designed to improve productivity and efficiency.

When the objective is economic growth, taxes should have a minimum effect in reducing the rate of capital formation. Indeed, the Tax Reduction Act of 1975 offered an incentive to capital formation in the form of an increased investment tax credit; we merely ask that a detrimental influence to capital investment, in the form of a discriminatory excise tax, be removed.

B. The parts tax impedes the development and use of better and safer parts

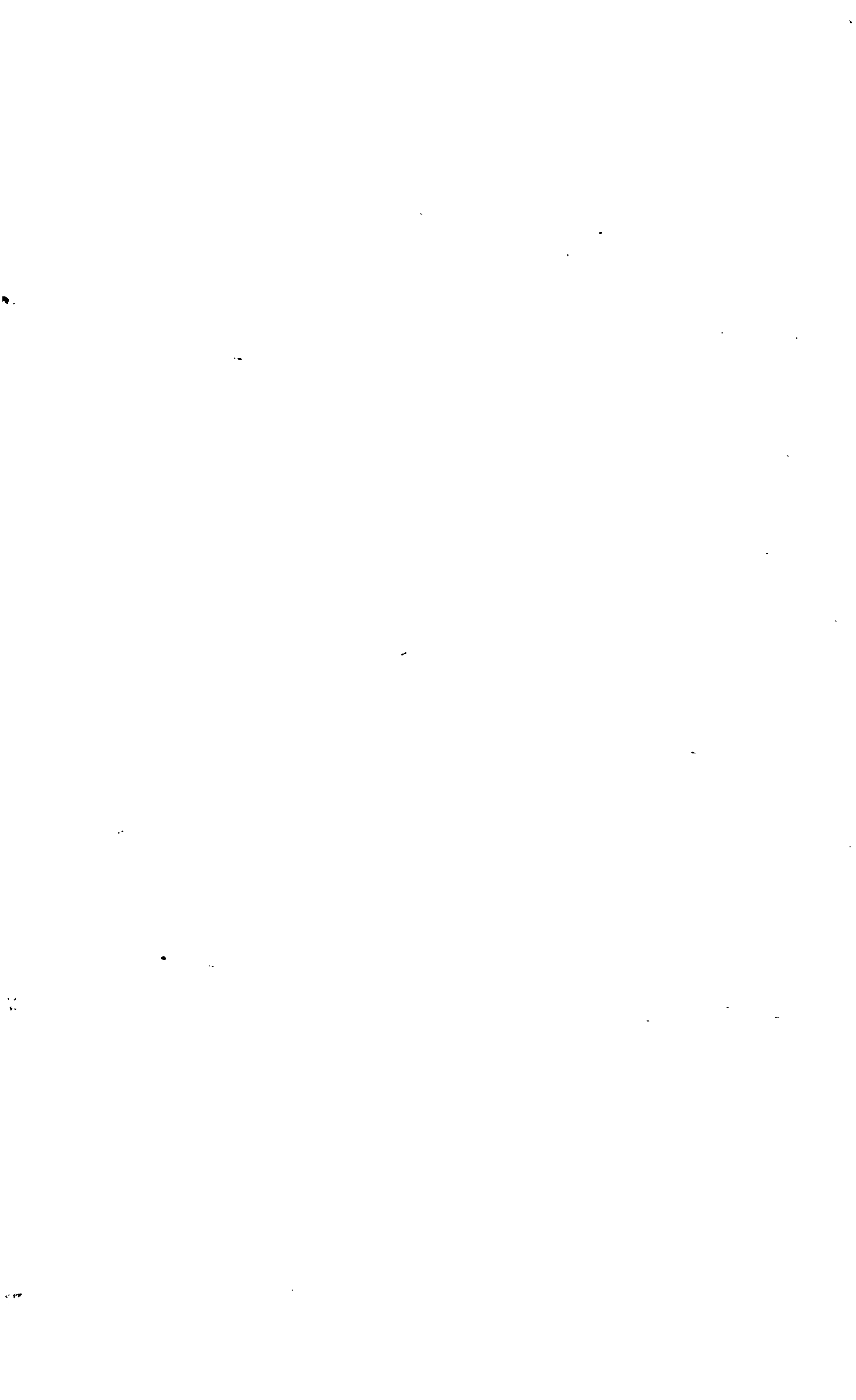
Another undesirable feature of the tax on truck parts is that it taxes articles which, in many respects, are necessary for the safe operation of the vehicles. It can be, quite literally, a tax on safety. The quality of parts and their timely replacement are factors which greatly affect the safety characteristics of any motor vehicles.

As individuals, and consumers, we are all aware of the importance of such articles as shoes and drums for brakes which must be replaced periodically to insure safety for the operator of the vehicle as well as others on the highway. And yet, most replacement parts for off-highway vehicles, including farm machinery, which are as vital to the safe condition of these vehicles as automobile replacements parts are to automobiles, have to carry the disincentive to their purchase of an 8 percent excise tax. The price of safety equipment to the consumer can be a determining factor when a consumer is considering the purchase of a safety device. If we are to encourage preventive maintenance, rather than remedial maintenance, and increase the safety as well as the fuel-efficiency of all vehicles, the price incentive of an excise tax cut on truck parts having off-highway uses will be of great assistance.

X. CONCLUSION

In conclusion, we submit that an amendment which would repeal the excise tax on truck parts and accessories—or, at the least, for those parts and accessories having off-highway uses—will have an obvious energy-conserving effect, will not adversely impact either the purpose or the revenues of the Highway Trust Fund, will promote the use of better and safer parts and will make excise tax determinations more uniform in the automotive industry. Equally as important is the fact that the savings from repeal of the tax will pass through, with a multiplier effect, to the ultimate consumer.

We urge this committee to give its serious consideration to the excise tax repeal recommendations set forth in this statement.



Consolidated Returns by Life Insurance Companies

Statement of American Mutual Insurance Alliance

In Opposition to Legislation Permitting Filing of Consolidated Returns by Life Insurance Companies

The American Mutual Insurance Alliance is opposed to the enactment of S. 2985 and H.R. 12126 (on which testimony was received from one witness on April 5, 1976), or any similar legislation to permit life insurance companies to join in the filing of consolidated returns with non-life companies.

The Alliance is a nonprofit association, established in 1922, composed of over 100 mutual fire and casualty insurance companies, which together write almost $4 billion of fire and casualty insurance for its policyholder members each year.

The Alliance had previously advised the staff of the Joint Committee on Internal Revenue Taxation of its opposition to such legislation last November. The Alliance has recently been joined in this opposition by the National Association of Independent Insurers, a nonprofit association of over 600 mutual and stock fire and casualty insurance companies, which together write over $23 billion of fire and casualty insurance each year.

Summary

It has long and repeatedly been concluded by both the Congress and the courts that the method of taxation of life insurance companies is so different from that of other types of companies (including fire and casualty insurance companies) that they should not be permitted to file consolidated returns with such other types of companies. Although the method of taxation of life companies was modified in 1959, this principle remains sound today. If a life company were permitted to file a consolidated return with a casualty insurance affiliate as if it were a single company, its tax liability would differ significantly dependent upon whether its life or casualty insurance business predominated. If a life company were permitted to file a consolidated return with a casualty insurance affiliate on a "bottom line" basis by simply mathematically combining its net life company taxable income (computed under part I of subchapter L) with its net casualty company taxable income (computed under part II and III of subchapter L), less tax would be paid in many instances than if the combined enterprise were taxed as a single company (under parts I, II or III of Subchapter L) contrary to the underlying principle of consolidated returns of "taxing as a single business unit what in reality is a single business unit." It was never intended that, by shifting income and deductions between affiliates, consolidated returns be used to enable an enterprise consisting of several companies to pay less tax than if operated as a single enterprise.

Assuring life companies that if they enter or engage more vigorously in the fire and casualty business, they will be able by means of consolidated returns to write off losses which cannot be written off by other companies in the first and casualty business, could have the competitive effect of destroying the existing fire and casualty industry and make it even more difficult, if not impossible, for the now beleaguered industry to meet their obligations to their policyholders. The ultimate result would be loss of capacity and instability for a prolonged period—at the expense of both the Treasury and the public.

EXISTING LAW WITH RESPECT TO THE TAXATION OF INSURANCE COMPANIES

Insurance companies are now subject to taxation under one of three separate methods—depending upon the way in which they are organized and the nature of the business which they conduct:

Life insurance companies—whether stock or mutual—are subject to tax under part I of subchapter L (sections 801–820) of the Internal Revenue Code of 1954.

Mutual nonlife (fire and casualty) companies are subject to tax under part II of subchapter L (sections 821–826), I.R.C. of 1954.

Stock nonlife (fire and casualty) companies are subject to tax under part III of subchapter L (sections 831 and 832), I.R.C. of 1954.

The method of taxation of life companies is distinctly different from the method of taxation of nonlife companies. The method of taxation of mutual fire and casualty companies is now essentially the same as that of stock fire and casualty companies, except in the case of very small mutual fire and casualty companies (having annual gross premiums and investment income of less than $500,000) and except for certain special adjustments as described hereinafter. See H. Rept. 1447, 87th Cong., 2d sess., p. 42, and S. Rept. 1881, 87th Cong., 2d sess., p. 54.

Simply stated, a life insurance company subject to tax under part I of subchapter L computes its tax as follows: First, it computes its "gain from operations" (as defined in section 809), which can be roughly defined as the mathematical sum of its investment income (or loss), its capital gains (or losses), and its underwriting income (or loss). Next it computes its "taxable investment income," under section 804; in arriving at "investment income," all capital gains as well as dividends, interest, et cetera, are included; in arriving at "taxable investment income," however, the "policyholders' share" of such income (other than long-term capital gain) is excluded based on policy reserve requirements. Then the company is subject to tax at regular corporate rates on (1) the lesser of (a) the company's share of taxable investment income or (b) its "gain from operations," plus (2) 50 percent of the excess, if any, of its "gain from operations" over its taxable investment income. In determining underwriting income (or loss) a deduction is allowable for dividends to policyholders limited in general by section 809(f) to the excess of "gain from operations" (computed before such deduction) over "taxable investment income" and $250,000. In addition, in the case of a stock company, it will ultimately be taxed on the remaining 50 percent of the excess of its "gain from operations" over taxable investment income, but only if and when—after distributing all other accumulated earnings—it distributes such excess.

By contrast, both mutual and stock fire and casualty companies are, except as hereinafter indicated, generally taxed (under parts II or III

of subchapter L) currently at regular corporate rates on simply the sum of their total investment income (or loss) (as described in section 832(b)(2)), their capital gains (or losses), and their underwriting income (or loss) (as described in section 832(b)(3)). See sections 823 and 832. In determining underwriting income (or loss), a deduction is allowable for dividends actually paid to policyholders under section 832(c)(11) without limit as to amount. Mutual fire and casualty companies are required to adjust their underwriting income for additions to or subtractions from their "protection against loss account" (See sections 821(b)(1)(C), 823(a)(1)(B), and 824). Small mutual fire and casualty companies having gross premiums and investment income of less than $1,100,000 are permitted an additional deduction of a maximum of $6,000 under section 823(c). Small mutual fire and casualty companies having annual gross premium and investment income of over $150,000, but less than $500,000, may elect under section 821(c) to be taxed on their investment income only, and small mutual fire and casualty companies having gross annual premium and investment income of less than $150,000 are generally exempted from tax by section 501(c)(15).

We believe that difference in the method of taxation of the three types of companies is justified by differences in the nature of their businesses.

HISTORY OF CONSOLIDATED RETURN AVAILABILITY FOR INSURANCE COMPANIES

Section 1504, in defining an "affiliated group" eligible to file a consolidated return specifically includes—

> Insurance companies subject to taxation under section 802 [part I of subchapter L, i.e. life companies] or 821 [part II of subchapter L, i.e. mutual fire and casualty companies].

except that it does provide that "two or more domestic insurance companies each of which is subject to taxation under the same section" may file a consolidated return for an affiliated group consisting of "such insurance companies alone." See sections 1504(b)(2) and 1504(c). Thus, (1) a life company may now file a consolidated return with another life company but not with a fire and casualty company, or with a noninsurance company, (2) a stock fire and casualty company subject to taxation under section 831 (part III of subchapter L) may file a consolidated return with another stock fire and casualty company or a noninsurance company, but not with any other type of insurance company, and (3) a mutual fire and casualty insurance company may not file a consolidated return with any other type of company. (The latter prohibition results from the fact that section 1504(c) permits the filing of a consolidated return only with another insurance company subject to tax under the same section of the Code, that is, another mutual fire and casualty company, and since by definition a mutual fire and casualty company has no stock it cannot have another mutual company as either a parent or subsidiary so as to meet the affiliation test of section 1504(a) of the Code.)

Congress has at least five times over the last 50 years considered the question of whether life companies should be permitted to file consolidated returns with other companies and has repeatedly concluded that they should not.

As early as the Revenue Act of 1928, it was specifically provided in section 141 (e) that an insurance company subject to the tax imposed by section 201 (life) or 204 (stock fire and casualty) could not file a consolidated return with a corporation subject to the regular corporate tax. Most mutual casualty companies were not then subject to tax.

The Revenue Act of 1932 amended section 141 (e) to further provide that a life company could not file a consolidated return with a stock casualty company. The Senate Finance Committee report of the 1932 Revenue Act explained:

"Under existing law, life insurance companies or insurance companies other than life or mutual are not permitted to file consolidated returns with corporations engaged in other lines of business because of the difference in the method of taxing insurance as compared with ordinary corporations. The same difficulty has been encountered in connection with life and fire insurance companies. Accordingly, the proposed amendment does not permit a life insurance company to file a consolidated return with a fire insurance company."—S. Rept. 665, 72d Cong. 1st sess., p. 33).

It was subsequently held that even prior to the 1928 and 1932 amendments, a consolidated return between a life insurance company and an ordinary corporation, or between a life insurance company and a nonlife insurance company was impracticable:

The commissioner correctly held that a life insurance company either life or other than life or mutual, was not entitled under the Revenue Act of 1921 (42 Stat. 227, 240) and subsequent acts to file consolidated returns with an ordinary corporation taxable under the provisions of the acts applicable to corporations generally, and to have its tax determined on the basis of such consolidation.

The fundamental and underlying reason for denying the affiliation between an insurance company and an ordinary corporation existed for 1921 and subsequent years because of special treatment and classification by Congress of insurance corporations.

* * * * * * *

Special provisions were enacted for the determination of taxable income of such corporations consisting solely of investment income . . . and the deductions allowed life insurance companies as well as those allowed insurance companies other than life or mutual, differed materially from those allowed ordinary corporations. *National Life Insurance Company* v. *United States*, 4 F. Supp. 1000 (Ct Cls., 1933), cert. den. 291 U.S. 683.

Permitting a life company to file a return with a nonlife company—

would result in a hybrid of two different systems quite as much as if the combinations were between an insurance and an ordinary corporation. The cases established that separate classification and different methods of computation reasonably imply an exception to the literal terms of the statute. Accordingly, the life insurance company will be denied the privilege of filing a consolidated return with insurance companies of a different type. *Commissioner* v. *Travelers Indemnity Co.*, 83 F. 2d 937 (2d Cir., 1936).

The Revenue Act of 1934 subsequently abolished the filing of consolidated returns for all types of corporations except railroads.

The Second Revenue Act of 1940 (excess-profit tax) reinstated the election of filing consolidated returns for excess-profit tax purposes. Section 730(e) (6) excluded from the definition of "includible corporations" for consolidated return purposes, insurance companies subject to tax under section 201 (life), section 204 (stock fire and casualty) or section 207 (mutual). However, section 730(f) provided that two or more insurance companies subject to tax under the same section

could file consolidated returns. The Conference Committee report contained the following explanation:

> While insurance companies in general are not includible in an affiliated group, an insurance company may be affiliated with other insurance companies of the same taxable character. For example, an insurance company taxable under section 201 may file a consolidated return with another insurance company taxable under the same section, assuming both companies meet the stock ownership test. An insurance company taxable under Section 201 may not, however, file a consolidated return with another insurance company taxable under section 204 or section 207.—H. Rept. 3002, 76 Cong. 3d sess., p. 54.

The Excess-Profit Tax Amendments of 1941 amended section 730 (e) (6) so as to exclude from the definition of an "includible corporation," only those insurance companies taxable under section 201 (life) or 207 (mutual). The Ways and Means Committee report with respect to this amendment, which permitted the affiliation of an insurance company taxable under section 204 (stock fire and casualty) with a noninsurance corporation, stated:

> Section 730 of the present law dealing with consolidated returns under the excess-profits tax does not permit an insurance company to join in a consolidated return with a noninsurance company. This restriction was inserted because of the special manner in which the income of insurance companies is computed under the income-tax laws. It is believed, however, that the differences of computation in the case of an insurance company other than life or mutual are not so significant as to prevent such a company from filing the consolidated return with an ordinary corporation with which it is affiliated. Consequently, this section amends section 730 to permit such insurance companies, that is, those subject to taxation under section 204, to join in consolidated returns with ordinary corporations.—H. Rept. 146, 77th Cong. 1st sess., p. 14.

The Revenue Act of 1942 reintroduced the election of filing consolidated returns generally for income tax purposes. Sections 141 (e) (2) and (f) as pertinent herein, contained the same provisions as did sections 730(e) (6) and (f) of the excess profits tax provisions, and excluded from the definition of an "includible corporation," an insurance company taxable under section 201 or 207, but permitted insurance companies taxable under the same section to file consolidated returns with each other assuming they met the stock ownership test.

Section 1504 of the 1954 code reenacted, substantially unchanged, the language contained in section 141(e) (2) and (f).

It has been said by proponents of the present proposal to permit consolidated returns that these conclusions are no longer sound in light of the enactment of the Life Insurance Company Tax Act of 1959, subjecting "all elements of a life company's income to tax." As previously noted and discussed in greater detail hereafter, life companies are not subject to tax today on simply the sum of their investment and underwriting income, as are fire and casualty companies. As late as 1974—15 years after enactment of the Life Insurance Company Tax Act of 1959—the Congress was faced with the problem of how life insurance company dividends should be treated for personal holding company consolidated return purposes. The Senate Finance Committee specifically noted:

> Life insurance companies generally are not eligible to participate as a member of a consolidated group which include other noninsurance companies even though the requisite common ownership exists between such companies (sec. 1504(b) (2)), because the unique accounting methods by which life insurance

companies are taxed make it difficult to consolidate their returns with other noninsurance companies. Consequently, under present law dividends from a life insurance company paid to another company constitute personal holding company income to that company even though sufficient common ownership exists to meet the requirements for filing consolidated returns.

The committee considered that the latter consequence was discriminatory. If the committee then thought that the general prohibition against life companies filing consolidated returns with nonlife companies was unsound, it could have solved the personal holding company problem with which it was then concerned by simply recommending repeal of the prohibition. Recognizing, however, that for reasons quoted, the basic prohibition was sound, it proposed instead—and Congress enacted into law as a part of Public Law 93–480—a provision that

. . . dividends to any member of a consolidated group of corporations from a life insurance company are not to be included either as consolidated personal holding company income or as consolidated adjusted ordinary gross income if the life insurance company is not a member of the affiliated group because of the provision prohibiting insurance companies from participating in a consolidated group.—S. Rept. 93–1061, 93d Cong., 2d sess.

OBJECTIONS TO S. 2985 AND H.R. 12126

Although, as now drafted, S. 2985 and H.R. 12126 would not only permit a mutual or stock life company parent subject to tax under section 802 (part I of subchapter L) to file a consolidated return with a stock fire and casualty subsidiary subject to tax under section 831 (part III of subchapter L), but also permit a mutual fire and casualty company parent subject to tax under section 821 (part II of subchapter L) to file a consolidated return with a stock life subsidiary—and many of our member mutual fire and casualty company members have such life subsidiaries—the Alliance nevertheless believes that the enactment of S. 2985 and H.R. 12126 would be contrary to the interest of the mutual fire and casualty insurance company industry and also contrary to the public interest.

S. 2985 and H.R. 12126 are silent as to the manner in which consolidation would be effected. A single company engaged in the life insurance business may also be engaged in the fire and casualty insurance business. In such instance, it will be taxed under parts I, II, or III of subchapter L dependent upon the nature of the mix of its business. To be taxable as a life company under part I of subchapter L, a company must meet the definition of a "life insurance company" contained in section 801(a), which defines such term to be limited for tax purposes to:

An insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—(1) its life insurance reserves (as defined in subsection (b)), plus (2) unearned premiums and unpaid losses (whether or not ascertained), or noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

If an insurance company fails to meet such 50 percent reserve test it is taxed as a mutual insurance company other than life (that is, a

mutual fire and casualty company) under part II of subchapter L or as an insurance company other than life or mutual (that is a stock fire and casualty company) under part III of subchapter L. There is no provision under which a company may be taxed in part under one part of subchapter L and in part under another part of subchapter L of the code. However, even though many State laws prohibit a single company from being engaged in both the life business and the fire and casualty business, the code does anticipate the possibility that a company may be engaged under some State laws in both a life business and a fire and casualty business providing, for example,

(1) In section 832(b)(4), for a casualty company to treat as unearned premiums "life insurance reserves as defined in section 801(b), pertaining to life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not quality as a life insurance company under section 801," and

(2) In section 810(10)(3), for reserves for life companies unrelated to "life, health or accident contingencies."

The Internal Revenue Service has also recognized the possibility of: (*a*) Taxing a multiline company on its entire business under section 831, in Revenue Ruling 65-240, 1965—2 C. B. 236, involving stock casualty company issuing life policies, and (b) taxing a multiline company on its entire business under section 802, in Revenue Ruling 72-432, 1972—2 C. B. 400 involving a life company issuing casualty policies.

The proposed legislation is silent as to whether these principles are to be applied in the case of a consolidated return filed by an affiliated group consisting of one company engaged in the life insurance business and another company engaged in the fire and casualty business. If the income of the two companies were consolidated as if they were a single multiline company, it is quite obvious that the way in which the group would be taxed would be quite different, dependent upon whether: (*a*) The life insurance business predominated, making it eligible for tax under section 802 (part I of subch. L) as a life company, or (*b*) the fire and casualty business predominated, making it subject to tax under section 821 (Pt. II of subch. L) as a mutual casualty company, or section 831 (Pt. III of subch L) as a stock casualty company.

The problem might be particularly difficult of solution if both a mutual and stock company were involved since in such case the mutual company must necessarily be the parent (since a mutual company by definition cannot be a subsidiary), but the predominant business might be that of the subsidiary, not the parent.

It is also obvious that: (1) Because life companies taxable under part I of subchapter L are required to include in "taxable investment income" only "the company's share" of investment income, whereas fire and casualty companies are required under sections 822 and 823 or 831 to include in taxable income their entire investment income, and (2) because life companies are in no event required to pay a current tax on an amount greater than their share of investment income plus one-half of the excess of "gain from operations" over "taxable investment income," whereas fire and casualty companies are required under sections 823 and 831 to pay tax on the sum of their total investment

income and their underwriting income, companies engaged in multiline activities in which the life insurance business predominates may well pay significantly less tax than a company engaged in a multiline activity in which the fire and casualty business predominates, even though their total economic income is the same.

It must also be recognized that since life insurance companies are limited to a deduction for dividends to policyholders of $250,000 plus underwriting gain, whereas fire and casualty companies are not so limited, there may be cases in which a multiline company engaged predominantly in the fire and casualty business will pay less tax than a multiline company engaged predominantly in the life business having the same total economic income.

As previously set forth, the Congress has repeatedly concluded that life insurance companies should not be "permitted to file consolidated returns with corporations engaged in other lines of business because of the difference in the method of taxing insurance as compared with ordinary corporations," and we believe that this is a sound principle which should continue to be applicable, in order to avoid giving competitive advantages to one segment of the insurance industry (predominantly engaged in one line of business) as compared to another (predominantly engaged in a different line of business).

One way in which the income of life insurance companies could be consolidated with the income of fire and casualty companies is on a so-called bottom line method of consolidation under which each company in the affiliated group would compute its income under parts I, II, or III of subchapter L, respectively, and then combine such income mathematically so as to arrive at a net taxable income on which they would pay tax. It can easily be demonstrated, however, that on this basis, some affiliated groups would pay far less tax than if their activities were conducted in a single economic unit, even if consolidated. Suppose, for example, a combined multiline enterprise has a taxable investment income of $750,000 of which the company's share is 46.67 percent for purposes of section 809, and 25 percent for purposes of section 804, no capital gains or losses, underwriting income (before deducting policyholder dividends) from the life insurance business of $300,000, a net underwriting loss from the fire and casualty business of $100,000, and pays out policyholder dividends—all to its life policyholders—of $550,000. Its tax liability would be computed as follows, dependent upon (*a*) whether its business is conducted in a single company or separate companies, (*b*) whether as a single company it would meet the 50 percent reserve test so as to qualify as a life company taxable under part I of subchapter L, and (*c*) the way in which it segregates its investments if operated as separate life and fire and casualty companies.[1]

[1] It is recognized that there are differences in the determination of "taxable investment income" under sec. 804, "taxable investment income" under sec. 822, and "investment income" under sec. 832, and that similarly there are differences in the computation of underwriting income under sec. 809 (c) and (d)—that term not being used in the statute, "statutory underwriting income" under sec. 823, and "underwriting income" under sec. 832, but the basic concepts are the same, and the recognition of differences under the various sections would accentuate rather than ameliorate the differences in result demonstrated below. It is further recognised that the company's share of investment income would not necessarily be the same if some of the assets of the enterprise in the example were held by the fire and casualty company instead of all in the life company.

Facts	Single company (50 percent test of sec. 801 not met)	Single company (50 percent test of sec. 801 met)	Separate companies		
			Life company	Fire and casualty company	Consolidated
Investment income	$750,000	$750,000	$750,000		
Underwriting income (before policyholder dividends)	200,000	200,000	300,000	(100,000)	
Policyholder dividends	(550,000)	(550,000)	(550,000)		
Taxable income:					
Taxable investment income	750,000				
Company share:					
At 46.67 percent (sec. 809)		350,000	350,000		
At 25 percent (sec. 804)		187,500	187,500		
Underwriting income (before policyholder dividends)	200,000			(100,000)	
Gain from operations (before policyholder dividends)		950,000	1,050,000		
Policyholder dividends (limited for life company to excess of gain from operations over investment income plus $250,000)	(550,000)	(550,000)	(550,000)		
Gain from operations (after policyholder dividends)		400,000	500,000		
Taxable income (limited for life company to (1) lesser of taxable investment income or gain from operations, plus (2) ½ of excess of gain from operations over taxable investment income)	400,000	293,750	343,750	(100,000)	243,750

It will be noted that in this example, regardless of whether the predominant business is a life business or a fire and casualty business, less tax will be paid if the enterprise is divided into two separate companies, and taxable income is then combined on a "bottom-line" basis, than if the enterprise were taxed as a single company, whether as a life or fire and casualty company. Should this be so?

Other examples could be devised, in some of which the enterprise would pay a greater tax on a consolidated bottom-line basis than if operated as a single company. But why even should this be so?

The principle underlying consolidated returns generally is the "principle of taxing as a business unit what in reality is a business unit * * *." (S. Rept. 617, 65th Cong., 3d sess., p. 9.) It was never intended that consolidated returns be used for the purpose of enabling an enterprise consisting of several companies to pay less tax than if operated as a single company.

Permitting life companies to file consolidated returns on a bottom-line basis with casualty companies would enable life companies to shift income and deductions between affiliates taxed as life companies and affiliates taxed as casualty companies so as to take maximum advantage of the taxing provisions for such type of company at the expense of the Treasury.

STABILITY OF THE FIRE AND CASUALTY INDUSTRY

Proponents of the proposal have called attention to the severe financial losses of many companies in the fire and casualty industry in recent years and have asserted that by enabling life companies to enter the fire and casualty business or to compete more vigorously in such business (by assuring such companies that the near-term losses they expect in the fire and casualty business can be immediately offset against the life company profits), there will be greater capacity and stability in the fire and casualty business. Adoption of the proposal could well

have the opposite effect; the existing fire and casualty industry is prohibited today from writing off its current operating losses against profits of the same businesses for other years except for a very limited period (3 years back and 5 years forward under sections 172, 823(b)(1) and 825) and if companies affiliated with life companies were permitted by means of the consolidated returns proposal to write off losses for the fire and casualty business which could not otherwise be written off, it is obvious that the proposal would provide the large life insurance companies with a casualty affiliation a competitive leverage which would have the effect of destroying the existing fire and casualty industry and make it even more difficult, if not impossible, for the companies now in that business to meet their obligations to their policyholders. The ultimate result would be loss of capacity and instability for a prolonged period.

While we concur that there is today a great need for property and casualty insurers to build up their solidarity in order to meet the capacity needs of our expanding economy, we do not believe that tax policy should be so structured as to limit the opportunity to do so to a small number of very large companies. This would create irreparable damage to the many hundreds and thousands of small companies which are providing an important market today. We suggest that a better way to get at the problem is by extending the "carryback, carryforward" provisions of the existing law. This would achieve the objectives sought by the supporters of S. 2985 and H.R. 12126 benefiting all fire and casualty companies, including those affiliated with life companies, without penalizing the small companies that traditionally serve the property and casualty insurance needs of our country.

Respectfully submitted,

HAMEL, PARK, McCABE & SAUNDERS,
By: K. MARTIN WORTHY,
Counsel for American Mutual Insurance Alliance.

STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

The National Association of Independent Insurers (NAII) appreciates this opportunity to join with the American Mutual Insurance Alliance in registering opposition to the enactment of S. 2985 and H.R. 12126, or any other legislation that would permit consolidation of tax returns by life insurance companies, nonlife companies, and noninsurance entities.

NAII is a voluntary trade association comprised of more than 600 stock, mutual, and reciprocal property-liability insurance companies. Our affiliated companies had a combined premium volume of $23 billion in 1975, and they do business in every State and the District of Columbia. NAII members range in size from the very largest insurance companies to the small, one-State writers. Most of our members would fall into the category of a "small" company.

NAII agrees with the American Mutual Insurance Alliance that enactment of S. 2985 or H.R. 12126 would bring harmful effects to the property-liability insurance industry and its customers. So as not to

be repetitious, we will not attempt to echo the arguments made by the alliance in a statement filed with this committee, but we will focus our remarks on the potentially disastrous effects that consolidated returns would have on the majority of our member companies.

NAII and its member companies believe in competition. We have been in the forefront of legistlative battles to institute open competition rating laws in the States. We have led the insurance industry competitive pricing and in many coverage and service innovations for the consumer. We believe that healthy competition can only benefit the insurance consumer and ultimately, the insurance industry.

But the primary requirement for achieving healthy competition is that all competitors must toe the same mark at the starting line. There must be no initial advantage given to any one competitor. If such an advantage exists, it destroys the potential benefit derived from competition.

That is what this legislation would do. By allowing life insurance companies to consolidate tax returns with nonlife companies, those life insurers are given a legislated competitive advantage that could eventually allow them to establish a cartel in the property-liability insurance business.

Large life insurers would be able to shift income and losses between affiliates, while property-liability companies would not be able to use this leverage. The property-liability insurance industry is highly competitive and any advantage, however small, given to one segment of the industry would create serious economic problems for the remainder of the industry. The unfair competition that would be created by the passage of this legislation could threaten the solidity of the large number of small- and medium-sized insurance companies that are currently responsible for the majority of insurance in force in the United States.

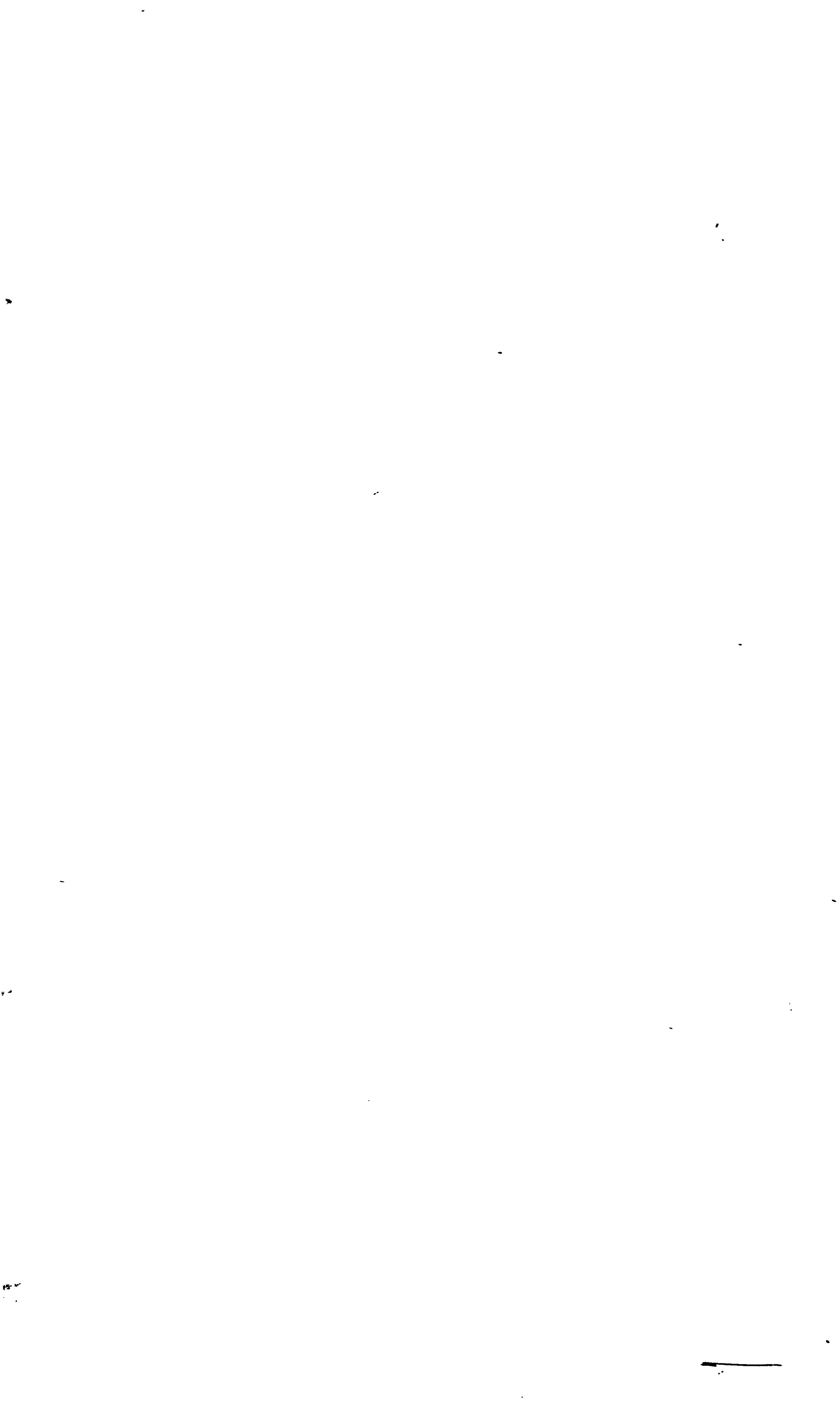
The proponents of this legislation argue that its passage would help create badly needed capacity in property-casualty insurance lines. NAII believes that just the opposite effect would be obtained.

Only a small number of large companies would obtain any benefit, while the majority of the industry would find it more difficult to compete and make a reasonable profit. The most important ingredient in creating capacity is favorable operating results. This legislation would not add to the stability or capacity of the insurance industry as a whole—but it would do so for a certain portion of the industry, at the expense of the remainder.

NAII believes that the entire industry needs assistance with capacity and solidity in these troubled economic times. This could be achieved by extending the carryback-carry forward periods contained in the existing tax law. Such a proposal would not create the inequities that would result from the enactment of S. 2985 or H.R. 1216. NAII would strongly support such a proposal.

SUMMARY

The National Association of Independent Insurers opposes S. 2985 and H.R. 12126 because the anticompetitive effect of this legislation could destroy a large and valuable portion of the existing property-liability insurance industry; and it would make it more difficult, if not impossible, for the industry to meet the growing insurance needs of our economy.



Life Insurance Company Distributions

3330

Statement of Business Men's Assurance Company of America in Support of S. 2704 and H.R. 10051 Amending Section 815 of the Internal Revenue Code

SUMMARY

Business Men's Assurance Company of America (BMA), a life insurance company, supports an amendment to section 815 of the Internal Revenue Code that would allow a life insurance company to disregard (for purposes of that section) a distribution made during the last month of its taxable year, deemed to have been made out of the policyholders' surplus account, if such distribution is returned to the company not later than the due date for filing its income tax return (including extensions thereof) for that year. The purpose of the amendment is to assure that a "phase 3" tax—perhaps the most burdensome in the code—is not imposed on a life insurance company because of an unintentional distribution from its policyholders' surplus account, provided the mistake is discovered and corrected prior to the filing of the return.

The amendment to section 815 has been introduced in the House as H.R. 10051 by Congressman Waggonner of Louisiana, and in the Senate as S. 2704 by Senators Dole and Talmadge on this committee.

The Treasury has indicated that it is not opposed to these bills. The Ways and Means Committee, after holding hearings on H.R. 10051, unanimously reported the bill favorably. On December 16, 1975, the amendment was also discussed and unanimously approved by this committee.

The amendment is needed because the Internal Revenue Service believes that section 815 must be interpreted in a harsh, inequitable manner so that, in BMA's case, a $6 million "phase 3" is due from the life insurance company on a distribution from the policyholders' surplus account which was clearly inadvertent and which was returned to the company shortly after the mistake was discovered. The tax claimed actually exceeds the entire amount of the inadvertent distribution.

This is an unjust result which should be corrected by legislation.

INTRODUCTION

BMA is a stock life insurance company headquartered in Kansas City, Mo., with more than 1 million policyholders located in almost every State. BMA timely requested an opportunity to testify before the Committee on Finance in support of S. 2704 and H.R. 10051, bills which would amend section 815 of the Internal Revenue Code. It was informed that an oral presentation would not be possible but that a written statement could be submitted for inclusion in the record of the committee's tax revision hearings. We appreciate this opportunity to express our support for legislation which would prevent the "phase

3" tax provisions of section 815 from being applied in an unequitable manner never intended by Congress.

PRESENT LAW

Under present law, a life insurance company is taxed currently on its "taxable investment income" plus one-half of the excess of its "gain from operations" (underwriting income) over its "taxable investment income." This currently taxed income is placed in an "shareholders' surplus account" and may be distributed by the life insurance company to its shareholders without further tax consequences.

Tax on the remaining 50 percent of the excess of gain from operations over investment income was intentionally deferred by Congress because "it is difficult, if not impossible, to determine the true income of insurance companies otherwise than by ascertaining over a long period of time the income derived from a contract or block of contracts." (See H.R. Rept. No. 34, 86th Cong., 1st sess. (1959), p. 4; S. Rept. No. 291, 86th Cong., 1st sess. (1959), p. 7.) Life insurance companies are permitted to accumulate these tax-deferred amounts in a contingency reserve known as the "policyholders surplus account." [1]

Subject to certain limitations not relevant here (see § 815(d)(4)), life insurance company officials are allowed to use their own best judgment as to when amounts in the policyholders surplus account represent "true income" to the life insurance company which is no longer needed for the protection of policyholders. A company which makes a distribution to shareholders out of this account after exhausting its shareholders' surplus eliminates the tax deferral on amounts so distributed. A distribution was thought to be an appropriate event for triggering the tax on the assumption that "the company itself has made a determination that [the distributed] amounts constitute income which [is] not required to fulfill the policyholders' contracts." (See H.R. Rept. No. 34, supra at p. 15; S. Rept. No. 291, supra at p. 25.)

The tax on distributions out of the policyholders' surplus account is popularly known as a "phase 3" tax. It is computed by applying the regular corporate tax rate to the amount distributed out of the policyholders' surplus account, "grossed-up" by the amount of tax payable in respect of the distribution. Because of this "gross-up" provision, at current corporate tax rates, a life insurance company must pay approximately $1 of tax for every dollar distributed out of the policyholders' surplus account.

REASON FOR THE AMENDMENT

The Internal Revenue Service has interpreted present law to require BMA life insurance company to pay the phase III tax on a wholly unintentional distribution out of the policyholders' surplus account even though the principal (99.8 percent) shareholder of the company promptly returned the distribution upon learning the true facts. The company had a long-standing policy of limiting its distributions to stockholders to amounts in the shareholders' surplus account, and

[1] Certain special deductions allowed in computing gain from operations are also added to this account.

footnotes to its published financial statements stated that the company had "no present plans for distributing the amounts in 'policyholders surplus'."

The company paid an extraordinary yearend dividend in the belief that the dividend was consistent with this declared policy, but discovered, on preparing its return for the year, that it had unintentionally invaded the policyholders' surplus account. Amounts distributed out of the policyholders' surplus by mistake were restored to the company before its return for the year was due.

Imposition of the phase 3 tax in these circumstances seems plainly inconsistent with the intent of Congress, which assumed that a distribution would evidence a conscious determination by the life insurance company's officials that amounts to be distributed out of policyholders' surplus "constitute income which was not required to fulfill the policyholders' contracts." Obviously, a life insurance company's officials could not have made any such determination if they were not even aware that a distribution was being made from the policyholders' surplus account.

Congress should be especially sensitive to the Internal Revenue Service's attempt to turn phase 3 into another trap for the unwary. The Internal Revenue Service's interpretation of the statute would result in substantial reductions in the policyholders' surplus account which provides a cushion for policyholders against adverse loss experience.

The reduction would be made before the life insurance company's officials made the determination contemplated by Congress that the cushion could safely be reduced. Moreover, the "gross-up" method under which phase 3 tax is computed resulted in a tax equal to 100 percent or more of the unintentional distribution—a drastic penalty for a mistake.

Rather than allow the Internal Revenue Service to obtain a phase 3 tax windfall from a life insurance company at the expense of its policyholders, the tax law should encourage the company's shareholders to return the unintentionally distributed policyholders' surplus by postponing the phase 3 tax if amounts distributed by mistake are promptly restored to the company. This is the purpose of the amendment to section 815 proposed herein.

EXPLANATION OF AMENDMENT

S. 2704 and H.R. 10051, a companion bill in the House, would add a new section 815(d)(6) to the Internal Revenue Code which would prevent the Internal Revenue Service from penalizing a life insurance company for having made an unintentional distribution out of policyholders surplus, provided that the amounts so distributed are returned to the company within a reasonable time. So that there will be no administrative inconvenience to the Internal Revenue Service, the amendment provides that the amounts must have been restored no later than the time prescribed by law for filing the return for the taxable year in which the distribution was made (including extensions thereof); the taxpayer would not be permitted to reopen any prior year.

Thus, if a company discovered upon preparing its return for the year that a dividend which it thought had been made from shareholders surplus during the last month of the year had actually been distributed out of the policyholders surplus account, section 815(d)(6) would permit the company to continue to defer phase 3 tax to the extent that its shareholders restore the unintentionally distributed amounts to the company by the time its return is due.

The proposed amendment to section 815 in S. 2704 attached hereto was originally proposed by Senator Dole of Kansas in December 1974 as a floor amendment (No. 2079) to H.R. 421. The Senate did not pass upon the amendment as it was ruled nongermane to the subject matter of H.R. 421, but Senator Long stated that he would "be happy to see the amendment considered next year." Congressional Record, December 17, 1974, pages S21802–3.

Senator Dole introduced S. 2704 in the current session of Congress, a bill identical to the amendment to section 815 which had been offered as a floor amendment to H.R. 421 in the previous session. Senator Dole's bill was discussed at a meeting of the Committee on Finance on December 16, 1975, where the committee unanimously authorized the chairman to include it along with other tax revision bills as an amendment to one of several pending tax bills. For reasons unrelated to their merits, neither S. 2704 nor the other bills was brought to the floor of the Senate at that time.

A companion bill in the House, H.R. 10051, introduced by Congressman Waggonner of Louisiana, was the subject of hearings held by the Ways and Means Committee on December 10, 1975. William D. Grant, chairman and chief executive officer of BMA, testified at those hearings. The Ways and Means Committee recently voted unanimously that H.R. 10051 be reported favorably by the committee.

Thus, the amendment to section 815 supported by BMA already has been unanimously approved by both the Ways and Means Committee and this committee. In addition, the Treasury Department has indicated that it has no objection to these bills. There can be no doubt that the present language of section 815, as interpreted by the Internal Revenue Service, is harsh and unjust in the case of unintentional distributions out of the policyholders' surplus account and should be corrected by legislation.

Tax Simplification (Deductions; Sick pay exclusion; Military Retirees)

3335

3336

Statement by Health Insurance Association of America

SIMPLIFICATION OF SICK PAY EXCLUSION AND DEDUCTION FOR MEDICAL EXPENSES

This is a statement on behalf of the Health Insurance Association of America, representing a membership of over 300 insurance companies which write approximately 80 percent of the health insurance written by insurance companies in the United States.

We appreciate this opportunity to state our views in support of the present tax exclusion for payments under sick pay plans and the separate deduction for health insurance premiums under the medical expense deduction. We shall also make certain suggestions for the improvement and simplification of these provisions.

I. SICK PAY EXCLUSION

Benefits of the sick pay exclusion

We should like to observe that the sick pay exclusion clearly meets the test of a desirable exclusion since it helps people in great need of extra resources stretch what little money they have through limited exemption from income tax. The day when the large local family group of our agricultural past could supply income security is long past. In an industrial and mobile society, the responsibility for support on the occasion of disability must fall upon the limited resources of the individual himself, on his employer, or on the Government. For the average wage earner, his own resources are inadequate. The flexibility of employer-sponsored plans and the fact that they require no direct outlay of Government funds makes them clearly preferable to welfare.

Prolonged disability is a disaster to any wage earner. It can be worse than death. The dead breadwinner may leave a widow and children in difficult financial circumstances. The disabled breadwinner adds himself to their burden.

The flexibility of section 105(d) helps small employers as well as large ones. Large employers with collectively bargained plans will usually have very adequate disability protection for their employees, either through group insurance or through self-insured plans. But this section helps the small businessman, too. Individual disability income insurance enables the local merchant to protect his loyal clerk. It permits the attorney in a small town to protect the secretary who serves him faithfully.

Historical background reflects public policy

The legislative history of the current section 105(d) of the Internal Revenue Code reflects the longstanding public policy of encouraging employers to make provision for their employees during periods of

illness and to minimize the financial hardship that frequently occurs at such times.

Section 105(d), the so-called sick pay exclusion, was first enacted as a part of the Internal Revenue Code of 1954. Construed with section 104 of the Internal Revenue Code of 1954, it is a limitation on the absolute exemption originally accorded accident and health insurance proceeds by Congress in 1918. This committee explained this exemption, written into the revenue bill of 1918, in the following language:

> Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income.[1]

The exemption of accident and health insurance proceeds was continued through the years, appearing in section 22(b) (5) of the 1939 Internal Revenue Code as an exemption of "Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness . . ." Thus, under the 1939 Code, disability income provided to an employee as accident or health insurance was not taxable to the employee, irrespective of the amount of the benefits.

In the *Haynes* case[2] decided in 1957, the Supreme Court of the United States held that under the 1939 Code sickness disability benefits paid to an employee by an employer under a noninsured plan qualified for the section 22(b) (5) exemption accorded benefits of health and accident insurance. In its opinion the court said, "For reasons deemed satisfactory, Congress, since 1918, has chosen not to tax receipts from health and accident insurance."

The sound public policy underlying the sick pay exclusion is well stated by the U.S. Circuit Court of Appeals for the 7th Circuit, in the *Epmeier* case,[3] where, in holding that the section 22(b) (5) exemption in the 1939 Code applied to sick leave payments made by an employer to an employee, the Court said:

> The provisions of section 22(b) (5) undoubtedly were intended to relieve a taxpayer who has the misfortune to become ill or injured, of the necessity of paying income tax upon insurance benefits received to combat the ravages of disease or accident.

As inclusion of disability income in employee benefit plans became widespread in industry, controversy arose over the construction of the language "accident or health insurance" in section 22(b) (5) of the 1939 Code. The Internal Revenue Service took the position that the exemption was limited to health insurance benefits paid under insurance policies issued by commercial insurance carriers, but the U.S. Court of Appeals for the 7th Circuit held in the *Epmeier* case[4] that the exclusion likewise applied to sick pay benefits received by an employee in an amount equal to his regular salary where there was no formal insurance policy but merely an employer's plan for payment of sickness benefits.[5]

---

[1] Internal Revenue Cumulative Bulletin 1939–1, pt. 2, p. 92.
[2] *Haynes* v. *U.S.*, 353 U.S. 81, 1 L. Ed. 2d 671, 77 S. Ct. 649.
[3] *Epmeier* v. *U.S.*, 199 F. 2d 508.

In formulating the 1954 Code, new section 104 and 105 were designed basically to continue the old section 22(b)(5) exemption of accident and health insurance proceeds, except that such exemption was withdrawn from proceeds attributable to contributions by an employer not includable in the gross income of the employee, unless such employer-financed proceeds constituted (1) reimbursements for medical expenses (section 105(b)(2) payments for permanent loss or disfigurement computed without relation to absence from work (section 105(c)), or (3) wage continuation (sick pay) plan payments (section 105(d)). The net effect then, of new sections 104 and 105 was: (1) to limit the exemption of employer-financed accident and health disability insurance benefits to $100 a week, where there had been no limit before; (2) to make clear that the limited $100 a week exclusion also applied to uninsured company salary continuance or sick leave plans.

These statutory rules were refined further by Congress in 1963. The refinement, however, applied only to the waiting period, that is, the time when the $100 a week exclusion becomes applicable. Under the 1954 provisions of the Code simply stated, the $100 a week exclusion became applicable after the first 7 days of absence from work on account of sickness or on the first day of absence if the disability resulted in hospitalization or was the result of personal injury. The 1963 revision added a rather complicated and confusing provision. The very description of it demonstrates its complexity. Stated as simply as possible, the $100 a week exclusion is applicable after 30 days absence from work; however, if during the first 30 days of absence from work the sick pay is not more than 75 percent of the employee's regular salary, the employee may exclude his sick pay in amounts up to $75 a week commencing after the seventh day of absence from work unless he is hospitalized at sometime during his disability, in which case a $75 maximum exclusion is applicable from the first day of his absence from work.

Recommendation

It is with respect to the waiting period, or when the exclusion becomes applicable, that we wish to make a recommendation to simplify the present sick pay exclusion. To help employers, and particularly small employers, to better understand their obligations under the law and to explain them to their employees, we recommend that the 75 percent—$75 rule of the present Code section 105(d) be abolished. We recommend that the exclusion be made applicable after the seventh day of absence from work or on the first day of hospitalization, whichever first occurs. This would substitute a simple and easily understood rule for one that is difficult to understand and apply.

Sick pay should be recognized and encouraged as an employee benefit

Sick pay which is excluded from taxation under section 105(d) of the Internal Revenue Code should be recognized as an employee benefit. It reflects the natural concern of an employer for the welfare of his employees and their dependents upon the occurrence of a disability. If a sick pay plan were not in effect when disability occurs, the disabled

---

[4] *Epmeier v. U.S.*, 199 F. 2d 508.
[5] H. Rept. No. 1337, 83d Cong., 2d sess., p. A33.

employee would lose his entire income since he would be unable to work. The sick pay plan fills this void and provides a benefit upon which the employee and his dependents may rely in meeting the economic demands which continue during the period of disability.

It is common to measure the amount of the sick pay benefit by reference to the income being received by the disabled employee prior to his disability. This should not, however, lead to the conclusion that sick pay is simply a continuation of the employee's compensation during the period of his disability. The sick pay is an employee benefit and typically is only a percentage of the employee's compensation prior to disability.

Sick pay exclusion encourages disability income coverage

Income replacement during disability, particularly if disability is prolonged, is an absolute necessity if savings and property are to be preserved, or if the wage earner is to avoid becoming a public charge.

It is submitted that the public interest will be strongly served if an insured program of long-term disability coverage can be written on millions of Americans. To the extent that such a program financed by employer payments can be fostered, public assistance from public funds should be proportionately reduced.

As mentioned above, an income during disability is an absolute necessity for the average income earner. That fact is receiving growing recognition. As this recognition grows, individuals are going to insist upon the protection of a program of income replacement during disability. The arrangement should be between the employer and his employees, the alternative being an increase in social benefits, financed, controlled, and administered by the Government.

The sick pay exclusion of the Code has furnished great stimulus to the growth of insured disability plans financed by employers.

Sick pay exclusion means most to those in lower tax brackets and should be preserved for their benefit

In examining the sick pay exclusion we ask the committee to consider the fact that the exclusion is most beneficial to low-income taxpayers whose need for assistance on the occurrence of disability is greatest.

This is demonstrated by the distribution of income tax returns on which the sick pay exclusion is claimed. The report of the Internal Revenue Service, "Statistics of Income 1972—Individual Income Tax Returns," Internal Revenue Service Publication 198 (3–74), page 17, shows a breakdown by adjusted gross income classes of the number of individual returns on which the sick pay exclusion was claimed and the dollar amounts excluded on those returns.

In 1972, the sick pay exclusion was claimed on 1,118,821 returns. The total dollar amount excluded on those returns was $1.3 billion.

Of those returns, 17 percent showed adjusted gross income of less than $5,000 and accounted for 35 percent of the total sick pay excluded.

Forty-four percent of the returns showed adjusted gross income of under $10,000 and accounted for 60 percent of the total amount excluded.

Seventy percent of the returns showed adjusted gross income of under $15,000 and accounted for 78 percent of the total sick pay excluded.

Eighty-eight percent of the returns showed adjusted gross income of under $20,000 and accounted for 90 percent of the total sick pay excluded.

Recommendation

We have one further suggestion with respect to the sick pay exclusion. The $100 limit was adopted in 1954. Since that time the cost of living has increased substantially as a result of inflation. Thus, it would be in order for the committee to consider increasing the amount of the exclusion to $150 or $200, whichever the committee finds most appropriate.

Conclusion

In view of the history of the sick pay exclusion, which reflects its consistent recognition by the Congress and the courts, it is apparent that the exclusion is a well-established feature in our tax law, and it should be preserved for the benefit of those who are afflicted by disabilities. The exclusion should be improved by simplification of the rules regarding the waiting period and by increasing the amount which may be excluded from taxable income.

II. MEDICAL EXPENSE DEDUCTION

Under present law, a taxpayer may deduct one-half of his health insurance premiums up to a maximum deduction of $150. The rest may be aggregated with his other medical expenses and deducted to the extent the sum exceeds 3 percent of the taxpayer's adjusted gross income. Under changes recommended by the administration, the separate deduction for health insurance premiums would be eliminated, and the entire amount of the taxpayer's health insurance premiums would be deductible only as an ordinary medical expense, thereby eliminating the deduction completely for many.

The proposed elimination of this deduction (along with other deductions and exemptions) is intended to simplify the individual tax return. While we endorse the general concept of simplification, we strongly believe that this must be accomplished in a manner which preserves tax equity and is consistent with sound tax policy. The proposed elimination of the deduction for health insurance premiums does not meet these standards.

First, the present deduction (outside the medical deduction floor) for one-half of a taxpayer's health insurance premiums was added in 1965 in order to equalize to some degree the tax treatment as between an individual who purchases health insurance and one who chooses to self-insure. Without this deduction, it is likely that the taxpayer who purchases health insurance would never qualify for a medical expense deduction since his medical expenses are essentially averaged out over a period of years and will usually fall below the medical expense deduction floor. On the other hand, the medical expenses of taxpayers not covered by insurance tend to be concentrated in particular years, thereby making it likely that they will exceed the medical expense deduction floor in these years and qualify for a deduction. It was felt by the Ways and Means Committee in 1965 that such a disparity in tax treatment "may have the effect of discouraging the provision of insurance protection against future medical bills" (see Ways and Means

Committee report on H.R. 6675, 89th Cong. p. 137). For this reason, the existing deduction was added in 1965. And it would seem even more important, in view of the rising health costs, that it be maintained at this time.

The need for upgrading and broadening health insurance coverage is universally recognized. To destroy the present incentives in the tax law for the purchase of health insurance as part of a tax reform or simplification bill, while considering the best means to assure all Americans the best health insurance coverage, is contradictory. The Treasury and the public would be better served if Americans provided more, rather than less, health insurance for themselves.

To argue that the increased taxes on those persons providing their own defenses against the catastrophic financial impact of major illness will be offset by an increased standard deduction or otherwise lowered tax rates for all, is no answer to those adversely affected.

Many of those affected, particularly those struggling to buy their own homes (and thus taking substantial interest and tax deductions), will have their tax increased through the loss of the deduction, but will get no benefit from an increased standard deduction. Similarly, a general tax deduction spread over all taxpayers would only partially offset the increase in tax suffered by those losing the health insurance premium deduction.

The adverse results of this change will be magnified by the resulting increase in city, county, and State income taxes which are based on the Federal law.

Elimination of the separate deduction for health insurance does not mean a simplified return for all taxpayers. Millions of taxpayers take the health insurance premium deduction without taking a deduction for their other medical and dental expenses. For many of these, repeal of the simple health insurance deduction will eliminate one line of the tax form (a minimal simplification at best), but at the price of higher taxes.

For others, adding health insurance on to the other medical deductions will bring them over the "floor." Then, to claim a smaller medical deduction, they will have to justify not only their health insurance premium payments but all their varied medical and dental expenses which bring them up to the "floor." Thus, the life of some taxpayers would be simplified at a price, but for others it would be made much more complicated.

We further note that according to the latest published Internal Revenue Service figures, that this is not a deduction that affects those in high income brackets, but is basically a benefit for those in the middle and lower income brackets.

Recommendation

If the committee wishes to further simplify the return, we suggest the elimination of the existing limitation (50 percent or a maximum of $150). This would not only help those individuals who provide their own health insurance protection, it would simplify both the preparation and the audit of the return. Particularly it would simplify the return for the person who now has to make two computations instead of one.

Statement of the National Association for Uniformed Services

FEDERAL INCOME TAX EXEMPTION AND SICK PAY EXCLUSION FOR MILITARY DISABILITY RETIREES

We are indeed grateful for having been given the opportunity to submit to this distinguished committee our thought on two matters of vital interest to those who retired from the uniformed services for physical disability.

As a matter of background, our organization is composed of Active Duty, Reserve and retired, all other veterans, and wives and widows. We say this to emphasize that by including all categories of personnel, we receive a very diverse feedback and obtain a broad understanding of the impact of policy changes.

Section 104(a) of the Internal Revenue Code exempts military disability retired pay from Federal income tax. The basic principle underlying the exemption is to give material recognition to the individual whose earning capacity has been lessened and whose life expectancy has been curtailed because of injury or sickness incurred or aggravated while serving our country.

There are approximately 160,000 receiving military disability retired pay from the Department of Defense. Of that number, more than 96,000 are enlisted personnel. These retirees have based their financial plans for the remainder of their lives on the expectation that the Federal income tax exemption on disability retired pay would continue. They have made firm financial commitments based on the assumption that, once earned, these benefits would not be taken away from them by their Government.

The average retired pay of the 96,000 enlisted members is $291 per month or $3,492 per year. The average retired pay for the officer members is $455 or $5,460 per year. The 1975 poverty level for a family of 4 is $5,500. The Department of Labor estimates that it takes $9,200 per year for a family of 4 to maintain an austere standard of living. Surely our country is not in such dire straits that it must take money from the pockets of this group who were disabled in the services of their country when already they are suffering the ravages of inflation.

We are aware of the adverse publicity which alleged (but never proved) that a few high grade officers abused the disability retirement system. We emphasize that the total of all star grade officers retired for disability is only 1,224. That is less than 1 percent of the total, and remember that only a very few of this small percentage were accused of taking unfair advantage of the system. It would be extremely cruel to punish all 160,000 just to get at such a few. Latest data from the Department of Defense shows that the greateset number of disability retirees in enlisted grades is in the E–5 and E–7 levels and in the 02 and 03 level for officers. In addition, we suggest that tax laws are not the place to police the system. This should be done by administrative controls. Our information indicates that there has been a great deal of tightening down in the past several years; so much so that for a general, an admiral or a medical officer to retire on a physical disability now, it must be recommended by the Assistant Secretary of Defense (Health and Environment) and approved by the Secretary of Defense. See Public Law 94–225, March 4, 1976.

One of our esteemed members (Maj. Gen. Samuel E. Gee, U.S.A. Ret.) is well qualified to speak on this subject because for 5 years he commanded the U.S. Army's Physical Disability Agency which was responsible for the operation of six Physical Evaluation Boards and the Army Physical Disability Review Council. In a letter to Chairman Al Ullman of the House Ways and Means Committee last September, General Gee said, "* * * During my tenure with the Agency, over 70,000 cases were processed. About 70 percent of these involved members who had 4 or less years of service. I point this out since many people have the erroneous impression that only old folks are retired for disability. Due to the nature of the fighting in Vietnam and the fact that the Reserves were not called, young career officers and noncommissioned officers suffered tremendous casualties, both combat and noncombat. Over 80 percent of those processed were enlisted and less than 1 percent were generals. Each case was processed individually by at least one evaluation board and the review council consisting of a minimum of two doctors, one lawyer and three line officers. Not all cases were retired. Many were found fit, or not in line of duty, or that the disability existed prior to the term of service, or were a reevaluation of a case considered earlier and placed on the temporary disability retired list. * * *

"Unfortunately, as usual, we have the case of the dramatic incident where many are penalized because of the actions, real or imagined, of one. As in many other such cases, the scapegoat is a general—Lavelle by name. I have never met General Lavelle. From an inquiry to my Air Force counterparts when he retired for disability, it semed that the findings were legal and proper. The thing that was wrong was to have kept him on flying status in his physical condition. Now, we have another whereby at least one Congressman seems to have taken up the cudgels of those in the Office of the Assistant Secretary of Defense for Health and Environment in their protracted power struggle with the services over control of physical disability retirements. * * *"

The military careerist who retires for length of service but qualifies under the laws administered by the Veterans' Administration for disability compensation, must waive an equal portion of his military retired pay. He is the only veteran required to do this. Federal civil service retirees are not required to do it. No other veteran, no matter what his financial status, is subject to this reduction in income.

It was reported that the original House Ways and Means Committee proposal on this subject included removing the tax exemption from VA disability compensation. The loud protests from the over 3 million affected brought quick statements from the then Ways and Means Committee Chairman, Representative Wilbur Mills, that the Congress wouldn't think of treating its veterans that way. Yet the proposal was sent forward to remove the exemption for 160,000 other veterans.

Mr. Chairman, we urge this committee to continue the tax exemption for those drawing disability retired pay as has been done for those drawing VA disability compensation.

We also strongly urge continuation of the sick pay exclusion for disabled retirees. This exclusion has provided much needed assistance during the difficult adjustment period between retirmeent and attainment of normal retirement age. To eliminate or reduce it would create a financial problem for many who included this factor also in planning their finances upon retirement.

Several States have tax laws that parallel the U.S. Code. Consequently, elimination of these tax benefits would result in an increased adverse impact on retirees residing in those states.

Mr. Chairman, we hope that you and your committee will see fit to continue the federal income tax exemption and sick pay exclusion for those retired from the uniformed services on physical disability.

DENNIS S. KOLODY AND ASSOCIATES,
Warren, Mich., April 22, 1976.

Mr. MICHAEL STERN,
Staff Director, Senate Finance Committee,
Washington, D.C.

SENATOR RUSSELL LONG AND OTHER DISTINGUISHED MEMBERS OF THE SENATE FINANCE COMMITTEE: I want to thank you for this opportunity to express to you in writing, for your consideration, some of my thoughts and ideas on tax revision. It has been said before, and at the risk of being repetitious, I repeat, the most important aspect of our Federal tax system is the public confidence in it. That confidence has been eroded and will continue to be eroded unless steps are taken to stop that erosion. I feel there are two significant areas where confidence in the Federal tax system is being eroded: One is the increasing complexity of the system itself and the constant revisions attendant, involved in that complexity. Second, media representation of individuals, corporations and entities taking advantage of the system. These two areas must be addressed. The first is not any more important or difficult than the second. Both require and demand equal attention. We cannot continually, as we have been, revise and change our tax laws. We must to the extent that it is necessary, change and make the code equitable and consistent with economic policy. Howe.er, constant change of itself erodes confidence in the system. People, the average American citizen, cannot understand and keep up with the change. Even many "experts", IRS agents, CPA's and attorneys, have a tough time. Therefore, to a degree, this can be somewhat overcome by indexing many of the components in the law, the dependency deduction, the percentage standard deduction, the credit for personal exemptions and other items. Such a device will change as the economy changes and makes the necessary equitable adjustments to the system withnecessity of Congress delving deeply again and again and changing it again and again. I realize there are other areas and changing economic circumstances will require change from time to time but we should bear in mind that change of itself, even if deemed equitable, does erode confidence in the system and I mean to emphasize that point.

The second point is media negative reporting of the system. I would think that responsible media would point out more than one side; and if they do not, then some body of the government should have equal time or equal space to respond to such allegations. While it is true that there are individuals who pay a smaller percentage in Federal taxes than others, it is because they have taken the intended risks of business ventures in order to minimize their taxes; and in the end result, they may loose more than they ever saved in taxes. Further-

more, Congress has created those provisions in order to provide economic incentive to American industry and American capitalism upon which our system is built. To destroy those incentives, such as the investment tax credit, the ADR system of depreciation and depletion, and other would, if done solely in the name of equity, really destroy and hurt the economic vitality of the American system. It is vital that the other side of the story be told, while it is true there are some inequities and there are some unfair advantages being taken, they are not the case in every situation that is presented by the media.

Lastly, but not leastly, it is clear that the Internal Revenue Service is one of the best, if not the best, most efficient well run Government organizations, perhaps next only to the Senate Finance Committee. However, that does not mean that they cannot improve and expand their services and their fairness in dealing with taxpayers. In fact it is incumbent upon them and upon Congress that they do so, because it is clear to me, and I am sure to you, that the average American dealing with the Internal Revenue Service and the tax law, is continually perplexed, dismayed, confused, and often scared as hell. There are several possible remedies to this or perhaps a combination of these remedies. One, the Internal Revenue Service should itself more clearly and simply state the rights that taxpayers have and what is required of them. This may be difficult to do because on one hand it is true that the Internal Revenue Service is charged with the responsibility of collecting taxes, and this may, conflict with this rule. It may be necessary to set up a division within the service or a separate department in the Treasury to inform people of their rights. Another solution would be for the Government subsidies of some kind or/and practitioners and professionals to donate some of their time to giving tax counsel to the indigent and middle class taxpayers who cannot afford the tax counsel that the very wealthy have availed themselves of. This last point of mine is perhaps, as far as my knowledge is concerned, not old hat, but to some degree a new and novel idea. I do believe that it is necessary to implement some such program or to study the possibility of implementing it. The burden does not solely rest on Congress, but to a large degree it does and it must consider initiating such a program. The burden also lies on the professionals, certified public accountants, attorneys, agents enrolled before the Internal Revenue Service and the Internal Revenue Service.

I would like to thank you again for the opportunity to express some of my ideas and thoughts to you. I appreciate the complexity of the area and the difficult task facing you. I appreciate your work in the past and your continuing efforts in the future. Public servants have a difficult job but often the personal rewards far outweigh the personal sacrifices. You have much work ahead of you. Good luck, good tidings, and keep up the good work!

Sincerely,

DENNIS S. KOLODY,
Attorney and Counselor.

STATEMENT OF JAMES E. WHEELER, CHAIRMAN OF THE COMMITTEE ON FEDERAL INCOME TAXATION, AMERICAN ACCOUNTING ASSOCIATION

It is a pleasure for our committee to submit its written testimony. It should be made clear that this represents the view of this committee

but does not commit the association to any position. The committee members and their affiliations are listed at the end of our testimony.

A CHANGE IN DEDUCTION CATEGORIES CAN IMPROVE EQUITY AND REDUCE COMPLEXITY

To provide for more equitable and more consistent tax treatment among individual taxpayers, all currently deductible expenses associated with the production of taxable income should be deductible in arriving at adjusted gross income. Itemized deductions should consist solely of personal consumption expenditures which are specifically authorized by the Internal Revenue Code.

Within the formula for computing the individual income tax, various expenses usually appear either as deductions from gross income (GI) or as deductions from adjusted gross income (AGI).[1] Certain types of expenses (such as those incurred to produce income) may appear as deductions from either GI or AGI, depending upon whether the related income stems from a "trade or business" or from other sources (such as investments).

The major inequity under our present system of two deduction categories for expenses of producing income arises when the standard deduction is elected. Employees (persons in the business of furnishing their services to employers under the common law notion of master and servant) must claim certain expenses or portions thereof as deductions from GI (as specified in Code Section 62) while other expenses (such as the unreimbursed portion of entertainment, professional journals, uniforms, union dues, small tools, and so forth) must be treated as itemized deductions (deductions from AGI). Investors are forced to claim most of their income-producing expenses as itemized deductions. These taxpayers (employees and investors) lose the tax benefits of many of their income-producing expenses if they elect the standard deduction. This discriminates against employees and investors relative to taxpayers whose income sources qualify as a trade or business. This discrimination becomes greater when the standard deduction is increased as it frequently has been in recent years.

But even without the increased standard deduction, the dual treatment for expenses of income production has undesirable results. Depending on the source of income, the expenses of its production do affect AGI differently and thus alter those personal itemized deductions which are dependent upon the AGI figure. Why should the expenses of producing one type of income impact differently on the medical and charitable contribution deductions than the expenses of producing another type of income? The particular source of a person's income producing expenses should neither increase nor decrease otherwise allowable medical deductions, etc. Nor should the reimbursement or nonreimbursement of employee expense affect these personal itemized deductions.

The following appendix elaborates on the above points.

APPENDIX

The classification system

In the case of trade or business expenses, the appropriate classification of the deduction depends upon the capacity in which the expense

[1] About the only time expenses would not appear as deductions is when they may be taken as tax credits (e.g., in certain situations, Federal gas and oil taxes and certain foreign taxes).

is incurred—as a non-employee (proprietor or partner) or as an employee. If a trade or business expense is incurred as an employee, the appropriate classification of the expense is a function of the nature of the expense (travel, transportation, outside salesman, dues, licenses, and so forth). Further complicating the treatment of trade or business expenses incurred by employees is the treatment of expenses reimbursed by an employer. In some cases, reimbursement causes the deduction to be split with a portion of a particular expenditure deductible in each category.

In general, the expenses of an individual incurred to produce income could be classified as follows:

A. Deductible from GI if the expenses relate to a "trade or business": (1) conducted in a capacity other than as an employee; or (2) are travel, transportation, outside salesmen, and/or reimbursed expenses incurred by an employee.

B. Deductible from AGI if the expenses are: (1) trade or business expenses of an employee and they are not travel, transportation, outside salesman and/or reimbursed expenditures; or (2) incurred in an activity which fails to meet the notion of a trade or business.

The following is an illustration of classification of employment-related expenses incurred by an employee: Note that travel, transportation, and outside salesman's expenses are always deductible from GI, whether or not they are reimbursed.

Assume that in each of the cases, the taxpayer is an employee, and that he incurs employment related expenses totaling $3,000. He receives reimbursements from his employer totaling $1,500. The expenses are incurred for the following purposes:

Travel	$1,000
Transportation	500
Total	1,500
Dues and subscriptions	400
Professional licenses	600
Small tools	500
Total	1,500
Total expenses	3,000

Case A

The employee-taxpayer receives a $1,500 reimbursement specifically for the travel and transportation expenses he incurred.

Result

Gross income includes the reimbursement	$1,500
Deductions from GI:	
Travel	1,000
Transportation	500
Total	$1,500
Deductions from AGI: Other employment-related expenses	[1]1,500
Total deductions	3,000

[1] These amounts are deductible from AGI only when the taxpayer itemizes his deductions and does not claim a standard deduction.

Case B

The employee-taxpayer receives a $1,500 expense reimbursement specifically for his dues and subscriptions, professional licenses, and small tools. His travel and transportation expenses are not reimbursed,

Result

Gross income includes the reimbursement	$1,500
Deductions from GI:	
Travel expenses	1,000
Transportation expenses	500
Dues and subscriptions	400
Professional licenses	600
Small tools	500
Total	3,000
Deductions from AGI	0
Total deductions	3,000

It can be seen that under relatively similar circumstances the amounts deductible from GI range upward from $1,500 to $3,000 while the amounts deductible from AGI vary downward from $1,500 to $0. The various results stem merely from the expense category which is considered to be reimbursed by the employer. Given that an employer will reimburse the employee for a fixed dollar amount of his employment-related expenses, the mere fact that the employer designates the reimbursement to be for expenses other than travel, transportation, and outside salesman, will provide the employee with the maximum tax advantage.

To illustrate, assume that two taxpayers who are in a 30-percent marginal tax bracket will elect the standard deduction. The first taxpayer is reimbursed under the assumption of case A, whereas the second taxpayer is reimbursed under the assumption of case B. If they are otherwise similarly situated, the second taxpayer's tax liability could be $450 less than the first taxpayer.

Complexity under present law

Much uncertainty is associated with the notion of a trade or business and with the provisions applicable to expenses of producing wage income. The authority for deducting a trade or business expense is contained in Internal Revenue Code Section 162. But the notion of a "trade or business" is not defined in either the code or the Treasury regulations. Under regulation 1.162-1 and 1.162-2 [particularly 1.162-2(d)], it might appear that the earning of wage income constitutes a trade or business, but regulation 1.162-1(d) states that:

> For the purpose of the deductions specified in section 62, the performance of personal services as an employee does not constitute the carrying on of a trade or business, except as otherwise expressly provided.

Code section 62 does not authorize any deductions; it merely designates the place where valid deductions (deductible under the authority of other provisions such as sections 162 and 212) may be taken. In other words, section 62 simply classifies expenses as deductions from GI or from AGI.

Trade or business expenses of employees.—Even though wage income is considered to be trade or business income for most purposes.

Code section 62 requires that certain expense (primarily travel and transportation) of producing this income be deducted from GI and requires other expenses of producing this income to be deducted from AGI. Reimbursements further complicate the classification. If there has been a reimbursement by the employer, the expenses otherwise deductible from AGI become deductible from GI but only to the extent that they are reimbursed. Given these two deduction categories, partial reimbursement (due perhaps to a general expense allowance) causes inordinate complexity. For example, how much of each category of expenses has been reimbursed? Reimbursement of expenses of the first category (primarily travel and transportation expenses) does not affect the classification while reimbursement of expenses of the second category (for example, professional dues, entertainment, subscriptions, small tools, and so forth) can transform a deduction from AGI into a deduction from GI.

Trade or business versus investment activities.—The same type of activity, but conducted with different volumes of transactions, can receive different treatment. The question, "Is it a trade or business?," frequently arises in regard to individuals engaged in the purchase and sale of securities. This investment activity has led to the classification scheme of "investor," "trader," and "dealer." An investor is regarded as a casual securities trader and his investment related expenses are deductible from AGI.[2] A trader, in contrast, actively trades securities for his own account and thus he is considered to be in a trade or business with his investment related expenses deductible from GI. Lastly, a dealer maintains an inventory of securities which he sells to the public; he is clearly in a trade or business and his related expenses are deductible from GI. Whether an individual is more properly regarded as an investor or trader is a question of fact that frequently requires litigation to resolve. The point at which an investment activity shades into a trade or business is not always clear. The decided cases indicate that the number of transactions and the relative amount of time spent on the income-producing activity are more significant than the relative amount of income produced.

Obviously income production itself is not the key factor in the definition of a trade or business; if it were all of the expenses of producing wage or investment income would qualify as deductions from GI. As indicated earlier, an explicit definition of what constitutes a trade or business is not contained in the Code. The concept of profit motivation is frequently used to distinguish personal, hobby, and similar transactions from income-producing transactions. Within the Code, however, income production is considered to be a broader notion than that of a trade or business.

Net operating losses.—Another area of complexity involving the two deduction categories accorded expenses of producing wage income occurs when there is a net operating loss (NOL). In this case, certain expenses designated as deductions from AGI (for example, unreimbursed entertainment expenses) become business deductions in measuring the NOL (while not being regarded as expenses deductible from GI when computing taxable income). For purposes of computing a

---

[2] Whether an investor, trader, or dealer, the expenses in order to be deductible at all must relate to income which is taxable.

NOL, wages are considered as business income while income from investments is considered to be nonbusiness income. This treatment is clearly inconsistent with the classification scheme used in the deduction area. If expenses of producing wage income are business expenses for purposes of computing a NOL, why should some of them be treated as nonbusiness expenses for purposes of computing taxable income? This perhaps can be best illustrated by an overly simplified example comparing the NOL of a wage earner with that of a similarly situated investor. Assume the following facts occurred without any expense of income production:

	Individual A	Individual B
Salary	$20,000	0
Taxable interest income	0	$20,000
Adjusted gross income	20,000	20,000
Casualty loss deduction	(20,000)	(20,000)
Medical expense deduction	(21,000)	(21,000)
Taxable income before personal exemptions	(21,000)	(21,000)

$250,000 investment yielding 8 percent equals $20,000.

NOL COMPUTATION

	A		B	
	Business	Nonbusiness	Business	Nonbusiness
Wages (designated as business)	$20,000		0	
Interest (remain: nonbusiness)		0		$20,000
Casualty loss	(20,000)		[1] ($20,000)	
Medical		($21,000)		(21,000)
Total	0	(21,000)	(20,000)	(1,000)
NOLs	0		(20,000)	

[1] Casualty losses are always considered to be business losses for NOL purposes regardless of whether they involve business property or personal assets.

Within the measurement of a NOL, net nonbusiness losses do not increase the NOL while net nonbusiness gains would reduce the NOL. Note that if wages were designated as a nonbusiness source (as investment income is), individual A would have also enjoyed a $20,000 NOL.

Suggestions for improvement

The current concept of a trade or business does not serve any significant purpose. The problem of separating personal transactions from income-producing ones is not made easier because of this esoteric concept. It is, therefore, suggested that all income sources be considered as one category and that all expenses of income production be deductible from GI in arriving at AGI. The standard deduction, if taken, would then be replacing the same types of expenses (personal itemized deductions) for all taxpayers.

This would inmprove equity as the standard deduction would serve as a subsitute for the same types of deductions of every individual taxpayer without regard to the source of the taxpayers income. It would help to simplify compliance with the tax law since all income-

producing expenses would be deductible in one place in the tax formula. For employees this approach would remove the complexity in determining how much of a particular expense (for example, entertainment) has been reimbursed and is thus deductible for GI and how much is unreimbursed and thus deductible from AGI. This designation would also eliminate the gross inequity which currently exists in the measurement of an NOL.

For individuals with investment income, a problem of determining how much interest expense is attributable to personal use and how much is related to investment income remains. While this could be complex, it certainly does not appear to be of a sufficient magnitude to warrant our present two deduction categories for expenses of producing income. Since borrowed money is a fungible commodity, simple allocation rules, even if somewhat arbitrary, might easily provide the most equitable allocation of interest expense.

The same idea could be applied to any other potentially troublesome item such as State income taxes. Here the simple allocation rule could be the present general rule—itemized deductions only.

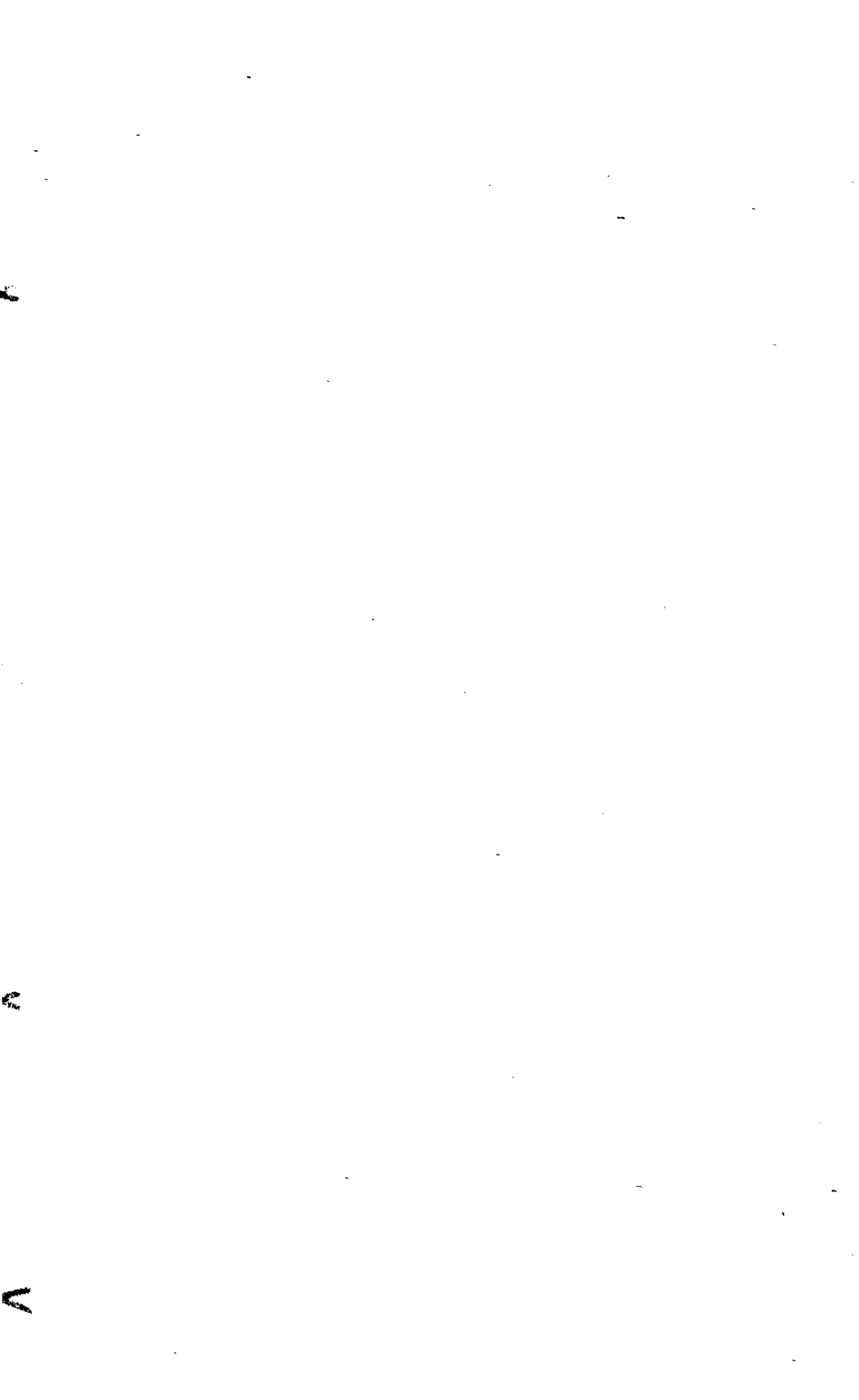
Our suggestions would probably increase the use of the standard deduction, and individuals might claim valid deductions which are currently lost due to ignorance and complexity; this would result in a revenue loss. By having one classification for expenses of producing any form of income, our suggestions would decrease AGI's, and thus result in increased medical deductions and, in limited cases, decreases in contribution deductions. The magnitude of the total revenue loss might be looked upon as a measurement of the present inequity. As to the NOL effects, there would likely be a modest revenue gain because personal itemized deductions would no longer offset investment income, a process which currently operates to increase NOL's of investors. With our suggestion, any individual's NOL would be easy to compute; it would simply be the adjusted gross income minus any casualty loss deduction.

Respectfully submitted by:

Albert H. Cohen, Price Waterhouse & Co. Prof. Hollis A. Dixon, University of Arizona. Prof. Dennis Gaffney, Northern Illinois University. Prof. Joseph E. Gibson, University of Virginia. Prof. John P. Klingstedt, the University of Oklahoma. Prof. Lawrence C. Phillips, Case Western Reserve University. Prof. Willis C. Stevenson, University of Wisconsin. Prof. James E. Wheeler, the University of Michigan.

Administrative Provisions

69-316—76--pt. 7——33



TAX CORP. OF AMERICA,
April 23, 1976.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee
Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted as a written statement by the Tax Corp. of America for the record of the public hearings before the Committee on Finance, relating to H.R. 10612.

The Tax Corp. of America is the second largest commercial tax preparer in the United States. It is vitally concerned that Congress recognize the important role in our Federal tax system now played by the commercial tax return preparer.

It is conceded by all involved that the Internal Revenue Code is extremely complex. Those who decry the complexity of our tax laws and call for "simplification" are most properly concerned with the impact on individual taxpayers. The point of that impact is, first, the annual agony of preparing a complicated tax return and, second, participation in audit of that return by the Internal Revenue Service. It is these areas with which both the Internal Revenue Service's taxpayer assistance service personnel and commercial tax return preparers are concerned.

In theory, the tax law could itself be simplified (and tax return preparation and audit thereby made relatively easy) by dispensing with the present system with all its special deductions, exclusions, credits and other refinements, and substituting in its place a simplified tax system. There are, however, in most cases good reasons for the complexity in present law, representing attempts over many years to "finetune" the tax system to achieve precise results and greater equity in the many varying situations of the elderly, the low-income individual, the larger family, the sick, those struck by disaster, and many others in special circumstances that are deemed to warrant some special adjustment in their tax liability. To change this system, so long embedded in our national economy and in the private lives of millions of taxpayers, likely would result in significant social, political, and fiscal dislocations. It is not realistic to expect simplification to be achieved at that price.

The available alternative is somehow to relieve the taxpayer of most of the burden of preparing a complex tax return—even though the law itself and the tax return remain complex. This can be achieved by broad-based, efficient, and readily available taxpayer assistance programs offered (*i*) by the Internal Revenue Service, (*ii*) by commercial tax return preparers, (*iii*) by accountants and attorneys, or (*iv*) by a combination of all three.

The Internal Revenue Service maintains a taxpayer service to respond to taxpayer questions and occasionally to prepare tax returns for individuals. In addition, section 6014 of the Internal Revenue Code

directs the Internal Revenue Service to compute the tax for taxpayers under certain limited circumstances.

The limitations on governmental taxpayer assistance must be recognized, however. First, the Internal Revenue Service does not, and probably should not, engage in large-scale preparation of tax returns. Second, if the Internal Revenue Service were to expand its services to include return preparation, it would be expensive, requiring significant additional authorizations. Finally, fundamental questions can be raised about the appropriateness of Internal Revenue Service preparation of tax returns in conjunction with its primary function of collection of taxes and administration of the Federal tax system.

Therefore, the expansion and strengthening of the commercial tax preparer services would appear to be most desirable in order to provide the necessary assistance to the lower and middle income taxpayer.

A number of Government agencies have examined various aspects of the tax preparation industry. These include the Federal Trade Commission, the Internal Revenue Service and the General Accounting Office. The GAO has prepared a report for the Joint Committee on Internal Revenue Taxation on commercial preparers in which the GAO found that:

"Commercial preparers, as a group, are not a special problem. A comparison of the returns prepared by commercial preparers with those prepared by professional preparers, a generally respected group, showed that the percentages of error in reported tax found by IRS were about equal. In addition, errors on the returns prepared by each appeared in the same places on the tax returns and were often made for the same reasons." [1]

Because of the rapid growth of the tax return preparer industry, the Congress properly is considering expansion of the authority of the Internal Revenue Service to deal with the industry. H.R. 10612 includes a number of provisions applicable to tax return preparers (§ 1201 of the bill). Although these provisions are very broadly drafted and could create unnecessary expense and confusion in the tax preparer industry, many of the ambiguities of concern have been clarified by the report of the Committee on Ways and Means accompanying H.R. 10612. To the extent that these and several other matters are clarified, the Tax Corp. of America supports this legislation. It does so for two reasons. First, section 1201 provides acknowledgment of the need for the commercial tax preparation industry in the Federal tax system. Second, this section grants authority to the Internal Revenue Service to control any potential abuses which may arise in the industry. Elimination of such abuses obviously benefits both our tax collection system and the tax preparer industry.

The Tax Corp. of America operates through independent counselors who assemble the information necessary for preparation of a return and forward this information to the company, which actually prepares the return. TCA signs each return, sends the original to the taxpayer for signature and filing, and retains all copies of the work papers and the returns in its records. TCA thus already is complying with

[1] "No Apparent Need To Regulate Commercial Preparers of Income Tax Returns," report to the Joint Committee on Internal Revenue Taxation, Congress of the United States, by the Comptroller General of the United States, Dec. 8, 1975, at p. 20.

the standards which H.R. 10612 would make mandatory for all tax return preparers.

In situations involving relationships such as those between TCA and its counselors, the report of the Committee on Ways and Means makes clear that information returns can be filed by the company which include the names of each counselor.

"Your committee's bill also requires that employers of income tax return preparers make an annual report to the IRS listing the name, taxpayer identification number, and place of work of each tax return preparer employed during the year. For purposes of this requirement, an individual who is self-employed as an income tax return preparer, or who acts as an independent contractor (other than as an agent of another tax return preparer which files a return that includes the agent), is required to file his own information return." (House Ways and Means Committee report on H.R. 10612, H. Rept. No. 94–658, 94th Cong. 1st sess. at 277.)

In compliance with this requirement, Tax Corp. of America is willing to file an information return for itself and on behalf of its independent counselors. In addition to clarifying who may file the information return where more than one preparer is involved in preparing returns, the Ways and Means Committee Report also makes clear that the bill has not intended to affect employer-employee definitions under any other Federal law. (Id. at 276 n. 1). TCA believes this clarification to be appropriate.

Several other ambiguities should be resolved by this committee. In situations where more than one tax return preparer is involved in the preparation of a return, records should be required to be retained and a copy of the return should include the identification number and be supplied by only one of the preparers. The preparer complying with these provisions should be required to retain records which will disclose the names of other preparers assisting in the preparation of a return and records of all returns in which a particular preparer assisted. In this way, the goal of having immediate access to all records and returns prepared by a particular individual can be achieved without unnecessary duplication of efforts or of recordkeeping. The necessary Internal Revenue Service regulation of individual return preparers thus can be achieved and, if necessary, civil sanctions for negligence could be imposed on such individuals. The report of this committee, however, should make clear that the responsibility for having accurate documentation with respect to a return lies with the taxpayer and that the return preparer is not required to verify such documentation in preparing a return.

The foregoing matters can be resolved by additional explanations in the Finance Committee report. We enclose as attachment I to this statement suggested report language which will achieve the purposes outlined herein. One item of concern to TCA, however, requires action by this committee.

Individual taxpayers may require assistance at two distinct levels in their relationship with the IRS: first, in preparing the taxpayer's return and, second, in the event of an audit of that return. IRS rulings limit the extent of commercial tax preparer assistance at the second stage, however. The IRS has taken a position that, in effect, prohibits

any person qualified to practice before the IRS from employment or association with a commercial tax return preparer. Treasury Department Circular No. 230 prohibits enrolled agents, as this classification of persons is defined in IRS regulations, from forming an association with persons soliciting business in a manner prohibited to attorneys or certified public accountants (§ 10.30). Since, as with every other business, advertising is an important aspect of operations, this requirement prohibits use of enrolled agents by commercial tax return preparers.

The IRS position has the practical effect of precluding qualified representatives of commercial tax return preparers from assisting taxpayers in any audit of their returns. This is highly incongruous since circular No. 230 permits nonenrolled tax return preparers to participate before revenue agents or district examining officers of the Audit Division with respect to returns which they have prepared [§ 10.7(7)]. The prohibition on association by enrolled agents with commercial tax return preparers is undesirable because it either denies taxpayers the most appropriate representation before the IRS or leads to a duplication of efforts with respect to such representation since the taxpayer is required to seek assistance from other, often more expensive, sources.

If the provisions of H.R. 10612 applicable to tax return preparers were to become law, the IRS position enunciated in circular No. 230 is not only burdensome to the taxpayer, but may be unfair to the tax return preparer. H.R. 10612 authorizes imposition of civil sanctions for negligence in the preparation of a return. Section 6694(d) which is added to the Code by H.R. 10612 provides that these sanctions are abated if a final administrative or judicial determination of the taxpayer's liability is made and a determination is made that no understatement existed for which the sanction was imposed. Because of the tax preparer's direct interest in the resolution of the taxpayer's liability, the preparer should have the opportunity to defend in the audit the position taken in the preparation of the return provided he is otherwise qualified to practice before the Internal Revenue Service or should have the opportunity to secure assistance from someone qualified to practice before the Service. Ability to participate in the taxpayer's audit presents many tax return preparers with a far more realistic opportunity to defend themselves than the costly administrative and judicial appeal structure established to permit review of a $100 civil sanction.

TCA would be happy to discuss the issue of participation by tax return preparers in taxpayer audits with the staff in greater detail so that an appropriate amendment could be prepared to alleviate this problem.

Very truly yours,

ROBERT J. DULSKY, *President*.

ATTACHMENT I

Suggested Report Language With Respect to § 1201(c) of H.R. 10612 [adding IRC § 6107] and § 1201(d) [amending IRC § 6109(a)].

Disclosure requirements [1].—If more than one tax return preparer assists in the preparation of a return, various obligations would be

[1] This paragraph could supplement the disclosure requirements discussed at 277–278 in Committee on Ways and Means report on H.R. 10612, H. Rept. 94–658, 94th Cong., 1st sess.

imposed on all such preparers under the bill. These requirements include: (i) stating on the return the identification number of the tax return preparer, (ii) retention of a copy of each return or list of returns prepared, and (iii) furnishing a copy of a return to the taxpayer at or prior to the time of signing such return. The Secretary has been given authority to establish rules and regulations with respect to situations involving more than one preparer participating in the preparation of a return. The committee expects that these obligations can be satisfied by one preparer so long as such preparer maintains records which disclose the names of all preparers assisting in the preparation of a particular return and records of all returns on which each such preparer assisted.

Suggested Report Language With Respect to § 1201(b) [adding IRC § 6694]

Penalties for negligent or fraudulent preparation[2].—The provision for imposition of penalties for negligent preparation of returns resulting in understatement of tax liability is not intended to require the tax return preparer to become an auditor with respect to the supporting data for a particular return. The tax return preparer should not bear the risk of such penalties if he fails to make a complete audit. The responsibility for adequate documentation rests with the taxpayer.

NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS,
Washington, D.C. April 12, 1976.

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

DEAR MR. CHAIRMAN: The National Society of Public Accountants is located at 1717 Pennsylvania Avenue NW., in the District of Columbia. NSPA represents some 16,000 independent practicing accountants who are principally serving the small business community of this country with accounting, tax and auditing functions.

Because the laws governing the practice of public accountancy are so varied, our membership includes certified public accountants, licensed or registered public accountants, accounting practitioners and accountants who practice under a number of other titles or descriptions.

It is our intention to focus our statement upon several narrow, but extremely important, aspects of the legislative inquiry before this committee in the tax reform area. We shall concentrate on the tax return preparer and proposed regulation of this field of activity.

NSPA is deeply concerned with the language in title XII of H.R. 10612 on several counts. We are also very concerned with what is *not* expressed.

The treatment of tax return preparers is something which ultimately touches nearly one-half of all of this country's taxpayers.

[2] Id. at 278–281.

Why? IRS studies show that a very large number of individual taxpayers use the services of outside preparers—both professional practitioners such as accountants, attorneys and enrolled agents and commercial preparers. Moreover, reports from the largest commercial tax preparation company indicate a sizeable increase in business in 1975. Yet one of the present problems is the lack of completely accurate information about the total source of outside assistance used by individual taxpayers.

NSPA would endorse most of the policies behind the provisions in title XII but the language adopted may not be the best means to achieve these goals.

DEFINITION SHOULD BE IMPROVED

We are disturbed by the definition found in section 1201(a). We are not sure whether this clearly and accurately establishes liability on the proper parties. It conceivably could exempt employees of preparers under (37)(B)(ii).

It would be more effective, in our view, to adopt the definition of a preparer already established by the Internal Revenue Service in its regulations on disclosure of tax information contained in 26 CFR, section 301.7216-1. This would provide consistency in the terminology. These regulations have already been put into force after exposure for public comment.

STANDARD OF CARE SHOULD BE CLEAR

NSPA firmly supports reasonable measures to penalize the incompetent or unscrupulous tax return preparer. We are, however, concerned with the careful delineation of the standards of care and degree of responsibility that a tax return preparer is expected to possess where the client supplies the data on which the return is based.

Testimony by the Secretary of the Treasury in 1973 expressed the view that "The effect of the proposal will be to make tax return preparers responsible *to a much greater degree than at present, for the returns they prepare*, and to raise the degree of compliance with internal revenue laws" (emphasis added).

It was further stated, "A preparer's obligations will be *to process* facts relating to a taxpayers financial affairs on a return in a manner *that reflects a proper application of the internal revenue laws, but a preparer will not have a duty to collect all relevant facts if the taxpayer does not furnish them or to verify those that are furnished*" (emphasis added).

This "clear" statement of policy is even less clearly set out in the language of section 1201(b).

What is the "proper application of the internal revenue laws"?

In a recent review of the taxpayer assistance program of IRS, the General Accounting Office verified what the Subcommittee on Oversight of this Committee had already determined. That is, that in a frighteningly large number of cases the IRS was incapable of properly applying the internal revenue laws to a relatively uncomplicated factual situation presented to them for a simple "yes" or "no" determination.

If this is a failure to properly apply the internal revenue laws, should federal employees be held to this standard with resultant liability?

A GAO report—"Telephone Assistance to Taxpayers Can Be Improved" (GGD-75-69)—found that incorrect answers about the proper application of internal revenue laws were given 18 percent to 20 percent of the time.

The present language of section 1201(b)(1) calls for civil penalties whenever the understatement of liability is due to the "negligent or intentional disregard of rules and regulations".

Negligence has been defined by decisions and regulation as applied to the taxpayer. Before the term, with its attendant civil penalties, is made to also apply to the tax return preparer, some safeguards and clarifications would seem in order.

If "willfulness" were an element of the cause of action under the "negligent or intentional disregard of rules and regulations" (that phrase being read to call for both elements) and that burden of proof were placed upon the Government, then NSPA would wholeheartedly endorse the provision.

NSPA would support a simple negligence standard even without willful action on the part of the preparer if clear and reasonable standards for the preparer were part of the legislation.

In any event, the actions needed to give rise to negligent or intentional disregard should be specified. Whether both neglect and intentional action (or inaction) are required to trigger this section should be clearly stated.

The burden is placed on the preparer to bring an action in a Federal district court for a refund of any payment of any penalty. This seems to us to be unfair since the civil monetary penalty is being utilized as an enforcement tool with criminal liability overtones.

It is interesting to note that only errors or actions leading to understatements of liability are penalized when, in fact, negligence could easily be in favor of the Government and to the detriment of the client.

NSPA SUPPORTS OTHER PROVISIONS

NSPA supports the requirement of section 1201(c) that the preparer must furnish a copy of the return to the taxpayer and retain either a copy of the return or a list of clients for 3 years. We have no objection to making this available for IRS inspection since the tax preparer identification information is to be disclosed on the return anyway. We support this concept in section 1201(d) and, in fact, that is a basic element of our own proposal for registration which we described in our statement to the House Ways and Means Committee on July 25, 1975.

The filing of an informational return listing preparers working for him is certainly unobjectionable to NSPA although it will involve additional recordkeeping and time.

The civil monetary penalties for failure to furnish a copy of the completed return to the taxpayer, failure to sign the return, failure to furnish the identifying number, failure to retain a copy of list, failure to file a correct information return listing preparers are all reasonable and appear to us to be an effective approach.

INJUNCTIVE POWER SHOULD BE LIMITED

The injunctive power of the Government to halt further preparation by a person preparing returns is a powerful remedy which should be carefully defined.

A question exists whether it should be available for negligent understatement of liability as presently set out in proposed section 6694. Should the degree of participation and scope of behavior by a preparer be so clearly harmful to the public, or some judicial finding of willful intent be present, so as to give basis for this action?

While NSPA agrees that misrepresentation of eligibilty to practice before IRS should be a grounds for strong remedies, we would like to see clarification in the law about the elements constituting misrepresentation of experience and education as an income tax return preparer.

NSPA does not permit any advertising or solicitation under its Code of Professional Ethics, but we are aware of the potential abuses and believe further refinement of the definition is necessary in the law so that regulations promulgated will have a legislative intent to guide their development.

A guarantee of refund or allowance of tax credit should be punished.

A very substantial concern exists in our minds with respect to the catchall phrase "engaged in any other conduct which is similar in nature to conduct specified in paragraph (1), (2) or (3) and which substantially interferes with the proper administration of the internal revenue laws". We know that this has been applied to shooting a revenue officer. We question what else it may be interpreted to mean in the context of its application to income tax return preparation. This has been modified in the House in an attempt to add greater clarity, but this may still be susceptible to abuse. Since this part represents a generalized category in addition to the specified grounds for injunctive action, we believe it could be deleted without impairing the ability of the service to act against demonstrable harms.

Injunction authority gives IRS a tremendous threatening power over preparers which might be abused at a local level, even contrary to national office directives of IRS.

The filing of a bond in the amount of $50,000 to stay any injunction specified above places large commercial firms in an advantageous position vis-a-vis individual practitioners. The resources for securing such a bond would certainly be more readily available in those instances whereas a sole practitioner might be effectively put out of practice while awaiting adjudication even if eventually exonerated.

SUMMARY OF VIEWS

NSPA takes the view that:

1. The definition of a tax return preparer now used by IRS in 26 CFR 301.7216-1 be employed.

2. The burden of proof of any alleged negligence should be placed on the Internal Revenue Service, not the return preparer.

3. The following language from the House Committee report should be incorporated into the legislation itself in section 1201(b)(1)(a):

"The penalty applies generally to every negligent or intentional disregard of such rules and regulations except that a good faith dispute by an income tax return preparer about an IRS interpretation of a statute (expressed in regulations or rulings) is not considered a negligent or intentional disregard of rulings and regulations. The provision is thus to be interpreted in a manner similar to the interpretation given the provision under present law (section 6653(a)) relating to the disregard of IRS rules and regulations by taxpayers on their own returns".

4. The bill should also include in section 1201(b)(1)(a) the following language proposed in the Government's own testimony of April 30, 1973:

"A preparer's obligation will be to process facts relating to a taxpayer's financial affairs on a return in a manner that reflects a proper application of the internal revenue laws, but a preparer will not have a duty to collect all relevant facts if the taxpayer does not furnish them or to verify those that are furnished".

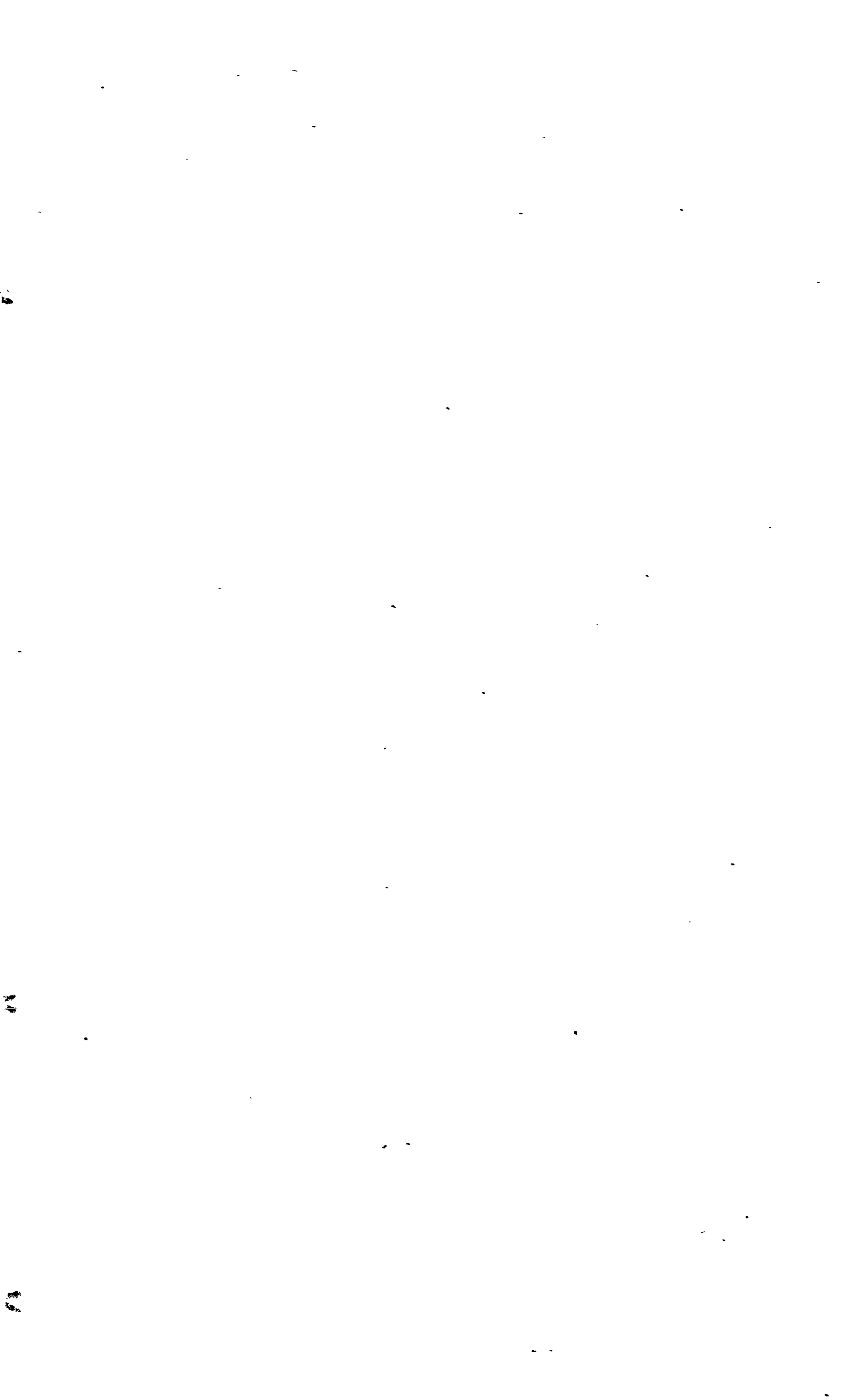
5. The provision in proposed section 7407(a)(4) should be deleted.

We would like to express our appreciation to the committee for this opportunity to be heard on this important matter. We pledge to you our cooperation in finding a practical solution to this complex and significant problem.

Sincerely,

ALBERT R. VAN TIEGHEM, *President.*

Tax Treatment of Employee Benefits Under Group Legal Service Plans



AMERICAN BAR ASSOCIATION,
Washington, D.C., April 8, 1976.

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

DEAR MR. CHAIRMAN: On behalf of the American Bar Association, I am writing to urge your committee to incorporate the provisions of S. 2051, relating to the tax treatment of employee benefits under group legal service plans, in H.R. 10612, the "Tax Reform Act of 1975," now under consideration by your committee.

Recent surveys conducted for the American Bar Association by the National Opinion Research Center have indicated that vast numbers of middle-income citizens do not receive needed legal assistance in resolving common problems. One of the most effective means of assuring the availability of such services to these citizens is through prepaid group legal service plans. Under such plans, individuals pay an annual premium to a fund and in return are guaranteed the availability of certain legal services. The association has been actively involved in encouraging and supporting the development of such plans, including the prototype in Shreveport, La.

The prime area for development of these beneficial programs has been in employee groups. Amendments to the Taft-Hartley Act in 1973 specified such plans as a proper subject for collective bargaining. But the uncertainty of the tax consequences to the employee of participation in such plans has stifled their use.

S. 2051 would clarify the situation by providing that an employee's gross income would not include the value of legal services furnished to the employee under the prepaid plan. The bill would provide for prepaid legal service plans to be treated like group medical plans with respect to the tax incidents of the employee.

The association has been in support of such legislation since 1974. We urge your committee to consider this legislation now so that such plans can be fostered and thousands of citizens can be benefited thereby.

Sincerely,

LAWRENCE E. WALSH.

Statement of Charles L. Huber, National Director of Legislation, Disabled American Veterans

Mr. Chairman and members of the committee: The Disabled American Veterans deeply appreciates this opportunity to participate in today's hearings for the subject of tax reform is "near and dear" to the hearts of most American's, including the 500,000 members of the Disabled American Veterans.

As an organization whose primary legislative goal is to initiate and support beneficial veterans' legislation in the Congress, the DAV would not normally take an official, public position on the issue of tax reform. However, in addition to supporting improvements in Federal benefit programs afforded to service-connected disabled veterans, their dependents and survivors, the DAV is directed by its National By-Laws to "resist and oppose any changes in laws . . . that would . . . deprive veterans or their dependents of benefits already granted by such laws" (paragraph 5, Section 7.10, DAV By-Laws).

It is this "continuing mandate" to safeguard existing veterans' benefits which compels our appearance here today, for a provision of H.R. 10612, the House passed Tax Reform Act, would indeed deprive service connected disabled veterans of federal monetary benefits—benefits that are due them solely on the basis of their having incurred a service related disability.

The provision in question is contained in Title V, Section 505 of H.R. 10612. Our objection is centered on paragraph (b) of Section 505 which proposes to alter the present income tax status of military disability retirement pay.

At present, Mr. Chairman, the uniformed service retirement pay of officer and enlisted personnel that is based on a service incurred disability is not subject to federal taxation (Section 104(a)(4) of Title 26, U.S. Code). The above mentioned provision of H.R. 10612 would remove this tax exempt status from all future military disability retirees who, (1) will have commenced active military service on or after September 25, 1975, and (2) who will have retired for disabilities not related to combat, extra hazardous duty or instrumentalities of war.

Mr. Chairman, never in our Nation's history has federal monetary payments based on the incurrence of a service related disability—be they emanating from the Veterans Administration or from a branch of our armed services—been subject to taxation.

This is just one of many material manifestations of gratitude that have been extended by the American people to its disabled veterans over the years. Taxation of military disability retirement pay, even on a limited basis, would be in direct conflict with the American tradition of special concern for this category of its veteran population. It is distressing to contemplate that this might occur in the year of our bicentennial celebration.

I hasten to add here, Mr. Chairman, that the DAV position on this matter has more substance to it than a mere, "status quo" opposition to change. As we shall point out, not only does this proposal place in jeopardy the entire concept of tax exemption for veterans' benefits, in addition, it would unfairly penalize future generation of service-connected disabled veterans, the vast majority of whom would be lower ranking enlisted and officer personnel. We also believe this aspect of the tax reform bill is based on misconceptions of the issues involved and pursuit of a goal which would not be realized even if the provisions were to become law.

I believe the following information will substantiate these contentions.

DISABILITY RETIREES

There are currently 95,000 former enlisted personnel and 65,000 former officer personnel who are drawing military disability retirement pay based on the incurrence of a service related wound, injury or disease. These disability retirees should not be confused with military longevity retirees (approximately one million), who are retired on length of service. Retirement pay based on disability is currently tax exempt, longevity retirement pay is not. The largest number of disability retirees, approximately 100,000 falls within the enlisted pay grades E4—E7 (Corporal—Gunnery Sergeant) and officer pay grades 0-2—0-5 (1st Lieutenant—Lieutenant Colonel). Disability retires who are in pay grades 0-7—0-10 (General ranks) comprise only .7 of 1 percent of the 160,000 total. The average monthly disability retirement pay of all retirees is approximately $402. The average monthly pay for enlisted disability retirees is only $257.

CAREER COMPENSATION ACT OF 1949

Prior to this law enlisted personnel could not retire on disability from the armed services. This in large measure accounts for the rather high ratio of officer personnel found among disability retirees—slightly more than 1 in 3 disability retirees are officers. On the other hand, among active duty personnel, slightly under 1 in 7 are officers. With the passage of time the disability retiree officer/enlisted ratio should approach that which applies to active duty personnel.

SICK PAY EXCLUSION EXEMPTION

Information on this subject is necessary as many people are under the impression that the tax exempt status of military disability retirement pay is directly related to the sick pay exclusion provisions of current law, and that a change in the sick pay exclusion provisions (Section 105(d) of Title 26, U.S. Code) necessitates a change in the law which authorizes tax exclusion of military disability retirement pay (Section 104(A)(4) of Title 26). This is untrue.

By virtue of IRS ruling RR 58-43, some military disability retirees, who meet certain eligibility criteria, find it advantageous to use the sick pay exclusion exemption. However, it must be understood that the tax exemption given to them under sick pay exclusion applies only to that portion of their retired pay which is based on length of

service and subject to taxation, not to that portion of their retired pay which is based on physical disability and already tax exempt.

Therefore, if it is this Committee's desire to alter or indeed eliminate the sick pay exclusion provisions which apply to all Americans, including military disability retirees, this can be done without changing in any way the current tax status of military disability retirement pay as authorized by Section 104 (a) (4) of Title 26. It is not necessary to reduce (tax) military disability retirement pay in order to correct any inequities in the current application of the sick pay exclusion exemption. I have attached to this statement an addendum which explains fully the use of the sick pay exclusion exemption by some military disability retirees.

HOUSE REPORT NO. 94-658 ON H.R. 10612

At the outset it should be noted that a savings through increased tax revenue is not at issue when considering the taxation of military disability retirement pay as proposed in H.R. 10612, and the House Report clearly states this fact. No revenue impact is expected whatsoever for quite some time and, in our opinion, when it does come it will be so small as to be insignificant.

According to the report, the primary reason for taxing the disability benefits of a limited number of future retirees is to prevent the abuse of military disability retirement determinations which allegedly has been occurring.

Mr. Chairman, we are all aware of recent "horrible examples" which indicate that some high ranking officers, seemingly in the best of health, are "suddenly" retired on tax free disability benefits shortly before they were due to retire on taxable length of service pay. Human nature being what it is, I am sure that "abuses" such as these do occur. However, this proposed solution to eliminate such abuses by a few is patently unfair to those future retirees who will incur bonafide serious service related disabilities that will require termination of their military careers.

Not only is this "shotgun" approach unjust, it simply would not work, for the incentive and the ability to abuse the system, that is, to gain tax-free retirement pay, would still exist. If a high ranking officer is disposed to use the influence of his position in a questionable way, the proposed change in Section 104 (a) (4) of Title 26 would not prevent him from attempting to secure an undeserved "combat related" status for a particular disability, or from attempting to secure a higher percentage disability rating than should be assigned. Frankly, the actual abuse or potential to abuse the disability retirement system would not be changed one iota by the proposed amendment of present law.

In fact, Mr. Chairman, the goal sought by this provision of the Tax Reform Bill has, in our opinion, already been achieved by virtue of a law recently enacted by the Congress. I refer to P.L. 94-225 which was signed by the President on March 4, 1976.

This legislation, among other things, requires that in cases of general and medical officers retiring for length of service, a finding of unfitness for duty by the Service Secretary concerned which would make such officers eligible for disability retirement pay, must first be approved by the Secretary of Defense with the prior recommendation

of the Assistant Secretary of Defense for Health and Environment. I submit, Mr. Chairman, that P.L. 94-225 will prove to be an effective vehicle for the prevention of military retirement abuses, and that its enactment renders superfluous the change in law proposed by Section 505 (b) of H.R. 10612.

In summation, Mr. Chairman, the proposed amendment to Section 104(a)(4) of Title 26, which I again underline need not be taken in order to effect changes in the sick pay exclusion exemptions of current law, would do the following:

1. Produce no additional revenue for the Federal Government in the near future and very little in the long run.

2. Reduce the relatively modest monthly disability benefits of certain future retirees, the vast majority of whom will be lower ranking enlisted and officer personnel.

3. Will not prevent or discourage present and future abuse in military disability retirement determinations.

4. Will depart from the time honored tradition of providing non-taxable federal benefits for disabilities incurred while on active military service, and

5. Encourage future encroachment upon the benefits and services afforded to American's service connected, disabled veterans.

Mr. Chairman, for these reasons the DAV respectfully urges this Committee to reject in its entirety that portion of H.R. 10612 which would amend Section 104(a)(4) of Title 26, U.S. Code.

In closing may I again thank you and the members of this Committee for giving us this opportunity to present our views on this important subject.

Addendum—Military Disability Retired Pay

Section 104(a)(4) of the Internal Revenue Code currently provides for the specific exclusion from gross income of:

> Amounts received as a pension, annuity or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces of any country or in the Coast and Geodetic Survey or the Public Health Service (or as a disability annuity payable under the provisions of Section 831 of the Foreign Service Act of 1946, as amended (22 U.S.C. 1081; 60 Stat. 10211)).

Under present law, if a member of the uniformed services of the United States is retired for disability, part or all of his retired pay will by excluded from federal income taxation. The manner in which the retired pay is computed determines whether any of the pay is subject to federal income tax.

If the member is receiving disability retired pay computed solely by multiplying his percentage of disability times his basic pay, all of his retired pay is currently exempt from federal taxation.

If he chooses to have his disability retirement pay computed on length of service (2½ percent times years of service times basic pay), the amount of his retired pay, which is in excess of the amount he would have received if he had elected to have his pay computed on the basis of his percentage of disability, is not excluded.

Example

An officer, Grade O-4, with 26 years' service, retires with a 40% disability. He elects to have his pay computed on the basis of his

length of service. His monthly retired pay is 2½% x 26 years (65%) x $1,494.00, or $971.00. If his retired pay was computed on the basis of his percentage of disability, it would be 40% x $1,494.00, or $597.00. The differences between the two figures—$971.00 minus $597,00, or $374.00 per month, would be subject to income tax, and would appear on his withholding statement (Form W-2), issued by the Finance Office.

USE OF THE SICK PAY EXCLUSION BY SOME MILITARY DISABILITY RETIREES

Under Revenue Ruling 58-43, however, the disability retirement pay which is in excess of the amount excluded under Section 104(a)(4) of the Internal Revenue Code may be excluded from gross income to the extent provided in Section 105(d) of Title 26 if such "sick pay" is received before the member reaches mandatory retirement age.

This same ruling (RR 58-43) also held that a member of the Armed Forces on the retired list for reasons other than physical disability is not absent from work on account of personal injuries or sickness within the meaning of Section 105(d) of the Internal Revenue Code. Therefore, no part of the retired pay of such a member may be excluded from gross income under the provisions of that section.

To be eligible for the "sick pay" exclusion, Mr. Chairman, the military retiree must be (1) retired for disability, (2) must not have reached mandatory retirement age, (3) must not be employed by the U.S. Government, and (4) his retired pay must be partially subject to taxation.

The following examples taken from the Uniformed Services Almanac illustrate the application of the sick pay exclusion to military retired pay:

(a) Lt. Smith retired after 22 years' service for a physical disability rated at 40 percent. He elected to have his disability retirement pay computed on the basis of his longevity, which amounted to $679 (i.e., $1,216.80 times 55 percent) per month. His percentage disability, 40 percent, times his monthly pay equals $487, and this amount is excluded from income tax. The balance of $192 per month, being at a payment rate of less than $100 per week (the maximum amount excludable under sick pay exclusion), is excluded from gross income until he reaches "retirement age", which is the earliest of the dates that he would have completed 40 years service or reached age 62.

(b) Major General Jones enlisted in the Army on July 1, 1932, was later commissioned, and was continuously on active duty until June 1, 1973, when he was placed on the retired list with a 30 percent disability. He elected $2,025 monthly retirement pay on the basis of over 30 years service ($2,700.30 times 75 percent). He would be entitled to a monthly exclusion of $810 ($2,700.30 times 30 percent) based on the disability portion of his retirement pay. However, since he had already reached "retirement age"—40 years' service or age 60—he may not apply the sick pay exclusion and the balance of $1,215 per month is taxable income.

(c) Major Kelley retired on June 1, 1973, after 26 years' service and not for physical disability. No part of his retirement pay of $914.75 $(1,407.30 times 65 percent) is excluded from gross income since disability was not a factor and neither can an amount based on the sick pay exclusion be applied.

(d) Sergeant Burns was placed on the military disability retirement list after 12 years' of active military service with a 60 percent physical disability. His basic pay at the time of retirement was $643.00 per month. His disability retirement pay computed on the basis of length of service (30 percent times $643) would be $192.90 per month. Computed on the basis of his percentage of disability (60 percent times $643), his retirement pay is $385.80 per month. Sergeant Burns obviously chooses the percent of disability computation method and all of his retirement pay is excluded from taxation under Section 104(a)(4) of Title 26.

Sergeant Burns makes no use whatsoever of the sick pay exclusion provisions of Title 26.

The foregoing examples clearly demonstrate that the sick pay exclusion is not applicable in the case of military retirees whose retirement pay is computed solely on the percentage of their service-incurred disabilities, or who do not meet the other eligibility criteria.

Statement of Paul H. Chappell, Attorney at Law, Chevy Chase, Md.

INCOME TAX RETURN PREPARERS

I am submitting for consideration by the Senate Finance Committee my comments regarding section 1201 of H.R. 10612 (Tax Reform Act of 1975) relating to the regulation of income tax return preparers.

BACKGROUND

According to the House Committee Report accompanying H.R. 16012, section 1201 is intended to grant the Service authority to regulate administratively (and penalize) unqualified, grossly negligent, or unscrupulous tax return preparers. The rapid growth of the business of commercial preparation of tax returns has created a number of widespread abuses such as the practice of flatly guaranteeing a taxpayer that he will receive a refund, obtaining a taxpayer's signature on a blank return (*i.e.*, before it is prepared), claiming fictitious deductions and exemptions on a return in order to achieve a tax refund promised the taxpayer, misrepresentation of the preparer's qualifications, failure to retain or provide the taxpayer with a copy of his return, etc.

PROVISIONS OF SECTION 1201

Under present law, persons who prepare returns for others for a fee may be subject to criminal penalties under section 7206 of the Code for willfully aiding or assisting in the preparation of a fraudulent return. The House Bill would add provisions granting the IRS authority to regulate preparers and penalize abuses. Section 1201 of H.R. 10612 contains a number of provisions dealing with tax return preparers, including the following:

1. Each prepared return, statement, or other document must contain the identification number of the return preparer and other data sufficient to identify the preparer. A $25 penalty is provided for each failure to comply, if without reasonable cause.
2. Each preparer must furnish to a taxpayer a copy of the return or claim for refund prepared by the tax return preparer at the time the return is given to the taxpayer for his signature. A $25 penalty is provided for failure to comply, if without reasonable cause.
3. Each return preparer or person employing a tax return preparer to prepare the returns of others must file an annual report with the IRS listing the name, address, identification number and place of work

of each preparer he employs. Failure to comply without reasonable cause would result in a $100 penalty for each failure to file an annual return and a $5 penalty for each failure to include a name, address, identification number or place of work in the annual report. These penalties are not to exceed $20,000 for a 12-month period.

4. Each return preparer or employer of return preparers must retain for three years either a list of taxpayers for whom returns were prepared or copies of their returns and claims for refunds. Return preparers are required to make copies of returns, refund claims, or lists of taxpayer names and identification numbers available for inspection, upon the request of the Secretary. A $50 penalty is provided for each failure to retain a copy of a return or to list a taxpayer for whom a return was prepared, up to a maximum of $25,000 for all returns in a year.

5. A $100 penalty is provided for negligent or intentional disregard of Internal Revenue Service rules or regulations by a tax return preparer. A $500 penalty is provided for a willful attempt to evade, defeat or understate any tax by a tax return preparer. A separate penalty may be imposed for each return or claim for refund.

6. A $500 civil penalty is provided for any endorsement or other negotiation by a person who is an income tax return preparer of any check received by a taxpayer from the IRS.

7. The IRS would be given the authority to seek a court injunction against income tax return preparers (1) engaging in conduct subject to penalties, (2) misrepresenting their qualifications (including eligibility to practice before the Internal Revenue Service), (3) guaranteeing the payment of a tax refund, or (4) engaging in other conduct similar in nature to the above types of conduct which substantially interferes with the proper administration of internal revenue laws. A tax return preparer who files a bond of $50,000 to guarantee payment of further penalties would not be subject to an injunctive proceeding for penalty-type conduct.

8. The Internal Revenue Service would be authorized to provide the names, addresses, and taxpayer identifying numbers of preparers to State authorities charged with enforcing State provisions regulating tax return preparers.

SUGGESTED CHANGES IN SECTION 1201 OF THE HOUSE BILL

The problems addressed by section 1201 of the House Bill are sufficiently serious to justify some form of regulation. I would favor the adoption of most of the provisions contained in the section. However, in my opinion, certain provisions set forth in section 1201 are highly objectionable. I would strongly recommend several changes in section 1201 as presently written. These suggested revisions are explained below.

(1) Negligent or intentional disregard of rules and regulations

For the purpose of furnishing guidance both to tax return preparers and to Service personnel, section 1201 should specifically spell out certain "safe harbor" situations in which the penalty cannot be assessed. The IRS should not be authorized to assess a penalty against a tax

return preparer who disregards the rules and regulations of the Service where:

(*a*) The return preparer has disclosed his position on the income tax return (or in a rider attached thereto), thereby flagging the item for Service personnel, or

(*b*) Where, even though not disclosed on the return, the position taken by the return preparer is based upon an opinion rendered by an attorney or by a certified public accountant.

The House Committee Report states at page 278 that a good faith dispute by an income tax return preparer with respect to an IRS interpretation of a statute is not considered to constitute a negligent or intentional disregard of rulings and regulations. The House Committee Report also states that proposed Code section 6694(a) is to be interpreted in a manner similar to the interpretations given to section 6653(a) of he Code under existing law. Section 6653(a) of the Code provides a five percent (5%) penalty to be assessed against taxpayers where any part of an underpayment of tax is due to "negligence or intentional disregard of rules and regulations." In applying section 6653(a), the courts have generally refused to impose the penalty in cases where the pertinent facts were disclosed on the income tax return. See, *e.g.*, *Brockman Building Corp.*, 21 T.C. 175, 191 (1953), affirmed 231 F2d 145 (9th Cir. 1955); *Pullman, Inc.*, 8 T.C. 292, 299 (1947); *Davis Regulator Company*, 36 B.T.A. 437, 444 (1937). Moreover, in a number of cases the courts have held that the five percent (5%) penalty provided by section 6653(a) is not applicable where the taxpayer has relied on an opinion of counsel or upon the advice of his accountant. See, *e.g.*, *Conlorez Corp.*, 51 T.C. 467, 475 (1968); *William A. Brown*, 47 T.C. 399, 410 (1967), affirmed 398 F.2d 832 (6th Cir. 1968); *R. E. Nelson*, 19 T.C. 575, 581 (1962).

If disclosure of a doubtful item or reliance upon an opinion of counsel (or the taxpayer's accountant) will avoid the application of the five percent (5%) penalty contained in section 6653(a), it certainly would seem unreasonable to authorize the IRS to assess a penalty against tax return preparers who either rely on the advice of a professional tax adviser or disclose a controversial item on a return, thereby taking a position at variance with the rules and regulations of the Service. To penalize tax return preparers who make an adequate disclosure of a questionable item or who in good faith rely on the judgment of legal counsel or a qualified accountant would unfairly penalize taxpayer reliance upon professional tax advisers. It is submitted that the text of the law itself should spell out these exceptions so as to make it abundantly clear that it is not the policy of Congress to deprive taxpayers of the benefit of independent professional tax advice. Moreover, it is my opinion that there should be an obligation imposed upon return preparers to either flag the treatment of a questionable item on the return (or on an attached rider), or to obtain an opinion from a qualified professional tax adviser as to the basis of the position taken.

The courts in several cases have refused to impose the negligence penalty for intentional disregard of Service rules and regulations under section 6653(a) of the Code (and its predecessor in the 1939 Code and prior revenue acts) in situations where a full disclosure of the questioned item is made on the return (or in a rider attached thereto)

and the taxpayer has reasonable grounds to differ from the Service position. See, *e.g.*, *Davis Regulator Co.*, 36 B.T.A. 437 (1937); *Frank T. Heffelfinger*, 32 B.T.A. 1232, affirmed 87 F.2d 991 (8th Cir. 1937); *Hermann Senner*, 22 B.T.A. 655 (1931). Further, the American Bar Association's Committee on Professional Ethics has expressed the opinion that an attorney may properly advise his client in filing an income tax return to take a position that is favorable to the client so long as there is a reasonable basis for the position taken.[1] In Opinion No. 314, the ABA Committee on Professional Ethics further expressed the view that, where the attorney believes there is a reasonable basis for a position favorable to the client, there is no obligation on the attorney to advise that a rider be attached to the client's tax return explaining the transaction. However, as noted above, it is my opinion that the return preparer should be required either to attach a statement disclosing the position taken, or to obtain an opinion from a qualified professional tax adviser setting forth the basis for the position.

Accordingly, although the House Committee Report states that the penalty for "intentional disregard of rules and regulations" is intended to be construed in the same manner as section 6653, I believe that two exceptions should be added to proposed Code section 6694(a) set forth in section 1201 of the House Bill. The proposed section should be amended to provide that no penalty shall be imposed upon a tax return preparer where (a) the return preparer has disclosed his position as to the questioned item on the income tax return, or (b) the position taken by the return preparer is based upon an opinion rendered by an attorney or by a certified public accountant, even though the item is not disclosed on the return.

(2) Disclosure of returns or lists of taxpayers

Proposed Code section 6107(b) contained in section 1201 of the House Bill requires each tax return preparer to retain for three years t completed copy of any tax return refund claim, or to retain a list of the names and identification numbers of taxpayers for whom a return or refund claim was prepared. The proposed provision would further require tax return preparers to make such copies or lists of taxpayers' names and ID numbers available for inspection upon the request of the Secretary of the Treasury. It is submitted that the provision requiring tax return preparers to make available for inspection by the Treasury Department copies of returns, refund claims, or lists of taxpayer names and ID numbers represents an unwarranted intrusion into a confidential professional relationship.

Where the tax return preparer is an accountant, I would note that the Supreme Court has held in *Couch* v. *United States*, 409 U.S. 322 (1973), that a state-created accountant-client privilege is not recognized in Federal tax matters. Nevertheless, it is submitted that the confidentiality to justify Congressonal recognition. A recent statement submitted on the subject of Federal Tax return confidentality by the American Institute of Certified Public Accountants to the Privacy Protection Study Commission hearings held on March 11–12, 1976, explains that the access which the IRS (through summons procedures)

---

[1] See Opinion 314, *ABA Comm. on Professional Ethics, Opinions*, 688 (1970); 51 *A.B.A.J.* 671, 72 (1965).

currently has to accountants' work papers frequently impedes the free communication between client and accountant which is necessary to provide the accountant with sufficient information to prepare accurate financial statements and income tax returns.[2] The AICPA statement further points out that Service personnel increasingly are demanding memoranda and work papers not directly relevant to the preparation of an income tax return. Accordingly, it is submitted that the Internal Revenue Code should explicitly extend the privilege of confidentiality to communications between taxpayers and their accountants. Most certainly accountants should not be required to disclose to the Treasury the identification of their clients, whether or not returns were prepared or refunds obtained on their behalf.

With respect to attorneys, most states have enacted statutes expressly extending the privilege of confidentiality to communications between attorney and client. Such statutes codify the historic common law privilege. The attorney-client privilege may extend to the *identity* of the client, and that where such identification could amount to the prejudicial disclosure of a confidential communication to the IRS, the information is privileged, and the attorney may not be forced to disclose it.[3] See *Baird* v. *Koerner*, 279 F.2d 623 (9th Cir. 1962); *Tillotson* v. *Boughner*, 350 F.2d 663 (7th Cir. 1965). In its opinion in *Baird* v. *Koerner*, *supra*, the Ninth Circuit stated as follows:

> Suppose . . . unknown clients had related certain facts to their attorney, and asked that attorney for an opinion as to whether the clients, as taxpayers, owed the government additional taxes. Could the attorney be required to state the information given him in confidence by the clients, and the attorney's advice in response thereto? Or could the government require every tax attorney to reveal the name of those clients who had consulted the attorney with respect to possible taxes payable, so that the government could institute investigations of all such taxpayers? We think the answer is "no" to both such questions.

The provision contained in proposed Code section 6107(b)(2) requiring a tax return preparer to make available for inspection by the Internal Revenue Service a list of those taxpayers for whom he prepared returns or refund claims constitutes a clear cut abrogation of the attorney-client privilege.

It is submitted that the files of professional tax advisers should not be susceptible of use by Treasury agents as dragnets with which to conduct fishing expeditions in the course of an investigative search for further taxpayers to examine and additional returns to audit. No practitioner, whether attorney or accountant, should be required to disclose the identity of any client to an agency of the United States. Accordingly, it is submitted that proposed Code section 6107(b)(2) should be deleted and the Internal Revenue Code should be amended so as to make it clear by explicit provision that tax return preparers and taxpayer representatives are not required to disclose the identity of any client.

(3) Injunctive authority

Proposed Code section 7407 contained in section 1201 of the House Bill would grant the IRS authority to seek a court injunction against

---

[2] See *Taxation and Finance* (BNA), Mar. 12, 1976, pp. J-3, 5.

[3] A similar application of the attorney-client privilege was made by Justice Story in *Chirac* v. *Reinicker*, 24 U.S. 278 [11 Wheat. 289] (1826). See also *NLRB* v. *Harvey*, 235 F. Supp. 580 (D.C. Va. 1964), in which the Court refused to compel an attorney to disclose the identity of his client to a representative of the National Labor Relations Board, following *Baird* v. *Koerner*, 279 F.2d 623 (9th Cir. 1962).

income tax return preparers in certain described situations. This provision authorizes the IRS to obtain an injunction which would "enjoin such person . . . from further acting as an income tax return preparer." It is submitted that the judicial authority to enjoin certain offending tax return preparers should not be of indefinite duration. Such injunctive authority, if permanent, may effectively destroy the means of livelihood of the professional tax preparer affected. In addition, if imposed against a licensed CPA or a practicing attorney in good standing, a permanent injunction would constitute an infringement upon the licensing authority of the states to certify and regulate attorneys and accountants. Section 1201 of the House Bill does not distinguish between professional advisers who are licensed by the states (such as attorneys and CPA's) and unlicensed tax return preparers. It is submitted that injunctive authority ought to be limited to a fixed period of years, *e.g.*, three years, or five years, rather than be permitted on a permanent basis. If a permanent injunction is authorized at all, it should be permitted to lie only against a tax return preparer who is not licensed by state law.

(4) Judicial review

Section 1201 if the House Bill permits return preparers subjected by the IRS to one or more of the prescribed penalties to file suit for a refund of the penalty assessed. This is the *sole* method of judicial review provided by the House Bill. It is submitted that provision should be made for elective review by a pre-payment forum, viz, the United States Tax Court. I would propose that all IRS penalty assessments should be subject to the regular deficiency notice procedure set forth in sections 6211–6215 of the Code and that all such proposed penalties should be subject to pre-assessment review by the Tax Court in the same manner and to the same extent as income tax deficiencies and attendant penalties under present law. There is no reason to deprive tax return preparers of the benefit of the long experience and special expertise of the Tax Court if they wish to avail themselves of that forum. Refund suits for the recovery of such penalties in the U.S. District Courts and the Court of Claims should also be available on an elective basis.

I would strongly urge that section 1201 of the House Bill be amended in accordance with the above-stated recommendations.

Corporate Taxation

Statement of Fortescue W. Hopkins

Mr. Chairman, members of the committee, I appreciate this opportunity to present to the committee my suggestion on tax revision as it may affect subchapter "S" corporations.

For reasons which follow, the undersigned respectfully requests the committee to consider the following proposed addition to section 312(m) of the Internal Revenue Code:

"(4) *Electing Small Business Corporation.*—For any taxable year beginning after June 30, 1972, the provisions of paragraph (1) shall not apply in computing the earnings and profits of an electing small business corporation as defined in § 1371(b)."

The purpose of the foregoing is to reverse the unintended and inequitable effect of section 312(m) [Public Law 91–172, sec. 442(a)] on electing small business corporations which requires that before a distribution can reach prior years undistributed taxable income (PTI), it must first include current earnings and profits; that is, the difference between straight line and accelerated depreciation in the year of distribution. (See "*Tax Coordinator, Research Institute of America*," vol. 2, par. D–1617.)

In enacting § 1371, et seq., Congress intended to allow the stockholders of sub "S" corporations to withdraw tax free undistributed taxable income of prior years (PTI). At that time (with the exception of the effect of depletion), "taxable income" and "earnings and profits" were generally synonymous terms.

The taxation of the excess of current "earnings and profits" over "taxable income" as a condition precedent to the distribution of PTI is particularly inequitable where a corporation has been an electing small business corporation from its inception and, therefore, has no earnings and profits accumulated prior to June 30, 1972. Thus, this difference between straight line and accelerated depreciation that must be picked up in the year of distribution of PTI is the equivalent of recapture of depreciation without an opportunity to increase depreciable basis.

More to the point, however, Congress never intended or anticipated the inequitable effect of § 312(m) on profitable small business corporations. In commenting on the desirability of this legislation, Senate Report 91–552 (C.B. 1969–3, p. 535) states in part as follows:

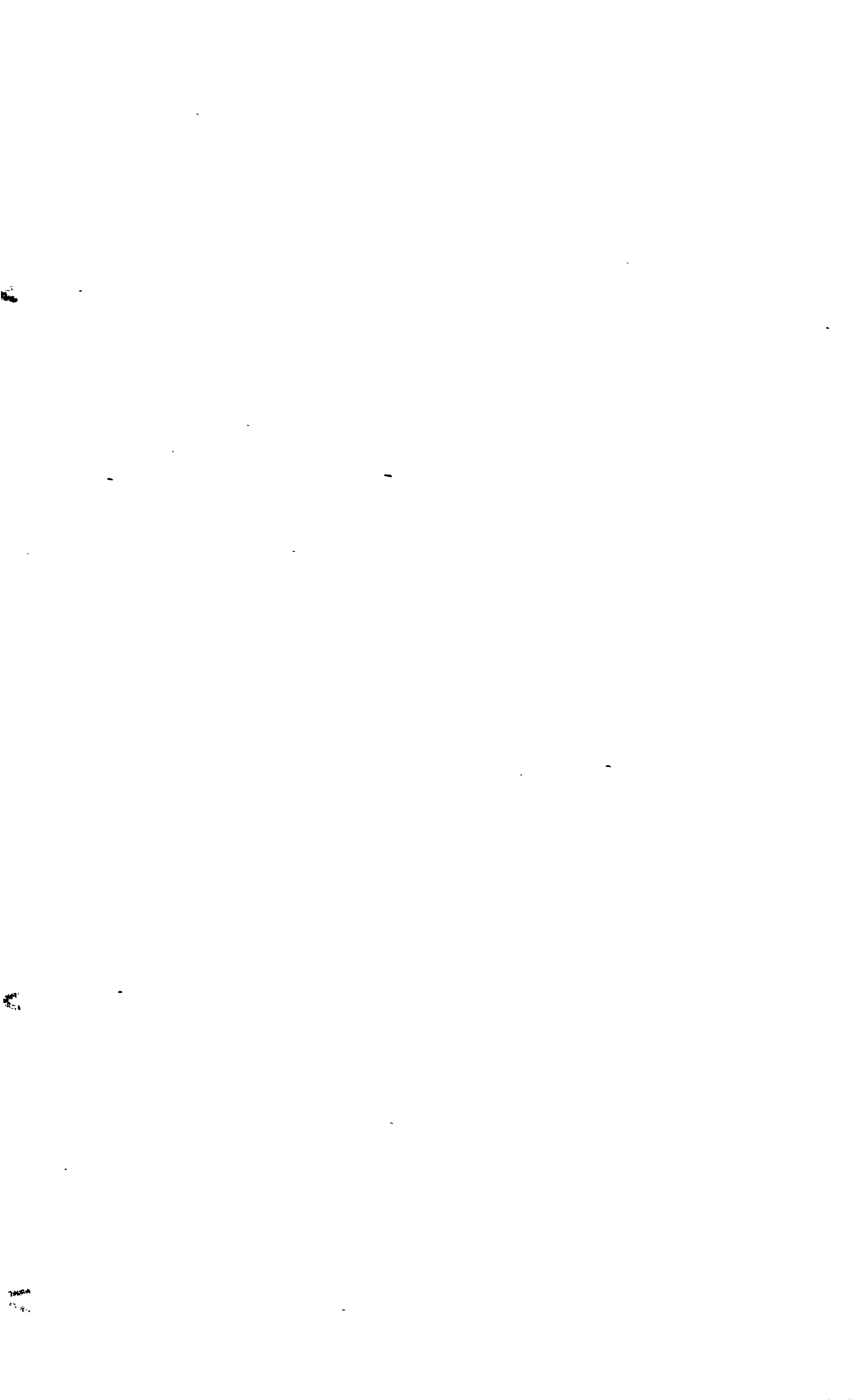
"*General reasons for change.*—Tax-free dividends from accelerated depreciation—in effect, resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at a long-term capital gains rates—appear to be increasing in a number of industries. Especially among utilities, a number of companies are regularly making such distributions. It was indicated that in 1968 private

power companies alone made such tax-free distributions totaling approximately $260 million. Statistical information is not readily available in the real estate industry on this point, but it is understood that substantial amounts of corporate distributions in this industry are also tax free. Availability of these tax benefits is generally unrelated to the purposes of accelerated depreciation and is of greatest value to individual stockholders in high tax brackets."

To the thousands of subchapter "S" corporations, because of its lack of publicity, the obscure nature of its effect, and its inequitable and unintended effect, § 312(m) poses a classic tax trap for the unwary.

I am proud to support this legislation and to promote equity, I urge that the foregoing proposed amendment to § 312(m) be made retroactive, in effect, to June 30, 1972.

Pension Matters



Statement of Charles D. Sylvest

In 1974, Congress adopted and the President signed the Employees' Retirement Income Security Act, which, it is fair to say, substantially revised the law applicable to employee benefit plans of all types. The act has been both highly praised and highly criticized, but it is quite evident that Congress dealt responsibly with a number of matters which had become serious problems.

Quite often, broad reform legislation of this type contains provisions which have the potential for creating a condition which is contrary to the goal originally set—namely, to improve the status of employees. There are at least two features of the legislation which I believe fall within this classification and I respectfully call them to the attention of this committee, in the hope that remedial legislation can be adopted.

The problem areas are the ceilings placed on the amount of pension benefit which can be provided by a qualified plan, as well as the ceiling placed on the amount which can be contributed annually for the account of any individual participant. The pension limitation to which I refer is that which provides that a benefit may not exceed 100 percent of prerequirement compensation or $75,000, whichever is the lesser. The contribution limitation prohibits a contribution in excess of 25 percent of earnings, or $25,000, whichever is the lower. While both these dollar limitations are subject to cost of living increases, it is my judgment that the base amounts are set much too low, and that they can and should be either eliminated or increased.

In today's economy, it is not uncommon to find management and executive personnel compensated at rates in excess of $100,000. In part, this may be attributed to the effects of inflation; but I also believe that in some measure, the higher levels of direct compensation seen today reflect changes made in the tax law through the Tax Reform Act of 1969. In that legislation, Congress, with due deliberation, evidenced its desire to give more favorable tax treatment to recipients of earned income as contrasted with taxpayers who derive unearned income.

Tax advantages which were once identified with deferred compensation arrangements, stock options and other similar plans were diminished, while more favorable treatment was attached to the direct compensation. In addition, the decline of stock market prices created nightmarish situations for many executive personnel, who had incurred substantial debt for the acquisition of stock subject to option, only to find a call on their loans at a time when the restrictions in the tax law prohibited a disposition of the underlying security at favorable tax rates. The combination of these factors, and perhaps others, has produced a climate which finds a substantial number of persons being compensated currently at rates in excess of $100,000 annually. Many

small business men, who are the owners or at least dominant or controlling stockholders of their companies, fall into this category. They are also the persons who decide what benefit plans are adopted for employees and the extent to which the company will commit itself to provide increased benefits.

In designing employee benefit plans, management considers numerous factors, such as overall cost, benefit expected to be derived by the company and the ultimate benefit to be received by personnel. The smaller business adds another dimension to consideration, namely, the benefit that might also be received by top management and shareholder-employees. When individuals, in the best of American business tradition, organize new enterprise, and through years of hard work and dedication built it to something of value, they necessarily feel a reluctance to ignore the effects of business decisions on their personal lives. The businessman whose pension plan, profit-sharing plan or employee stock ownership trust, cannot provide him with any more benefit due to the $75,000 or $25,000 limitation, has a natural lack of interest to voluntarily increase the benefits provided under the plan for the other employees. In the case of an employee-stock ownership trust, for example, the stockholder-participant experiences not only the dilution which results from the ownership of stock being transferred to the employees trust, but also suffers further dilution within the trust by virtue of the fact that his pro rata sharing in stock ownership ceases once the arbitrary limitations have been reached.

Likewise, an employer may wish to provide all of his employees with a pension benefit in excess of what the man was earning prior to retirement. An employee retiring on the basis of 100 percent of pay—say $20,000—may find that what he was receiving immediately prior to retirement is wholly inadequate to support his family 5 or 10 years down the road after retirement.

We are acutely aware of the erosion of the purchase power of the dollar due to inflation over the past few years. Why not permit the employer to provide a pension benefit equal to 110 percent or 120 percent of final pay? In view of the problems with social security, the private pension system should be encouraged, not discouraged.

Most of us can recognize that Congress felt compelled to establish some limitation in order to remove the temptation a taxpayer might have to fix abnormally high benefit and contribution levels. I respectfully suggest, however, that the limitations which were imposed may have the effect of undercutting the ultimate goal of producing a climate which will provide greater benefits for all employees.

As an alternative to the limitations imposed by ERISA, I suggest that this committee give consideration to the elimination of or substantial increase in the pension benefit and contribution limitations.

If benefits are related to compensation, effects on the revenue will be controlled by virtue of the fact that compensation is subject to the daily scrutiny of the Internal Revenue Service, and must be reasonable in amount to be deductible. Therefore, there should be no dramatic reduction in overall corporate taxable income as the result of such a change. Moreover, to the extent Congress encourages the private pension system, the demands in the social security and welfare systems will be reduced.

My purpose in calling this aspect of ERISA to the attention of the committee is to focus upon a very basic consideration most, if not all, small businessmen encounter, when considering the establishment or improvement of employee benefit programs. After struggling to establish and build a good business enterprise over a long period of time to a point where the company can afford to provide meaningful and increased retirement benefits for its employees, it seems patently unfair that the shareholder-owner be prohibited from likewise participating on a pro rata basis, due to the establishment of arbitrary ceilings. Likewise, the employer is prohibited by these arbitrary ceilings in providing meaningful retirement benefits to its devoted employees.

JOINT COMMITTEE ON PENSIONS,
Washington, D.C., April 15, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.
(Attention: George M. Foote, Jr.)

DEAR SIR: We request an appointment with you at your earliest convenience, to discuss the needs of the engineering profession as affected by pending tax legislation. We previously requested but were denied an opportunity to testify at hearings before your committee.

The engineering profession—over 1 million strong—is represented professionally in the United States by a variety of professional engineering societies. A group of the largest of these societies, whose insignia appear in the lefthand margin of this letter, have formed a Joint Pension Committee, which also includes certain other technical professional societies, for the purpose of undertaking certain joint initiatives to provide better retirement benefits for technical professionals. This committee, therefore, fairly represents the interests, with respect to pension matters, of the overwhelming majority of engineers and technical professionals in the United States.

Your committee has under consideration several measures of direct and vital interest to our members. The pending tax reform bill, H.R. 10612, includes a modification of section 408 of the Internal Revenue Code dealing with individual retirement accounts. This measure does not deal with Keogh plans but we have been informed that your committee voted last December to authorize a member of the committee to offer a floor amendment to an appropriate tax bill to permit under some circumstances a tax deductible Keogh contribution (the so-called "mini-Keogh") of up to $750 even if such contribution equalled 100 percent of self-employment income. We understand, however, that a tentative decision was reached to preclude the use of this provision in any case in which the taxpayer earned more than $15,000.

Our members suffer more pension losses than almost any other group of working Americans. Congress recognized this fact when it passed ERISA, for it required the Government to study and attempt to cure by procurement regulations the high pension forfeiture rate among "professional scientific and technical personnel" (ERISA § 3032). We would prefer to solve as much of this problem as possible by de-

signing our own plans. But we need some consideration in the drafting of the tax laws which will govern these plans.

As to IRA's, we need a modification of existing provisions (i) to permit highly mobile professionals who are unvested (and unlikely to vest) under their corporate plan to contribute to IRA's, and (ii) a requirement under corporate plans that we be permitted to "opt out" of a corporate plan and take an IRA deduction instead.

And as to the so-called mini-Keogh, we think your committee was right in its reported decision to restore the 100 percent/$750 deduction which Congress obviously thought it had authorized in IRC§ 404 (e)(4), as amended by ERISA. But we think your committee was mistaken when it proposed to limit the 040(e)(4) mini-Keog's to employees earning less than $15,000 per year. Such a limitation would exclude almost all of our members. If the motive in the proposed limitation was to deny a tax deduction to "tycoons," we can assure you, first, that engineers are not tycoons, and second, that no tycoon is going to become appreciably richer by deducting $750 per year from his income tax. But our members have a great deal at stake. We forfeit corporate pensions regularly. Nonetheless, many of our members who work for large corporations also do occasional consulting in their spare time ("moonlighting", if you will). It is that little bit of consulting income which could lay the basis for "mini-Keogh" plans, which in turn might solve part of our members' pension problems.

We need your help. But first, we need an opportunity to meet with you and explain to you why over 1 million American technical professionals have special pension problems—problems which need a solution, a solution which you and your committee should and can provide, once you understand the nature and importance of our problem.

We urgently request an opportunity for a face-to-face meeting to give you the details.

Very truly yours,

LEONARD FARRELL, *Chairman.*

AMERICAN LIFE INSURANCE ASSOCIATION.
Washington, D.C., April 22, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The purpose of this letter is to urge that a provision be added to the tax reform bill, currently being considered by your committee, to clarify the tax status under section 801(g) of the Internal Revenue Code of certain pension contracts utilizing life insurance company separate accounts. In this regard, we would appreciate having this letter included in the printed record of your committee's hearings on H.R. 10612.

The American Life Insurance Association, a division of the American Council of Life Insurance, has a membership of 377 life insurance companies which have in force approximately 90 percent of the life insurance written in the United States and hold 99 percent of the reserves of insured pension plans.

NATURE OF PROBLEM

Life insurance companies are a major funding medium for qualified pension and profit-sharing plans. They issue contracts funding retirement benefits for individual retirement accounts, small businesses, major corporations and Taft-Hartley plans. These types of plans are also funded through tax-exempt trusts in which plan assets are managed by banks and investment advisers.

One form of life insurance company pension funding is through contracts with reserves based on segregated asset accounts. These contracts are used principally in connection with equity investments, where the contract holder wishes to participate directly in the investment experience of a segregated pool of assets.

In 1959 and 1962, Congress enacted provisions in the life insurance company income tax structure designed, in part, to exclude from tax income earned by life insurance companies on segregated asset account reserves held for qualified pension funds—thereby taxing life insurance company segregated asset accounts on a basis similar to that applied to banks and other pension funding agencies.

Under present law, one of the requirements that must be satisfied to qualify for this segregated asset account treatment is that the life insurance company must issue a "contract which provides for the payment of annuities". (Section 801(g)(1)(B)(ii).) In several private rulings and in two published rulings,[1] the Internal Revenue Service has taken the position that a contract does not qualify under this provision unless it contains permanent annuity purchase rate guarantees with respect to all separate account funds held under the contract. In fact, a qualified plan may wish to self-insure, either wholly (by not providing for annuity purchases at all) or during the active life of the employee, or to share the insurance risk with the life insurance company. Nevertheless, under the IRS position, the life company may not issue a separate account contract to such a pension plan without inserting a rigid form of annuity purchase rate guarantees. The alternative is to run the risk that all of the investment results credited under the contract will be fully taxable to the life insurance company, and that fluctuations in the market value of separate account reserves will improperly increase or decrease the company's gain from operations.

We believe that the type of annuity features, if any, included in life insurance company contracts should be left to the contracting parties and not dictated by the tax laws. In this regard, the presence or absence of such guarantees would seem clearly irrelevant as a matter of tax policy.

PROPOSAL

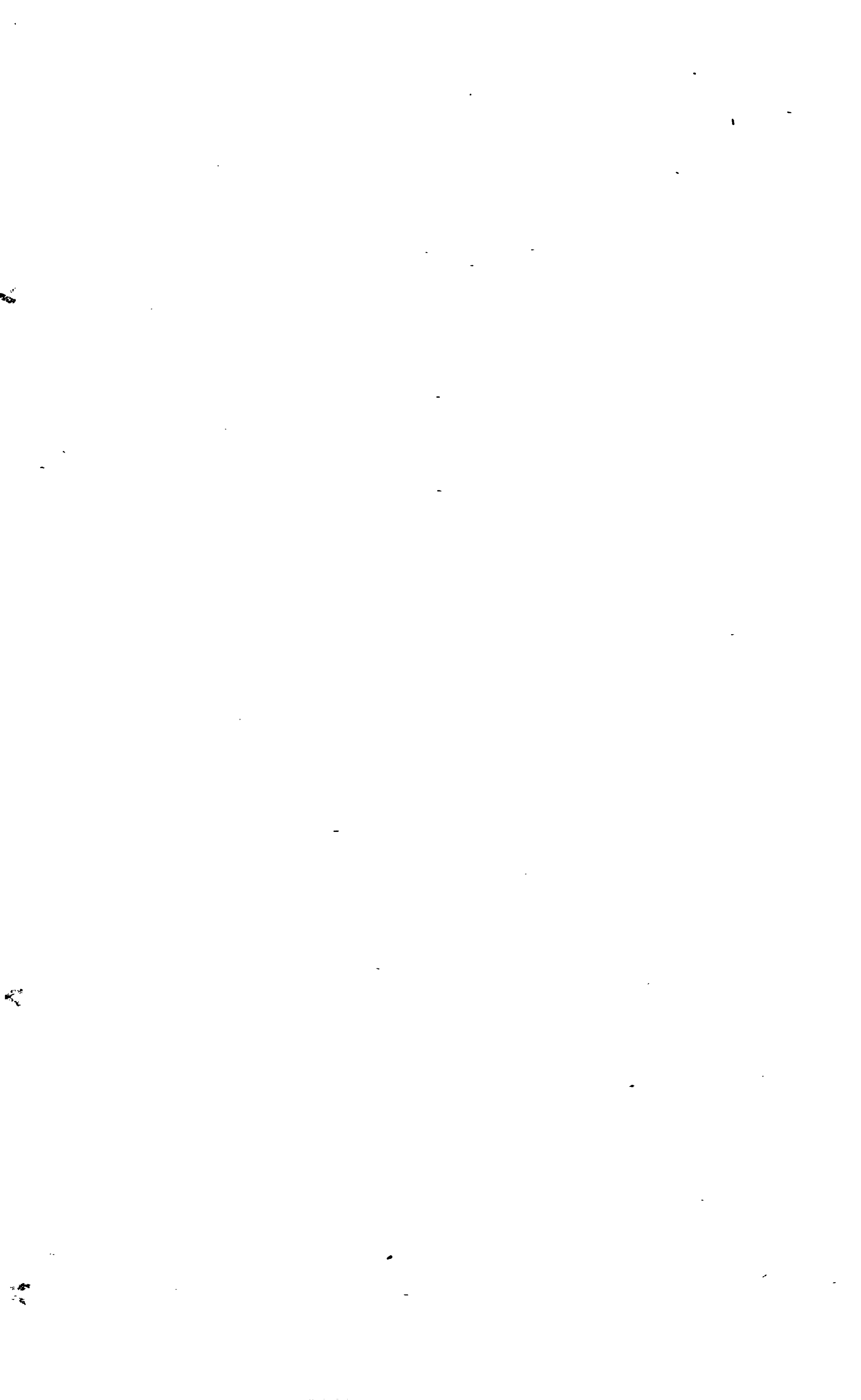
Thus, we urge that the Internal Revenue Code be amended to clarify the treatment of qualified pension contracts with reserves based on segregated asset accounts under section 801(g)(1)(B), by removing the requirement that such contracts must provide for the payment of annuities.

We would be happy to attempt to furnish any additional information which you or your committee might think helpful.

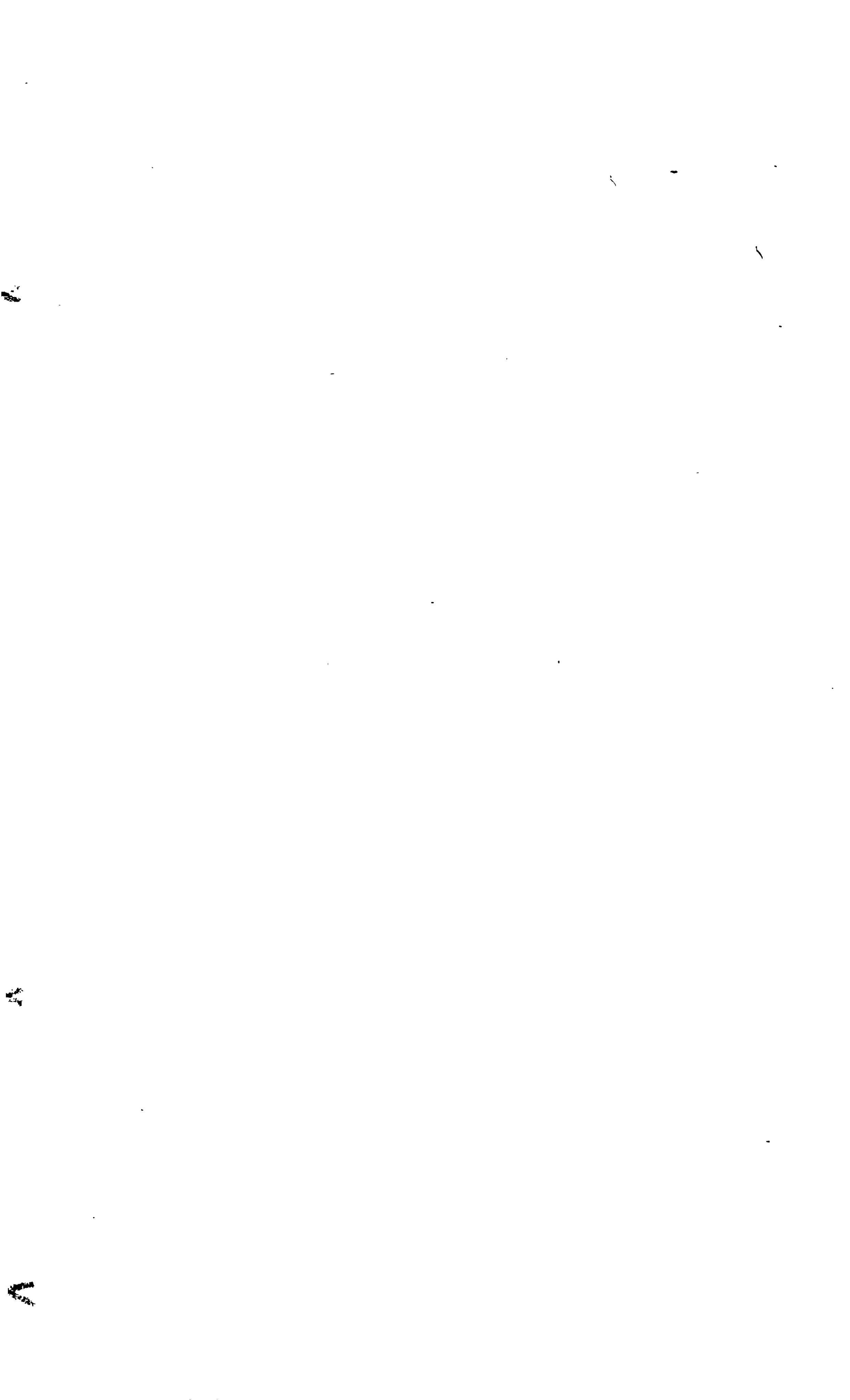
Sincerely,

WILLIAM T. GIBB, *Chief Counsel.*

[1] Rev. Rul. 73-333, C.B. 1973-2, p. 218 and Rev. Rul. 74-189, I.R.B. 1974-17, p. 10.



Tax Deductions for Tuition Costs



KANSAS CITY, MO., *May 21, 1976.*

To: Senate Finance Committee

There are several reasons for opposing tax deductions for tuition costs, as proposed by S. 2356.

1. S. 2356 WOULD PROVIDE AN ADDITIONAL TAX LOOPHOLE FOR PERSONS OF MEANS

S. 2356 provides that a taxpayer may enjoy a tax deduction of up to $1,000 per person (p. 2, 1.8) for tuition paid for his or other persons' enrollment (p. 2, 11.3–4) in some school.

There is no restriction as to the number of such deductions per taxpayer. Nor is there any requirement that the student beneficiary of tuition payments must sustain a legal relationship to the taxpayer.

Under S. 2356 a taxpayer—say, a wealthy owner of a business—could pay up to $1,000 toward the tuition costs of his employees' children and enjoy a tax break.

At present such a person can enjoy a tax break if he makes a contribution to an educational institution. However, the difference between existing law and the proposal in S. 2356 is that S. 2356 would permit the taxpayer to designate the student beneficiaries of his expenditure for educational purposes.

Under S. 2356 it would be possible for grandparents, aunts, uncles, neighbors, or friends to get a large tax break for making a personal gift in the form of tuition. Present tax law does not permit a taxpayer to claim a tax deduction on personal gifts.

2. S. 2356 VASTLY BROADENS THE LONGSTANDING POLICY RESPECTING TAX DEDUCTIONS ON EDUCATIONAL EXPENSES

The existing policy is that one may deduct educational costs incident to trade or business (cf. S. 2356, p. 3, 11. 3–6) or incident to maintaining one's present job, but that one may not deduct such expenses if the education is for the purpose of advancement.

S. 2356 continues the present policy but extends deductibility to self-improvement education unrelated to trade or business.

The only restrictions written into S. 2356 are: (1) Tuition must be paid to an "eligible educational institution," and (2) the per person, deductible sum may not exceed $1,000.

There is no effective safeguard in S. 2356. If Congress has power to define four types of schools as "eligible" (p. 2), it has power to place every conceivable type of school under the umbrella of eligibility. If Congress has power to put on the $1,000 ceiling, it also has power to take it off, removing the ceiling so as to benefit the wealthy who can afford the most expensive, elite, and discriminatory schools.

3. S. 2356 WOULD HAVE SOME EFFECTS OF DOUBTFUL CONSTITUTIONALITY UNDER THE NO ESTABLISHMENT CLAUSE OF THE FIRST AMENDMENT

The questionable effects of S. 2356 are: (1) Creation of a special class oriented toward religion, (2) advancing religion via tuition aid to education significantly oriented toward religion, (3) failure to create effective but nonentangling administrative machinery to insure that only secular education is aided, and (4) politicizing the electorate along religious lines.

A. Special class benefited

The class that S. 2356 attempts to benefit consists of those who pay tuition. The class is not limited to those who pay tuition for themselves or their dependents.

To identify the class it is necessary to answer this question: Which eligible educational institutions charge tuition? Most public schools don't; most nonpublic schools do. Thus, the special class consists, effectively and substantially, of those who pay tuition to private schools.

Major beneficiaries, therefore, are private schools and those who patronize them.

The U.S. Supreme Court and other courts have repeatedly observed that the overwhelming majority of nonpublic elementary and secondary schools (see S. 2356, p. 2, 11.14–15) are schools which are an integral part of religious missions, schools in which religion is so pervasive that these schools' education cannot be assisted at expense to the Public Treasury without violating the no-establishment clause of the first amendment by advancing religion, by involving State and church in impermissible administrative entanglement, or by sickening the political process by encouraging division along religious lines. *Lemon* v. *Kurtzman*, 403 U.S. 602 (1971); *Wolman* v. *Essex*, 342 F. Supp. 399 (S. D. Ohio 1972), aff'd, 409 U.S. 808 (1972); *Committee for Public Education and Religious Liberty* v. *Nyquist*, 93 S. Ct. 2955 (1973); *Sloan* v. *Lemon*, 413 U.S. 825 (1973), *Meek* v. *Pittenger*, 95 S. Ct. 1753 (1975).

It is established in case law that the no-establishment clause prohibits aiding such schools at expense to the Public Treasury by such devices as (1) contract for purchase of so-called "secular" educational services (*Lemon*), (2) salary supplements to these schools' teachers of so-called secular subjects (*DiCenso* v. *Earley*, decided with *Lemon*), (3) maintenance and repair of these schools' facilities in low-income areas (*Nyquist*), (4) tuition reimbursement for low-income patrons of such schools (*Nyquist*), (5) tax-deduction version of tax credits for other patrons of such schools, specifically those under a statutorily defined income ceiling (*Nyquist*), (6) tuition reimbursements (*Sloan; Wolman*), (7) tax credits as tuition aid (*Kosydar* v. *Wolman*, 353 F. Supp. 744 (S. D. Ohio 1972), aff'd sub. nom. *Grit* v. *Wolman*, 413 U.S. 901 [1973]), *United Americans* v. *Franchise Tax Board* (N. D. Calif. 1974), aff'd sub. nom. *Franchise Tax Board* v. *United Americans*, 95 S. Ct. 166 [1974]), (8) compensation for costs incurred in performing services mandated by law (*Levitt* v. *Committee for Public Education and Religious Liberty*, 413 U.S. 472 [1973]), (9) lending

educational materials, supplies, and equipment that is susceptible to religious use (*Meek; Public Funds for Public Schools* v. *Marburger*, 358 F. Supp. 29 (D. N.J. 1973) aff'd sub. nom. *Marburger* v. *PFPS*, 94 S. Ct. 3163 [1974]), and (10) sending public school personnel into such schools during regular school hours to perform secular educational services or services auxiliary to education (*Meek*), et cetera.

In the last 15 years or so there has been a hierarchically orchestrated campaign to find for church-related schools a key that would unlock the Public Treasury. Many, many devices have been fashioned on parochial school anvils. Politicians have joined in a cacophous campaign in behalf of parochialists' claims of a right to public funds. Since the success of the political campaign to strengthen and exploit a religious vote per se (U.S. News & World Report, Aug. 1, 1960, pp. 68–72), some politicians have thought that they had to outdo their rivals in wooing this religious vote. The most prominent was Richard M. Nixon who, in this campaign of 1960, began to advocate parochial aid, while his opponent sought to woo this vote in more subtle fashion. Since 1968, both major political parties, either because of ignorance of or insensivitity to first amendment principles, have advocated parochial aid. On March 3, 1970, President Nixon pledged to use the powers of the Presidency to assist parochial education at expense to the Public Treasury (Cong. Rec.); this, to the best of my knowledge, was the first time in U.S. history that a sitting President committed himself to the effective undoing of the no-establishment clause's prohibition against an establishment of religion. President Nixon set up a special panel of nonpublic school officials to tell him how the Government could assist nonpublic elementary and secondary education, a tactic that would be roughly analogous to the President's setting up of a panel consisting of top officials of the four major auto manufacturers to tell the President how Government could help them. (One may reasonably ask: If a President either does not understand or does not value the religion clauses of the first amendment—or both—what constitutional principles is he likely to understand or to value?)

In the last 10 years—and especially since the ruling in *Board of Education* v. *Allen*, 392 U.S. 236 (1968)—many State legislatures, especially where the parochial aid lobby has been strong (for example, New York, Rhode Island, Pennsylvania, Ohio, Louisiana), have enacted numerous schemes the effect, and probably the intent, of which was to aid religiously oriented education at expense to the Public Treasury. One by one these schemes have died at bar because of their illegitimacy under the first amendment.

S. 2356 has been fashioned in the laboratory of religiously oriented schools. S. 2356 is the product of the same brain trust which devised the numerous schemes of parochial aid which have fallen at bar since 1971. The effect, and probably the intent, of S. 2356 is to aid the same special class that several unconstitutional schemes were designed to aid.

Any legislative scheme that would aid a specific religiously oriented class of beneficiaries is constitutionally suspect (*Wolman; Kosydar;* and *Marburger*, all affirmed by the U.S. Supreme Court). Any right to attend and/or support private schools is in addition to the duty to

support and the right to attend public schools (*Brusca* v. *State of Missouri*, 332 F. Supp. 275, 279 [1971], aff'd, 405 U.S. 1050 [1972]);

"The limited nature of the class affected by the legislation, and the fact that one religious group so predominates within this class makes suspect the constitutional validity of the statute." *Wolman*, p. 412.

The inclusion of public school beneficiaries cannot overcome the infirmity related to a predominantly sectarian class (*Kosydar* v. *Wolman*, 353 F. Supp. 744 [S. D. Ohio 1972])—for the inclusion of a relatively small percentage of all public school students cannot protect the law against the effect of making organized religion "a substantial beneficiary" (*Wolman*, p. 412).

B. Advancing religion via tuition aid

The clue to the special tax benefit under S. 2356 is payment of tuition. As noted, the elementary and secondary schools which charge tuition are predominantly religiously oriented schools. Indeed, the majority of these schools are integral to the religious mission of the numerically strongest denomination in the United States, a denomination that claims over 48 million members or adherents in the United States, according to the World Almanac of 1975 (p. 322).

Does tuition aid a school and its purposes? Tuition aid at expense to the Public Treasury is "a form of financial assistance inuring to the benefit of the private schools themselves" (*Norwood* v. *Harrison*, 93 S. Ct. 2804, 2810 [1973]). Tuition is not inherently secular; it cannot be sustained in argument that tuition aid is "neutral" or "'atmospherically indifferent on the score of religion'" (*Wolman*, pp. 413, 414). "Tuition forms the major part of a school's general fund and moneys derived from it can be used for any purpose it deems legitimate" (ibid., p. 414). Tuition goes into a school's general operating fund and can be used to finance any purpose served by the school (for example, see ibid.; *Nyquist*, *Sloan; Americans United* v. *Bubb*, 379 F. Supp. 872, 894 [D. Ks. 1974]; *Americans United* v. *Dunn*, 384 F. Supp. 714, 721 (M. D. Tenn. 1974]; *Almond* v. *Ray*, 89 S. E. 2d 851 [Va. 1955]; *Hartness* v. *Patterson*, 179 S. E. 2d 907 (S. C. 1971); *State of Nebraska ex rel. Rogers* v. *Swanson*, 219 N. W. 2d 726, 730, [Neb. 1974]; *Weiss* v. *O'Brien*, 509 P. 2d 973 [Wash. 19732; and numerous other decisions, some of them mentioned in *Norwood*, p. 2810, fn. 6].

A tax deduction is dependent on "legislative grace." When Congress has control and authority over money subject to taxation and then chooses to grant tax deductions thereon for tuition paid to private schools, Congress operates the Internal Revenue Code in such way as to bestow on private schools "a 'grant' of Federal financial assistance" (*Kosydar*, p. 756, fn. 10). A legislative body cannot employ the tax laws "in a fashion which impedes public policy or violates constitutional protections" (ibid., p. 756).

Can Government provide, generally, tuition aid for attendance at schools significantly oriented toward religion? Univocally, the courts have said "no." If a school practices racial segregation (see *Norwood*, p. 2810, fn. 6) or is part of a denomination's religious preference in admissions, provides religious worship or activities which students may voluntarily attend under its "convocation" policy, or potentially can test students on religious understanding (*Bubb*)—there can be no tuition aid chargeable to the Public Treasury.

It is well established that there can be no public aid—not even the minimal aid which Government provides when it, instead of a private school, sells revenue bonds with which to aid facilities to be used by the private school, facilities on which the private school pays lease or rental fees adequate to amortize the bonds (*Hunt* v. *McNair*, 93 S. Ct. 2868, 2872, including fns. 4, 6 [1973]—to religious instruction, worship, or a department of religion of any particular denomination (*Tilton* v. *Richardson*, 403 U.S. 672, 675, 680 [1971]). This prohibition exists in perpetuity (*Tilton*). Indeed, the mere possibility of public aid to a school's religious purpose is enough to invalidate the aid under the No Establishment Clause (*Nyquist*, pp. 2969, 2971, fns. 36, 39).

If Government cannot finance the general education of church-related schools directly, it cannot do so indirectly. Courts look at the substance, not the form, of a transaction (*Wolman*, p. 415). The fact that the aid goes through persons who pay tuition does not cleanse a transaction (*Griffin* v. *State Board of Education*, 239 F. Supp. 560, 563 [E. D. Va. 1965]; *Nyquist*, p. 2972). It is constitutionally insignificant whether the public aid be called reimbursement, reward, subsidy, or tax credit, for label alone does not satisfy constitutional requirements (*Nyquist*, pp. 2972, 2974). What Government cannot do directly in aid of religion it cannot do indirectly (*Wolman*, p. 413).

Any law that has the effect, and certainly any law that has the intent, of aiding religion or of assisting persons in the "free exercise of religion" in respect to a religiously-oriented education fails tests applicable to the Religion Clause (*Brusca*, p. 278). Under the No Establishment Clause, a law must have a secular purpose and a primary effect that neither advances nor inhibits religion (*School District of Abington Township* v. *Schempp*, 374 U.S. 203, 222 [1963]). The No Establishment Clause was designed to prevent the "evils" of Government's sponsorship of religion, its financial support of religion, and its active involvement with religious activity or institutions (*Lemon; Walz* v. *Tax Commission*, 397 U.S. 664, [1970]).

Having failed to get tuition grants to assist persons in attending church-related schools, some now seek a special tax break via deductions on funds paid to such schools as tuition. S. 2356 would establish this tax break.

Whether the tax break is called a grant, reimbursement, or credit for tuition purposes, it represents a charge on the public treasury (*Nyquist*, pp. 2974–5). The same holds true of tax deductions that would primarily aid parochial schools and their patrons. The constitutionality of such a "hybrid benefit does not turn in any event on the label we accord it" (*Nyquist*, p. 2974).

Whereas persons have a right to establish and attend parochial and private schools (*Pierce* v. *Society of Sisters*, 368 U.S. 510 [1925]), this right cannot be extended to a claim of entitlement to aid at public expense in order to exercise this right (*Norwood*, p. 2809; *Luetkemeyer* v. *Kaufman*, 364 F. Supp. 376, 382 [W. D. Mo. 1973], aff'd, 95 S. Ct. 167 [1974]).

S. 2356 would have the effect of conferring on parochial schools and/or their patrons a financial benefit chargeable to the public treasury, a benefit which Government cannot provide directly.

"While the ingenuity of man is apparently limitless, the Court has held with unvarying regularity that one may not do by indirection

what is forbidden directly; one may not by form alone contradict the substance of a transaction." *Wolman*, p. 415; aff'd, 409 U.S. 808 (1972).

C. Unrestricted tuition aid

S. 2356 contains no statutory safeguard whatever against a school's using tax-deductible tuition funds for religious purposes.

Courts have ruled with unvarying regularity that any tuition-related scheme that would help church-related schools at expense to the public treasury is unconstitutional on its face unless legislation explicitly sets up machinery by which the Government can insure that public aid does not assist religious purposes. The ruling in *Lemon* v. *Kurtzman* implies at least this—that "any general purpose aid, lacking nonentangling restrictions on use, constitutes an almost per se violation of the Establishment Clause" (*Wolman*, p. 415, fn. 20).

It is the responsibility of the legislature, not of an administrative agency of the executive branch of Government, to erect adequate safeguards to insure that public aid advances only secular purposes (*Lemon*, p. 613; *Dunn*, p. 721; *Nyquist*, pp. 2970–1; *Sloan; Wolman*, pp. 413–4).

"In the absence of any effective means of guaranteeing, that the State aid derived from public funds [or chargeable to the public treasury] will be used exclusively for secular, neutral, and nonideological purposes, it is clear from our cases that direct aid in whatever form is invalid." *Nyquist*, p. 2969; cf. *Weiss* v. *O'Brien*, 509 P. 2d 973, 991 (Wn. 1973).

Because money is not neutral, it is of direct aid to church-related schools whether it comes directly from the Government or indirectly through individuals, serving as conduits (*Nyquist; Wolman*).

The nature of the safeguarding machinery, however, must be so delicately tuned that it avoids continuous, intimate, and excessive entanglement between the Government and church-related schools (*Lemon; Tilton; Meek*), S. 2356 contains no language about proper safeguards. Therefore, any discussion of administrative entanglement would be mere speculation.

D. Political entanglement

The fact that the major beneficiaries of S. 2356 are persons who support church-related elementary and secondary schools, most of them affiliated with a few religious groups, and private colleges, many of them church-related or denominational schools, carries the potential of political divisiveness along religious lines.

The fact that more denominations conduct schools covered by S. 2356 than schools limited to elementary and secondary education enhances the likelihood that several denominations will work together politically so as to obtain support for their schools at expense to the public treasury—much as leaders of several denominations with a philosophy of church-state union supported the Virginia bill against which James Madison wrote the famous "*Memorial and Remonstrance*" in 1784. See texts of the bill and Madison's document in *Everson* v. *Board of Education*, 330 U.S. 1, 63–73 (1947).

The public interest will not be well served when officialdom in church and in state work together to obtain financial support for re-

ligious education at cost to the public treasury. And, more specifically, public schools can only suffer when our Nation's lawmakers subscribe to the principle that they are responsible for assisting private schools—some of them in the high style to which they have grown accustomed.

The principle of church-state separation prohibits Government "from fusing functions of Government and of religious sects, not merely to treat them all equally" (*People of the State of Illinois ex rel. McCollum* v. *Board of Education*, 333 U.S. 203, 277 [1948]), prohibits concert, union, or dependency of church or state upon the other (*Zorach* v. *Clauson*, 343 U.S. 306, 312 [1952]), and prohibits aid from the public treasury to one religion or all religions (*Everson*).

One of the "evils" against which the no establishment clause affords protection is political entanglement along religious lines (*Lemon*). Some clues of such entanglement are (1) partisans for and against public aid to religion-related education, (b) consideration of candidates in light of their stands on such matters, (c) annual aid and likelihood of expanding aid, et cetera (*Lemon; Nyquist; Meek*).

S. 2356 provides a basis for divisiveness. There is nothing sacrosanct about the $1,000 ceiling; if Congress passes S. 2356, it will only be a matter of time until the ceiling is raised or removed.

4. S. 2356'S EXPENSE TO THE PUBLIC TREASURY WOULD BE VERY COSTLY, AND ITS MAJOR BENEFICIARIES WOULD BE THOSE WHO PATRONIZE PRIVATE SCHOOLS.

I do not have at hand exact statistics on the tuition charges imposed by all colleges, universities, vocational schools, and elementary and secondary schools. Nor do I have exact figures on the adjusted gross income of each taxpayer whose tax liability would be reduced by S. 2356.

At few private colleges is tuition less than $1,000 per year; at few public colleges does tuition and/or mandatory fees exceed $1,000 for State residents, though costs above $1,000 are not uncommon for out-of-State students. Over one-fourth of college and university students attend private institutions. At an average deduction of $900 for each student enrolled in a private college or university, the total deduction against Federal adjusted incomes would be around $2 billion, with the tax rate varying from taxpayer to taxpayer, depending on his/her tax bracket.

It is difficult to calculate the tuition costs of nonpublic elementary and secondary schools. (Public elementary and secondary schools do not charge tuition.) Some private schools cater to an elite clientele in the high-tax bracket. Religious schools—often called Christian day schools—are growing, particularly among evangelical conservatives.

The costs of tax deduction legislation to the public treasury may be illustrated. A fiscal note to a 1975 bill before the Missouri General Assembly indicated that there were about 92,000 students enrolled in nonpublic elementary and secondary schools in Missouri, that the effective State tax rate on educational expenses of around $55 million would be around 3¼ percent, and that the loss to the State treasury would be around $1.8 million per year—or about $19.56 per student.

Since the Federal tax bite is considerably higher—indeed, several times higher—than the State tax bite, S. 2356's cost to the Federal Treasury is of staggering proportions—perhaps as high as $1.5 billion for private school students alone, plus reductions incident to paying tuition at public colleges. From Missouri taxpayers who send children to parochial schools only, IRS would probably collect $8 to $12 million less than it would collect if legislation like S. 2356 does not pass. Add to this the reduced revenue attributable to college tuition and the deductions to taxpayers in other States, and one readily sees S. 2356's cost to the public treasury from only one State.

CONCLUSION

For reasons cited, I urge you to oppose S. 2356.
Respectfully submitted,

HUGH WAMBLE.

STATEMENT OF NATIONAL ASSOCIATION OF LAITY

(By Dr. Joseph T. Skehan, Economist, President)

The NAL, the independent Catholic lay agency devoted to the mandates of Vatican II Council (1962–65), opposes S. 2356.

Added, indiscriminate tax relief to private (mostly Catholic parochials and segregationist academies) schools would:

1. Violate the U.S. Supreme Court interpretations of the Constitution (see *Lemon* v. *Kurtman*, 1971 and NAL amicus brief, *Meek* v. *Pittenger*, 1975, and *Pearl* v. *Nyquist*, 1973);
2. Flout public policy by reinforcing segregation and by furthering undemocratic control of Catholic education;
3. Reinforce undesirable episcopal policies such as antiunionism, sole control of parochials; and
4. Thwart basic U.S. Catholic community aims, that is, to reduce racism, foster unionism, provide parents/teachers/students a voice in parochials, to provide basic religious education to all Catholics (not only children in the bishops' schools).

Vatican II stressed human dignity and hence an end to discrimination based on race, income or sex. U.S. Catholics with high incomes (Catholics of Irish, German, Italian and Polish origin now rank Nos. 2, 4, 3, and No. 5 as highest income receivers, on the average, in the United States—see Greeley, *N.Y. Times*, October 15, 1975, and *Parochials in a Declining Church*, 1976) stood ready to give billions more to parochials provided they stress human dignity and share control with parents/students/teachers, et al.

NAL, Hispanic and black Catholic agencies welcomed with enthusiasm USEA 1965, supported by all U.S. religious communities, exactly because it gave tax funds, even to parochials, in order to serve the victims of racism and poverty—a fit congruence of public and Catholic policy.

But the policy of most bishops since 1965 has sought to thwart shared control of parochials, and thereby to reinforce antiunionism in other agencies under their control (hospitals, social services, *et al.*),

to dampen academic freedom and autonomy of the several sciences (despite conciliar endorsement of them) and to turn USEA 1965 away from its public-policy goal—help to victims of racism and poverty—and toward their own goals. (See the report of Dr. LaNoue, Columbia University on USEA 1965 administration in 60 parochial school districts).

Over the past decade, partly in reaction or interreaction, first, Catholic parents took one-third of the students out of parochials and forced scores of colleges under episcopal control to close; second, tens of thousands of nuns left the parochials; third, bishops have: (a) Preemptorily closed many parochials serving poor, black and Hispanic Catholics, sometimes threatening even excommunication to victims with too many questions; (b) mounted a concerted propaganda campaign claiming (1) they were poor (most don't publish financial reports) and (2) that curricula permeated by religion on orders from the Vatican was somehow "secular"; (c) mounted a long-range political campaign to move legislators at every level to help finance with public funds their policy to retain sole control of all Catholic education, and to thwart thereby large elements of the Catholic community.

S. 2356 represents one more effort to support such episcopal control, to thwart American Catholics, and to foster segregation, and thus to thwart congressional intent, i.e. to help victims of racism and poverty (USEA 1965).

NAL strongly urges you to reject S. 2356 as antipathetic to basic U.S. public policy and to the Constitution of the republic.

Enclosed: "Religious Education", 1969 NAL basic resolution on Catholic education.

Religious Education

In spite of overwhelming evidence, including such serious studies as the "Notre Dame Report" and the "Greeley-Rossi Study" pointing to the home as the primary influence, to the parents as the key persons in transmitting a Christian value system, there is little real support and guidance for parents and families structured into present parish life. The financial and energy drain on parishes required by current religious education programs eliminates the resources necessary for a parish thrust that would serve all its members.

In view of this, we of NAL strongly urge that every resource presently used in religious education programs for children be redirected into a total, comprehensive approach to the human and religious needs of all; that every possible resource be directed to explore ways of establishing meaningful Christian community.

As a lay group, we reiterate what many of the foremost authorities in catechetics are suggesting today: Children ought simply be allowed to grow up and be given the opportunity to meet "the Word" in the flesh before they hear it: adults ought to pray with them and, out of the security of a truly supportive Christian community, search for ways to change the society and the conditions in which they live.

In order to develop this approach, we suggest that:

(1) A gradual phasing-out process for church-run elementary and secondary schools be formulated and made public. This phasing out

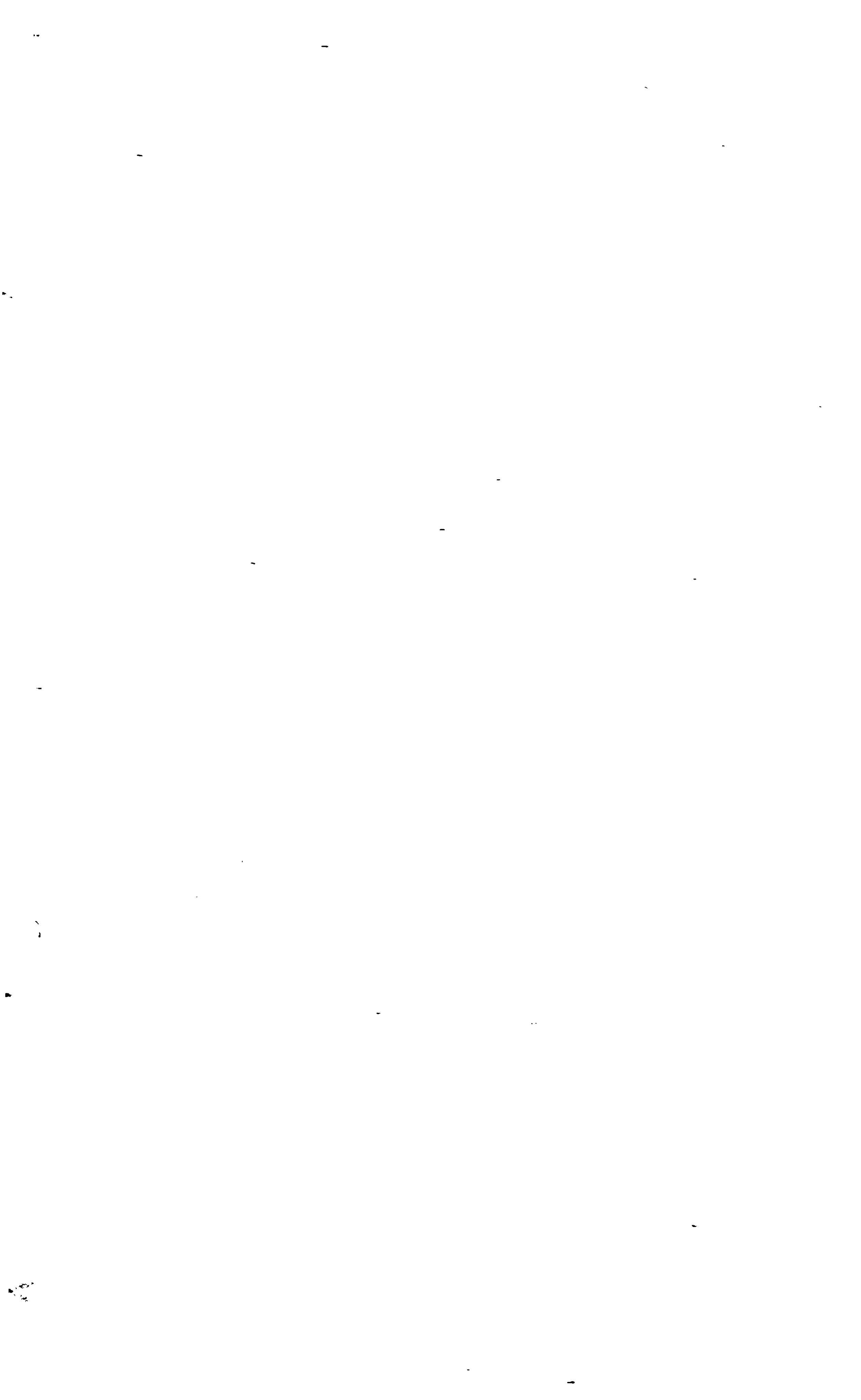
would not include any school programs designed to serve the exceptional child: the culturally deprived, the disturbed, the retarded; school programs attempting to meet needs presently not addressed by the local school system.

(2) As buildings, personnel and finances are made available, they be utilized where feasible to create parish community centers. These centers could be used for informal religious education programs for these experientially prepared to discuss the Christian truths: adults and young adults. Developmental religious experiences serving children in the context of the adult community could be integrated into the center's program as experts judge the need. Marriage and family counseling under the direction of trained professionals would be available. The parish would serve as a social center for young and old and, when possible, a meeting ground for the broad community.

(3) In the large parish, some form of subgrouping be developed in order to supply that essential aspect of Christian life for young and old: identification with a mutually supportive Christian reference group. Such groups must be small enough for all to experience the events in the lives of the members and their Christian dimension; small enough to experience a community search for truth and for an adequate response to God in today's world. Only such experiences can provide the background for a young adult's study of the Christian life and give him the fullness of person necessary for his witness.

Energy Conservation

69510—76——36



TAXATION WITH REPRESENTATION,
A PUBLIC INTEREST TAXPAYERS' LOBBY,
Washington, D.C., April 19, 1976.

STATEMENT BY THOMAS J. REESE, LEGISLATIVE DIRECTOR, TAXATION WITH REPRESENTATION, REGARDING THE ENERGY BILL, H.R. 6860 PRESENTED TO THE SENATE FINANCE COMMITTEE

Mr. Chairman, and members of the committee, my name is Thomas J. Reese, and I am legislative director of Taxation with Representation, a public interest taxpayers' lobby with almost 18,000 members.

The Senate Finance Committee plans to take up the energy bill (H.R. 6860) at the same time as the tax reform bill. We have already furnished our comments on the reform bill to the committee. The following additional comments relate to the energy bill.

I. THOROUGHLY BAD LEGISLATION

As it stands, the energy bill contains two main sets of proposals. First, there are energy conservation measures that are, in themselves, of dubious worth. In connection with these provisions, we suggest more reliance on the free market mechanism and less government interference in the form of price controls, quotas, and tax gimmicks.

Second, the energy bill contains a hodgepodge of thoroughly ill advised and highly objectionable tax provisions, some of which are more or less thinly disguised as energy conservation measures. Included in this objectionable category are:

1. The repeal of the excise tax on radial tires (sec. 222).
2. The proposed tax credit for insulation of residences (sec. 231).
3. The proposed tax credit for solar energy equipment (sec. 232).
4. The proposed tax credit for the purchase of electric cars (sec. 233).
5. The 5-year amortization for railroad equipment (sec. 422).
6. The 5-year amortization for railroad rolling stock (sec. 423).
7. The special investment credit for solar energy equipment and insulation (sec. 431).

In short, whether the energy bill is looked at from the standpoint of energy conservation, or as a tax measure, it constitutes thoroughly bad legislation. We recommend that it be set aside, and that it be allowed to die a quiet death at the end of this Congress.

II. A DISCUSSION OF THE BILL'S TAX PROVISIONS

Set forth below are the reason for our objections to each of the listed tax provisions of the energy bill:

1. *Excise tax on radial tires (sec. 222)*.—This provision would give a special tax advantage to one segment of the tire industry at the expense of others. Discrimination of this sort between one firm and

another is hard to justify. Furthermore, the revenue cost of the radial tire proposal—which is estimated at $75 million annually—seems far greater than the possible energy savings can justify. Finally, it is important to remember that the excise tax on tires is intended as a user charge to defray the cost of building the Nation's highways. The radial tire proposal would breach that principle by allowing radial tire owners to use the highways even though they have not paid their fair share of the cost.

2. *Insulation of residences* (*sec. 231*).—This is a politically appealing but utterly misguided attempt to encourage individuals to insulate their homes. It is structured so that those who least need help will get Government aid, and those who most need assistance in installing insulation will get no Government help at all. This upside-down irrationality results from use of the tax system, rather than direct appropriations, to achieve an important national goal.

The persons who most need help in insulating their homes are those too poor to pay income tax. Moreover, they are the individuals who suffer most from the effects of high-energy prices. This proposal will give them no help at all, while conferring substantial help to wealthier individuals earning large incomes. At a minimum, the credit should be made refundable, so that the poor will benefit too.

In general, however, we feel that direct appropriations are a far better means of encouraging home insulation, if government intervention is felt to be necessary. When direct appropriations are used, the costs of a program can be carefully controlled, unlike the costs of a tax credit, and aid can be directed to the areas of greatest need. Moreover, use of the appropriations route will encourage more careful scrutiny of both costs and likely benefits. At present, it seems that the possible benefits of this proposal, estimated at a saving of 100,000 barrels per day of oil in 1977, does not justify the huge revenue loss which is involved: $260 million annually.

3. *Solar energy credit* (*sec. 232*).—This provision is a woolly minded attempt to do good by providing encouragement for the development of solar energy. The revenue loss through 1978 is expected to be minimal, only because no one expects this provision to have any effect before that date. From 1979 on, however, the revenue loss will grow, because more solar energy equipment is expected to come into use at that time.

Thus, the proposed credit will be useless during the important developmental stages of solar energy technology, but it will constitute a fiscal time bomb with respect to future tax revenues. A direct appropriation for controlled funding of solar energy research makes far more sense than providing open-ended tax credits which can cause serious trouble in the future, but which will be of little or no immediate help in solving our energy problems.

4. *Electric car credit* (*sec. 233*).—A tax credit for electric cars makes about as much sense as a tax credit for breathing. Electric cars are being sold as fast as they can be built. A tax credit will simply allow the producers and sellers of these vehicles to raise their prices by approximately the amount of the credit. Moreover, the cars are less energy efficient than cars powered by internal combustion. This provision is therefore a recipe for energy waste and tax windfalls.

5. *Five-year amortization of railroad signals, yards, et cetera (sec. 422)*.—This provision has nothing to do with energy conservation. It grants further tax breaks to profitable banks and railroads that don't need help, while doing nothing for bankrupt railroads that do. Under the proposal, new signals, traffic controls, classification yards, loading and unloading facilities, and tracks will become eligible for rapid amortization. The firms that would benefit from this provision already enjoy both accelerated depreciation and the 10-percent investment credit; that should be enough. Those railroads that need help to stay in operation would not be aided by this provision. Only banks—which pay almost no Federal taxes now—will be able to take real advantage of this provision through their leasing operations. At a minimum, we recommend that the benefits of this provision be denied to corporate lessors, including banks and other financial institutions.

6. *Five-year amortization of railroad rolling stock (sec. 423)*.—As with section 422, poverty-stricken railroads, which pay no taxes because they have no profits, will not benefit from this provision. Instead, the beneficiaries will be banks and financial institutions, which have enough tax loopholes already—so many, in fact, that the largest commercial banks now pay Federal tax at an effective rate of only 2 percent, far below the tax rates paid by ordinary wage earners. If Congress wishes to aid railroads, it should do so through the appropriations process, not through new tax loopholes.

7. *Investment credit for solar energy structures and insulation (sec. 431)*.—Buildings and similar structures already get favorable treatment under the tax code, in the form of accelerated depreciation and other benefits. For that reason, Congress has not extended the 10-percent investment credit to buildings. This proposal would breach that precedent, and thereby open the way to huge potential revenue losses. But there is no need to incur this serious risk, because the high price of fuel will encourage all the business use of insulation that is needed. Creating tax breaks will only lead to installation of more insulation and solar energy equipment than can be justified economically.

III. ENERGY CONSERVATION AND CONVERSION—TITLES III AND IV

In general, Taxation with Representation opposes trust funds, including trust funds for energy purposes, such as the fund that would be established by section 311–314 of the energy bill. Trust funds tend to lock Congress and the government into supporting programs that no longer have high priority. If a program is important, Congress should appropriate money for it annually out of general revenues. Tying money up in trust funds is an admission that Congress cannot be trusted to make intelligent decisions about national priorities. We believe that Congress should be free to determine how Federal revenues should be spent, and that it should not tie its hands through use of a trust fund for energy purposes.

Taxation with Representation does not support the proposed excise tax on business use of petroleum and petroleum products as set forth in section 411 of the bill. This provision might have made sense when the bill also included a gasoline tax, but it makes no sense to discriminate against the use of petroleum for business as opposed to nonbusiness purposes.

We also oppose rapid amortization of certain energy use property, as proposed in section 421 of the bill. In opposing this section, the Treasury Department has testified that the provision will encourage only an insignificant amount of conversion to coal of facilities that currently use oil or gas. To waste taxpayers' money on ineffective tax incentives is just as bad as wasting money on planes that don't fly or public-assistance programs that fail to serve real needs.

Corporate tax rates and surtax exemption (*title IX*).—We are very strongly opposed to increases in the corporate surtax exemption. These increases are extremely costly in terms of lost reveue, and they make the corporate form an even more attractive tax shelter than in the past. We recognize that these proposals are billed as aid for small business, but most small businesses are not incorporated. In fact, the principal benefits of these proposals go to larger firms and to the upper bracket owners of closely held corporations, who prefer to squirrel away profits in their firm where the initial profits are taxed at a rate of only 20 percent, rather than pay a 70-percent tax on distributed dividends.

Treatment of foreign income (*title X*).—We strongly support repeal of the exclusion for income earned abroad (sec. 1011). We oppose the exemption for U.S. charitable organizations or for employees working on construction projects.

We support the provision dealing with U.S. taxpayers married to nonresident aliens (sec. 1012). We also strongly support restrictions on foreign trusts (secs. 1013–1015). Further restrictions on these trusts are necessary.

We support complete elimination of deferral on foreign subsidiaries of U.S. corporations. Repeal of deferral would make sections 1021 to 1025 of the bill unnecessary along with the enormously complex rules of subpart F of the code. Absent complete repeal, we support the elimination of the provision dealing with less-developed country corporations (sec. 1022) and oppose sections 1021, 1023, 1024, and 1025 which merely widen the opportunities for deferral.

The tax reform bill repeals the per country limitation on the foreign tax credit (sec. 1031). We favor repealing overall limitation. The purpose of the foreign tax credit is to prevent double taxation. Given this, the best answer in this area is the per country limitation, with a provision that recaptures startup losses across the board for all firms, including oil and minerals. In contrast, the overall limitation confers the right to average taxes between high- and low-tax jurisdiction, and this encourages the use of tax havens.

We support the recapture of foreign losses when foreign income is earned in future years (sec. 1032). We also support grossing up dividends paid by less developed country corporations (sec. 1033.) And we support noninclusion of capital gains in foreign source income for purposes of the foreign tax credit, if no substantial foreign tax had been paid on that income (sec. 1034). We oppose a carryback for extraction taxes which would otherwise be disallowed with respect to foreign oil and gas extraction income (sec. 1035).

We oppose making permanent the existing exemption for interest on bank deposits in the U.S. received by a nonresident alien (sec. 1041). We also oppose widening this exemption to include dividends paid by U.S. corporations to foreign investors. We oppose these pro-

posals for several reasons: (a) A reduction in the withholding tax is the main quid pro quo available to U.S. negotiators when requesting similar concessions from foreigners; unilateral elimination of the tax would make it much more difficult to get similar concessions for U.S. persons investing in foreign countries; (b) although these proposals are designed to attract OPEC oil money, they seem unlikely to do so, because OPEC can already invest in the U.S. to the extent desired through dummy corporations formed in countries that have tax treaties with the U.S.; (c) the proposal would turn the United States into a tax haven jurisdiction, thus attracting unstable hot money, which is liable to flow out of the United States again at the first sign of difficulty. If the committee wishes to take action in this area, it should concentrate on the dummy corporation problem, item (b) above, rather than on schemes for turning the United States into a tax haven.

We support changes in ruling requirements under section 367 with respect to reorganizations involving foreign corporations (sec. 1042).

We oppose allowing mutual life insurance companies maintaining separate operations in countries contiguous to the United States, for example, Canada, to treat the operations as if carried on through a foreign subsidiary (sec. 1043). If they want to be treated as a foreign subsidiary, let them reorganize themselves as a foreign subsidiary.

In general, we feel that banks should be subject to the same capital loss limitations as are other taxpayers in connection with worthless securities. Thus, we oppose the special treatment already given to domestic banks by existing code section 582. But if domestic banks are to be given the special treatment of losses provided in section 592, we see no reason for failing to extend the same treatment to foreign banks (sec. 1044). However, we believe that any change of this sort should be made on a prospective basis, rather than as a retroactive favor for specific firms.

It is not at all clear why Puerto Rico should enjoy special treatment. We therefore oppose section 1051. We strongly support the repeal of the Western Hemisphere Trade Corporation (sec. 1052) and the China Trade Corporation (sec. 1053) provisions.

Domestic International Sales Corporation (*title XI*).—The Domestic International Sales Corporation provisions of the code should be repealed entirely. The DISC provision is tremendously costly, and is no longer needed for balance of payments reasons, if indeed it ever was, because we have solved our balance-of-payments problems by floating the dollar.

Administrative provisions (*title XII*).—We support the proposals to regulate the rapidly expanding tax return preparation industry (sec. 1201). At the same time, we would like to make several observations:

1. The growth of the tax return preparation industry is a direct result of the fantastic complexity that now characterizes our revenue laws. This complexity, in turn, is a result of the failure of Congress to enact basic tax reform. See the discussion, earlier in this presentation, of the tax shelter and minimum tax proposals.

2. The sums paid by ordinary taxpayers to tax return preparers are, in effect, a hidden tax, over and above the actual tax paid. Congress can reduce this hidden tax through basic tax reform.

3. One of the main reasons why tax return preparers need to be regulated is that individual tax returns must all be filed on or before April 15 each year. This encourages fly-by-night return preparers who operate for a few months each year and then disappear. Staggered filing of individual income tax returns throughout the year would enable return preparers to offer year-round employment, and would lead to greater professionalism in their ranks.

We support the provision providing for declaratory judgments with respect to section 501(c)(3) status and classification (sec. 1202). We also support the provision allowing assessments in case of mathematical errors (sec. 1203), and the provisions for withholding (secs. 1204–1207). We suggest that withholding be extended to include withholding on dividend and interest income. Substantial amounts of dividend and interest income still go unreported each year, despite the ineffective information reporting requirements enacted a decade ago, and the time has come to put an end to this form of upper bracket tax evasion. What is needed is a withholding system with respect to dividends and interest similar to our existing system of wage withholding.

The exemption from the taxes on wagering for State-conducted lotteries can be viewed either as a clarification of existing law or as a measure of assistance to those States that have decided to conduct lotteries (sec. 1208). To that extent, it seems unobjectionable.

Tax court review of jeopardy and termination assessments (sec. 1209) is supported by Taxation with Representation as is the minimum exemption levy for income (sec. 1210). We also support section 1211 dealing with administrative summons.

Taxation with Representation has strongly supported the public inspection of letter rulings (sec. 1212). The provision of the bill, however, needs to be improved. For a complete explanation of our position see the March 4, 1976, memorandum of understanding between the IRS and other parties to the rulings dispute.

Technical income tax provisions (*title XIII*).—We have no objections to the proposed tax treatment of cooperative housing associations (sec. 1301) nor to the treatment of agriculture disaster payments (sec. 1302). We do object to special tax treatment of the cancellation of certain 1972 disaster loans (sec. 1303). The limits put on the tax forgiveness by the provision, however, make it less objectionable. But if special relief of this sort is to be granted, it should be handled as a private relief bill, and the beneficiaries should be named. We have no objectives to section 1304 dealing with the tax treatment of certain debts owned by political parties to accrual basis taxpayers (sec. 1304). Nor do we object to the clarification of the definition of produced film rents (sec. 1305).

Prepublication expenses should be capitalized rather than deducted currently. They do not properly qualify as research and development costs. We oppose section 1306 because it departs from these principles.

Treatment of capital losses and gains (*title XIV*).—It is grossly inequitable to tax capital gains more lightly than income earned by the sweat of one's brow. Furthermore, existing capital gains privileges are the root cause of much of the existing complexity of our tax laws. And capital gains privileges are enormously costly in terms of lost revenue, with substantially all of the benefit going to the very richest segments of the population. For all these reasons, we oppose enlarge-

ment of existing capital gains privileges and applaud efforts to reduce them.

For the reasons just outlined, we oppose increasing the amount of ordinary income against which capital loss may be offset (sec. 1401). Unless capital gains are treated as ordinary income, there is no justification for treating capital losses as offsets to ordinary income.

We strongly support an increase in the holding period for long-term capital gains or losses (sec. 1402). However, we feel that even 1 year is a very short time in which to qualify a gain as long term. Given the extraordinary character of existing capital gains privileges, we feel that 5 years should be the minimum time required to qualify for long-term-gains privileges.

We strongly oppose allowance of 8-year capital loss carryover in case of regulated investment companies (sec. 1408). If the capital loss carryover period is to be extended, that steps should be taken with respect to all taxpayers, not just investment companies. Moreover, any legislation in this area should be prospective, rather than retroactive.

Individual retirement accounts (*title XV*).—While we regard IRA's as a highly questionable tax aid for wealthy professionals and others, we see no ground for objecting to these housekeeping amendments, which are primarily designed to prevent unexcepted tax consequences if a plan terminates, and to permit use of IRA's by certain individuals who would otherwise be barred from eligibility by participation in a qualified pension, profit sharing, or annuity plan.

Real estate investment trusts (*title XVI*).—The special tax favors granted real estate investment trusts are premised on compliance with clearly specified rules relating to income sources and distributions. This set of provisions would excuse REITS from many of the consequences of noncompliance with those rules, and would make a number of other changes designed to facilitate organization and operation of REITS. We believe that the existing tax rules relating to REITS should be strictly enforced, and that there is no justification for seeking to increase the attractiveness of a form of business organization which has tax minimization or avoidance as one of its major goals.

Tax treatment of railroad tunnel bores and ties (*title XVII*).—Both sections of this title should be deleted from the bill (secs. 1701 and 1702). Tax relief for railroads only helps those few railroads which are already making profits. If the railroads need help, they should get it directly through direct expenditures which will be targeted to where there is the greatest need. Retroactive tax relief for tunnel bores does not encourage improvement of the railroads.

Tax credit for home garden tools (*title XVIII*).—If this provision did not cost over $20 million, it would be humorous. A tax credit for tools for home vegetable gardens is impossible to administer. How can the IRS know whether the tools are used for vegetable or roses? The tax provision is wasteful. How many people buy $100 worth of tools each year for the vegetable garden? This provision will just add another complex item to the tax return form which will cut taxes no more than a maximum of $7 per taxpayer. It is better to just give this $20 million in general tax cuts.

Deadwood bill (*title XIX*).—We support enactment of the deadwood bill as a means of removing useless verbage from the Internal Revenue Code.

OTHER REFORMS

In order to make the bill a true tax reform bill, taxation with representation urges the committee to close some other loopholes. In particular we favor:

Taxation of unrealized capital gains at death or gift.

Estate taxation of generation skipping transfers.

Provision of a Federal interest supplement large enough—40 percent—to insure that States and localities will voluntarily issue taxable rather than tax exempt bonds.

Allocation of deductions between taxable and tax exempt income.

Repeal of percentage depletion for all minerals.

I have additional information on each of the above proposals which I will be happy to make available to any member of the committee or Senate.

Thank you, Mr. Chairman.

INSTITUTE OF SCRAP IRON AND STEEL, INC.,
Washington, D.C., April 23, 1976.

Re Tax Reform Act of 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: The Institute of Scrap Iron and Steel, Inc. previously requested the opportunity to appear before the Finance Committee to present its views with respect to proposals for a tax credit for utilization of recyclable commodities. Because of the large number of witnesses wishing to testify and because of scheduling difficulties, the Institute was unable to appear. This letter is submitted to you and to other members of the committee in lieu of such appearance and in support of an amendment to H.R. 10612 to include a tax credit for use of recyclable commodities.

The Institute of Scrap Iron and Steel is a national trade association representing approximately 1,450 member companies involved in metallic scrap processing.

Because of the dramatic reduction in energy utilization and because of the environmental benefits which are achievable if commodities are made from recyclable materials as opposed to virgin minerals,[1] it is important that the tax code not remain structured in such a way that it continues to favor the virgin minerals to the detriment of recyclable commodities. The present tax code has such a bias in favor of virgin minerals. The amendment herein proposed seeks to achieve tax equality between the competitive virgin and recyclable commodities and to provide an incentive for the use of the recyclable commodity.

Under existing law, a taxpayer who extracts a depletable mineral is required to take as a deduction the greater of percentage or cost deple-

---

[1] According to an Environmental Protection Agency study 75 percent less energy is consumed in making steel from scrap and, in addition, 86 percent less air pollution and 76 percent less water pollution occurs when ferrous scrap rather than iron ore is used in steel production.

tion. Since percentage depletion is geared to increasing market value whereas cost depletion is limited to the taxpayer's adjusted basis in the property, percentage depletion generally exceeds cost depletion. Thus, the tax benefit with respect to the virgin mineral is the difference between percentage and cost depletion. On the other hand, recyclable commodities are not eligible for depletion. The recyclable commodity thus is placed at a competitive disadvantage vis a vis the virgin mineral by virtue of the percentage depletion allowance.

With respect to iron ore, it has been estimated, using the very limited available data, that the tax benefit between cost depletion and percentage depletion could approximate 5 percent. In order to equalize the treatment afforded to purchasers of virgin and recyclable commodities, it is proposed, first, that a tax credit be offered to the purchaser of ferrous scrap in an amount equal to 2½ percent of the total value of the recyclable goods purchased. This credit could approximate the tax benefit now enjoyed by iron ore.[2] This credit would apply to all purchased ferrous scrap from industrial and post consumer waste sources but would not include inplant or home scrap.

Second, in order to encourage the increased use of recyclable commodities because of the energy savings and beneficial environmental effects achieved, an additional tax credit of 5 percent is proposed for increased purchases of recyclable commodities above a base period amount. It is suggested that the base period for existing ferrous scrap purchasers be the amount purchased in the period 1973 through 1975. This appears to be a representative period. The base period for new entrants into the market is suggested as an amount equal to 75 percent of the total purchases for the 13th through 24th months of operation. During the period prior to establishment of the base period amount, new entrants would receive a 2½ percent tax credit. This approach offsets the difference between percentage and cost depletion, yet does not give an undue competitive advantage to new entrants over existing purchasers.

The revenue impact of the proposal with respect to iron and steel scrap is estimated to be approximately $50 million a year. The amount will increase slightly over time as the total volume of ferrous scrap purchased increases.

In supporting the proposed amendment, the Institute would like to make clear that its members are not the recipients of the tax credit. The credit would be available only to top purchasers from the scrap processing industries—the steel mills and foundries. The Institute supports this tax credit proposal both because of its belief in the environmental and energy saving benefits to be derived from this proposal and because of the assist that this credit gives to the purchasers of recyclable materials in meeting their needs for capital investment in the coming years.

The Institute would be pleased to continue working with the committee staff to develop an amendment along the lines herein suggested.

Very truly yours,

HERSCHEL CUTLER.

---

[2] If it were to be shown that the differential between cost and percentage depletion was different than that estimated, the Institute would support an appropriate credit based on this differential.

MARTIN & SONS,
FOAM INSULATION CONTRACTORS,
Egg Harbor City, N.J., April 12, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am a foam insulation contractor of Rapco Foam Insulation. As a small businessman, I feel that the H.R. 6860 bill would promote significant energy savings nationally and financial savings for many American consumers.

I feel that the insulation materials that would be approved for tax credit should not be restricted to insulation materials specified in the National Bureau of Standards. This means that only insulation materials that have either a Federal specification number or an American Society of Testing and Materials (ASTM) production designation materials would be approved. Obtaining a Federal specification number or ASTM designation of this kind can take as long as 5 years. This means that any new insulation product, as effective as it may be, would not receive the tax credit for a long time.

Urea-formaldehyde foam, u-f foam, is a proved home insulation which could be ruled out for tax credit because it doesn't have a Federal specification number or an ASTM designation. This U-F foam has been proved to have a better insulating conductivity than most insulation. It is fire resistant, unlike other plastic insulation foams and has been installed in more than 50,000 homes. It is guaranteed for the life of your home and has many special and unique qualities. An example of this is: U-F foam will flow around, behind, and over pipes and wires and anything else inside the house walls filling the entire space. Other insulation, such as fiberglass insulation, will not do this.

I strongly feel that the energy conservation bill, H.R. 6860, should permit a tax credit be given to the product that I sell. This product has been approved by the FHA and has a license to be manufactured and sold in North America according to the patented Isoshaum process.

Currently, I am under contract to foam insulate the U.S. Coast Guard Station in Cape May, N.J.

Very sincerely yours,

DONALD H. MARTIN.

YOUNG BUILDERS, INC.,
Phoenix, Ariz., April 20, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We are involved in the insulation business in Arizona. Much of our time is spent promoting the use of better types of insulation materials as well as more conventional materials.

Most of the new insulation products that have come on the market in the past few years have a higher insulation value per inch than the more conventional materials. For instance, we have been installing the urea-formaldehyde foam extensively in new and existing homes,

apartments, commercial structures, etc., for the past 2 years. We also install blankets, batts, blown-in insulation, and styrofoam sheets; however, the U-F foam has a much higher insulating value than the other materials mentioned and because it completely fills any voids found within the wall and will not sag, rot or deteriorate and because it is fire resistant, we feel that it is superior in many ways to most of the products you intend to approve under the restrictions specified in the National Bureau of Standards: "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit"; NBSIR 75-795, prepared for the Federal Energy Administration.

Some of the products that have been used for many years with satisfactory results and most of the products that will most certainly be developed over the next few years have been automatically disqualified under your bill because of the time required to obtain an ASTM or Federal specification. If you are really interested in energy conservation, you cannot, in good conscience, disqualify some of the most efficient energy saving materials on the market. The U-F foam has been approved by ICBO and all cities and municipalities subscribing to ICBO. It has been very successfully used in thousands of homes for retrofit purposes.

In the best interests of the homeowner and of the energy conservation issue, we strongly urge you to permit a tax credit for any commonly used home insulation material that is accepted under local code requirements.

Sincerely,

JOHN YOUNG, *President.*

M.R.S. URETHANE CO., INC.,
Masury, Ohio, April 22, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We, of M.R.S. Home Insulation Co., a division of M.R.S. Urethane Co., are in complete accord with the home insulation tax credit provisions of the proposed H.R. 6860 bill except for some significant point.

The subsequent benefits from the passage of this bill would be prodigious. Energy conscious citizens would be justly rewarded as would our Nation as a whole. Because of the immense number of uninsulated and inadequately insulated homes in our country, statistically placed at 90 percent by knowledgeable sources, we are wasting an inestimable and inconceivable amount of energy. Our heritage contradicts that this should be, and for it to continue belies the American way of life. The response to usage of this tax credit, for the purpose of which it intended, should be overwhelming as will the effect.

But there is a serious flaw in the discriminating and banning of certain insulating materials because they are not recommended by the National Bureau of Standards.

Although urea formaldehyde was invented in Germany in 1928, it is still relatively new to the general public. Nonetheless the industry

has been growing rapidly since 1968 in our country, and U-F foam is gaining popularity over all other insulations as is demonstrable in its current demand. In excess of 50,000 homes have been insulated with U-F foam to date, and a conservative forecast would place the number at 500,000 by the end of this decade.

The National Bureau of Standards has a booklet available, "Retrofitting Existing Housing for Energy Conservation," SD Catalog No. C13:29:2/64, that is quite informative. It is completely unbiased in its comparisons of quality, durability, weaknesses, and costs of all available insulation materials.

U-F foam is broadly covered and shown to be comparable or superior in all areas. Why, then, is it not recommended in NBS's "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit"?

The obvious reason is that U-F foam, and there are other retrofitting materials, does not have either a Federal specification number or an ASTM (American Society of Testing and Materials) product designation.

Obtaining either of these would require considerable time, 4 to 5 years, and expense. Consequently, we feel that this would be the public's loss.

In conclusion I respectfully request that H.R. 6860 be extended to permit a tax credit for such insulation materials that meet local and national building codes and are proven from actual consumer usage.

Sincerely,

HERBERT ROMELFANGER, *President.*

THE HOMEFOAMERS,
ALL SEASON INSULATION, INC.,
Glenwood, Iowa, April 16, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Building,
Washington, D.C.

DEAR MR. STERN: Our company is very concerned about the wording in the Energy Conservation and Conversion Act, H.R. 6860. As it is now written it would unfairly discriminate against the many homeowners who recognize and appreciate the superior job Rapco-Foam (a ureaformaldehyde foam—not a polyurethane foam) insulation will do for them.

The facts have been explained in detail to you, Mr. Stern, in a letter from Charles H. Stillman, president of Rapperswill Corp.

This bill would surely aid people who are aware of the need for insulation resulting in energy conservation but who are financially unable to stretch their budgets for the needed improvement to their homes.

The energy conservation bill should permit a tax credit on any commonly used home insulation material that meets local building code requirements; the requirements of any national building code; or has clearly proven itself in actual use in houses and commercial buildings.

Please give this matter your attention. When you become aware of the superiority of some of the newer insulation materials such as Rapco-Foam, we're sure you will realize the bill would be very unfair if passed as it is now written. We have more than 200 satisfied customers whose homes we have insulated with Rapco-Foam during the past year. It would certainly be unfair for our future customers to be denied the tax credit.

Sincerely,

DOUG ANDERSON,
CHUCK GREEVER,
Coowners.

S. & R. HOME FOAMERS,
Miles City, Mont., April 20, 1976.

Re Energy Conservation and Conversion Act H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: As a concerned citizen, I feel, but for one exception, that the home insulation tax credit provision of proposed H.R. 6860, is a great step forward toward the conservation of energy in the field of home and business heating.

My objection is to the limiting as to the types of insulation that qualify in the provision. It is my feeling that any proven insulation that meets FHA and VA specifications and that meets or exceeds all local and State building codes, should not be excluded for the lack of a Federal specification number or ASTM product designation.

One insulation of this type is urea formaldehyde foam insulation which has a higher R factor than almost any insulation on the market. It is fire resistant and when injected into existing structures, will fill every crevice through which heat can escape.

With the older established insulation put into existing structures, will not provide a R factor that would meet FHA or VA minimum requirements for a R11 factor.

By limiting types of insulation, I feel that this would act as a curtailment of incentive to develop even far better and more economical insulation products than we know of today.

Thank you for your kind attention to this matter.

Yours truly,

GARRY T. SCHYE.

STATEMENT OF PAUL W. EGGERS, PRESIDENT, GEOTHERMAL KINETICS, INC.

Geothermal Kinetics, Inc., Phoenix, Ariz., is engaged exclusively in the development of geothermal energy. The company is 5 years old, and during that period has spent in excess of $5 million on exploration and drilling for geothermal energy. Almost all of its operations have been on a joint venture basis with other companies.

GKI has an in-house capability to develop a project from the initial geological studies, geophysical field work, leasing and to the final

drilling of the prospect. We have our own drilling subsidiary company and a geothermal subsidiary company headed by Drs. George Keller and Normal Harthill, leaders in developing electrical geophysical methods for finding geothermal resources. The company has ownership in leases in various Western States. We are presently drilling a well in the Geysers Area and another will in southern Utah. We drilled a well in the Geysers Area, Sonoma County, Calif., 2½ years ago which was a commercial producer.

The geothermal industry is at a stage where the oil and gas industry was 30 to 40 years ago. It has been predicted that under an aggressive exploration and drilling program the geothermal industry could replace 1 million barrels of daily oil production by 1985. This is only a small answer to our overall energy crisis, but when you consider that our domestic production is between 8 to 9 million barrels of oil a day, this becomes a very viable alternate answer to the crisis.

The potential of geothermal energy in this country cannot and will not be developed unless incentives are provided to enable this infant industry to become viable. Exploration and drilling are very expensive operations and require considerable amounts of risk capital. Such capital will be made available only if there are reasonable prospects of substantial gain. With geothermal not presently being provided incentives of the type that were originally available for the development of the oil and gas industry, and with it not being provided depletion allowances of the type available to coal and other minerals, the prospects of significant production at competitive prices are remote. It must be remembered that the geothermal industry is not in competition with coal. There is, of course, a depletion allowance available for the mining of coal.

With respect to the well drilled in the Geysers area which is in commercial production, the owners of the lease of surface rights claim the geothermal rights belong to them rather than to the lessees of the mineral rights. This has been in litigation for more than 2 years and, although a decision by the district court in Sonoma County, Calif., is expected momentarily, this litigation can be expected to continue through appellate courts for several more years while production is held in abeyance. There is also litigation over the tax treatment to be accorded geothermal. The U.S. Court of Appeals for the Ninth Circuit has held in *Reich et al.* v. *Commissioner*, 454 Fed. 2d 1157, affirming 52 T.C. 700 (1969), that geothermal is a gas within the meaning of 26 U.S.C. 613 and thus is entitled to depletion under that statute. However, the Commissioner of Internal Revenue did not acquiesce in that decision, but has taken the position that geothermal is not entitled to depletion allowances. With litigation hampering development and with the Commissioner asserting there is no right to depletion, it is impossible to attract significant investment funds and to further develop this industry on a meaningful scale.

If determination of congressional intent with respect to geothermal energy is delayed through many years of litigation before there is a final determination much will be lost. GKI projects that we will need to spend $10 million in the next 5 years for lease acquisition, geophysical work, drilling, and developing. This can be accomplished only through the acquisition of partners who will invest in the venture.

The refusal of the Internal Revenue Service to acquiesce in the decision in the *Reich* case will deter potential investors. It is essential that the issues be clarified by the Congress at an early date rather than awaiting prolonged litigation.

We urge, therefore, that the committee approve S. 2608 which will clarify congressional intentions, provide sufficient incentives for the development of geothermal energy, and thus help reduce the dependency of the United States upon foreign sources for its energy supplies. While we recognize that nuclear and synthetic fuel programs should also be developed, geothermal energy is an immediate, readily available, partial answer to our increasing energy crisis.

STATEMENT OF GERALD HASLER, PRESIDENT, NATIONAL REMODELERS ASSOCIATION

On July 15, 1975, I filed a statement with your committee on behalf of the National Remodelers Association, favoring approval of H.R. 6860, which was then the energy "package" before it. Our focus was on section 231 of that bill, which provided a tax credit for energy-conserving home improvements. On behalf of the Nation's 160,000 local home improvement contractors, we stated to you that section 231 provided a solid incentive for our industry to use in merchandising to the public energy conservation in the home.

Since that time a number of events have occurred. On the down side, the energy package became stalled while segments of it were removed from it and given priority attention by your committee. The prime inducement to the general public to participate in energy conservation, the tax credit, stayed in committee while other considered more pressing became detached from the package and were enacted. On the positive side, the credit has been enlarged to $225 (or 15 percent of the first $1,500 qualified expenditure), and the language of the House bill, which extends the qualification to all energy-conserving home installations has remained intact.

In March of 1976, with your committee once again seeking a broadly based, public energy conservation program, we urge quick enactment of section 231. We do so not alone for the reasons articulated to you last July, but because an additional consideration makes this credit more important in policy terms now than it was last July.

That consideration is the changing structure of the home improvement business.

Last July we told you of the vast energy savings that this uniquely citizen-participation program would generate. That is still completely true: 41 million gallons of fuel oil will be saved annually if the tax credit is utilized in the insulated siding market as that market was in 1974, the last statistics we have for it. Moreover, an additional 90 percent of that figure (close to 37 million gallons of fuel oil) will be conserved annually in the insulated doors and windows segment of our industry if the tax credit is projected from our experience for the same year.

Our concern this March is not alone for conservation but also for the economics of our industry. Home improvement revenues annually

generate a projected $26 billion, a healthy figure. That figure is growing annually. We have been able to perform in the marketplace and for public agencies (in certain of HUD's programs) where the homebuilders were incapacitated by financial losses and failures. And while we can report overall health within our businesses, we remain an industry made up of small, local units uniquely sensitive to economic fluctuations. Our concern today is for one important segment of our industry: its smallest in individual size and financial strength, the young contractor and the neighborhood contractor with limited resources. We face the phenomenon of overall affluence within our industry and, at the same time, a disappearance of numbers of our single-owner or double-owner businesses as the economic tides force them from the industry.

The first of these pressures was the credit crunch. No industry—with the exception of the home developers—was so heavily hit by the unavailability of local credit as was home improvement. What occurred was that while the overall size of our industry, and its revenues, remained stable, hundreds of contractors, unable to finance their operations from local banks abandoned home improvement for other work.

Another of the events which left their marks on the smallest of the small, our contractors in small towns and in rural areas, was the increasing regulation of local consumer financing at the State and Federal level, which had the effect of diverting local banks away from the small contractor toward financing the commercial paper of his larger, more affluent competition. On May 14 of this year the Federal Trade Commission's rule effectively abolishing holders in due course of consumer paper will go into effect. The single most clearly felt impact of this rule is that all consumer financing will be "recourse" financing, a form of financing that this segment of our industry simply cannot afford. If these contractors cannot secure financing, they will surely leave this industry.

Finally, general attrition, felt by large and small contractors alike in the economic slump of 1974 and 1975, had a more severe impact on the smallest of our contractors.

Overall, the profile of our industry is changing. We are going the way of many other industrial units within our economy: the small single worker shop is disappearing as the industry regroups in larger financial units.

Although this change involves only a portion of our industry, we do not welcome it. It is anticompetitive. And the neighborhood home improvement contractor, operating by himself or with up to a half dozen subcontractors, has been an integral part of the residential scene in this country for over 100 years. With all the problems that our industry has had, it has always meant to the American neighborhood the personal attention and craftsmanship of a workman well-known to all of his customers. There is no economic benefit that compensates for the loss of this kind of attention. Indeed, there is no discernible economic benefit (certainly no difference in costs) arising from the loss of close neighborhood service by an independent artisan in our small towns and rural areas.

Thus it is in April of 1976 we view the tax credit as a needed stimulus to the local small contractor, one that he sorely needs in the face of economic stresses aimed right at him, aimed directly toward his elimination both as a competitive factor and as a local workman serving his own neighborhood.

We urge consideration and quick passage of H.R. 6860 as a remedy, albeit a partial one, against the rather vast economic forces that small local home improvement contractors, serving our more isolated areas, have not been able to cope with, and have fallen victim to. We urge this as a separate consideration from that of energy-saving, which remains a clear and undisputed benefit that directly flows from H.R. 6860. Finally, we urge this as a means of providing the broadest possible base to any congressional energy-conservation program, a base that will extend into every neighborhood, and, if our industry is armed with this incentive, into every home.

ATLANTA RAPCO INSULATION CO., INC.,
Atlanta, Ga., April 7, 1976.

Senator HERMAN E. TALMADGE,
Senate Office Building,
Washington, D.C.

DEAR SENATOR TALMADGE: The Energy Conservation and Conversion Act (H.R. 6860), as presently written, would preclude the use of insulation materials that were not specified in the "Recommended Criteria for Retrofit Credit", prepared for the Federal Energy Administration by the National Bureau of Standards (NBSIR 75-795).

Since it requires approximately 5 years to secure National Bureau of Standards approval for a new product, many of the energy saving insulation products, which have not yet been certified by NSB, are eliminated from consideration for any tax reduction for the homeowner.

This is a gross injustice to homeowners and to insulation suppliers, since there are insulation materials on the market with superior thermal values which have not yet ground their way through the bureaucratic approval mill.

Restricting the tax credit only to those old long-established insulation materials in the NSB recommended criteria would be detrimental to the public interest. In order to secure the tax credit, homeowners would be denied the opportunity to select the insulating material having the best thermal value with the highest potential for energy saving.

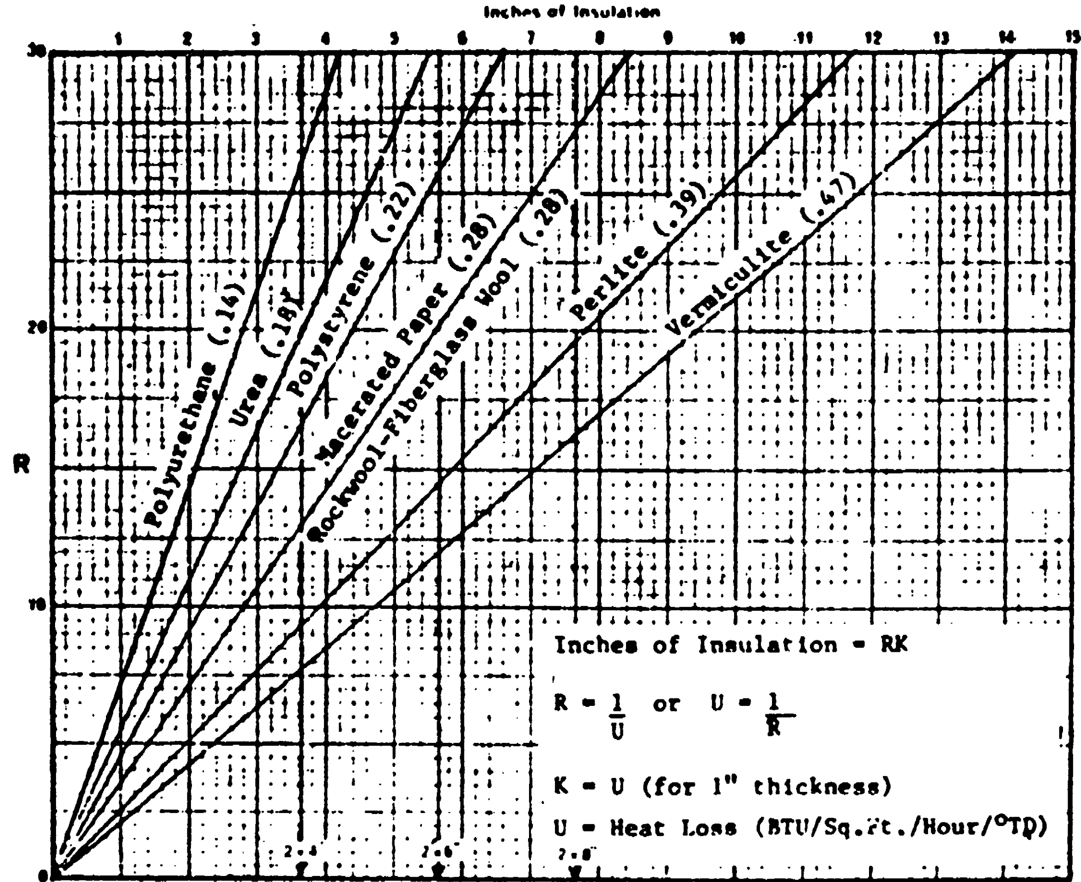
The attached enclosure prepared by a recognized heating and air-conditioning expert, compares the thermal values of all insulation materials on the market today.

We urge you to give consideration to a change in H.R. 6860 that would not be restrictive and would allow the homeowner to choose the insulation material best suited to his needs.

Respectfully,

JAMES M. SMITH, *President.*

PROPERTIES and CHARACTERISTICS of INSULATION



PHYSICAL PROPERTIES & CHARACTERISTICS

Characteristics		ORGANIC (dried out)				MINERAL				PLASTIC (rigid)		RESIN		REFLECTIVE FOIL	
		Wood	Paper	Cork	Cotton	Vermi-culite	Perlite	Fiber-glass	Rock-wool	Styro-foam	Ureth-ane	Urea Foam		Batt / Board	Multi-foil
"K" Factor	L	.67	.28	.28	.28	[illegible]	.39	.28	.28					Depend on product makeup.	
	B	.28	.28	.39	.28	[illegible]		.28	.28						
	R	.47	.47	.39		.47	.39	.32	[illegible]	.22	.14	.18			
Fire Resistant		No	No	No	No	Yes	Yes	Yes	Yes	No	No	Yes		No	No
Moisture Resistant		No	No	No	No	No Yes	No Yes	No Yes	No	Yes	Yes	Yes		No	No
Vermin Proof		No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes		No	Yes
Rot Proof		No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes		No	No
Vapor Seal		No	No	No	No	No Yes	No Yes	No Yes	No	Yes	Yes	No		Yes	Could Be

L. = Loose B = Batt R = Rigid

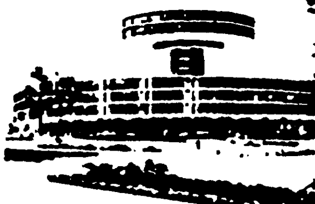
REGARDING THESE CHARTS DESIGNATED 'A'

These charts were prepared by John M. Englisby, Electric Heating Specialist, Long Island Lighting Company (LILCO). Mr. Englisby is recognized as one of America's foremost heating engineers.

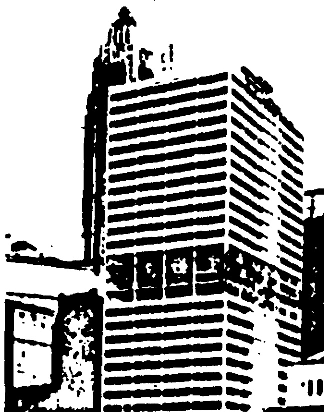
RAPPERSWIL corporation
306 East 40th Street
New York, New York 10016

PROJECTS COMPLETED UTILIZING UREA-FORMALDEHYDE FOAM

Project	Owner	Architect	Contractor
No. 1 Liberty Plaza	U.S. Steel	Skidmore Owens Merrill	Turner Const.
Standard Oil Bldg.	Rockefeller Center	Harrison & Abramowitz	Fuller Const.
1633 Broadway	Uris-Capital	Emery Roth	Uris Bros
77 Water Street	Kaufman Organization	Emery Roth	Diesel Const
127 John Street	Kaufman Organization	Emery Roth	Diesel Const.
747 Third Avenue	Kaufman Organization	Emery Roth	Diesel Const
1411 Broadway	Chanin	Owner	Chanin Const
St. Clair Pl. Devel.	Columbia Univ. State of N.Y. Dormitory	Brown Gunther Bataglia & Galvin	
Bard Haven Devel.	Columbia Univ. State of N.Y. Dormitory	Brown Gunther Bataglia & Galvin	Cauldwell Wingate
Philharmonic Hall	Lincoln Center		Philharmonic Hall
R C A. Recording Studios	R C A Studios	Acoust Eng Mr Stevens	R C A Studios
Police Headquarters	City of New York	Dept Public Works	Jarcho, Inc
Downstate Hospital	New York State	Seelye Stevenson Value & Knect	
Staff Residence	Roosevelt Hospital	Frost Associates (Arch.)	Algo Eng
Park Slope North	City Day Care	Byer Blinder Belle	Raeburg
Early Child Center	N Y Housing Auth	Hausman & Rosenburg	Marson Const.
Queens Family Court	City of New York	Dept Public Works	Direct
AMF Headquarters	Shulman Invest.	Thomas J Hannino	Shulman
Indust. Pk 555 Tarrytown Rd	Halpern	Owner	Halpern Bldg
Pt. Pleasant Fire House	Same (Fire Co No 2)	Carl Feltz	Birdsall Const
U S Steel Bldg 1 Lib Pl	U S Steel	Skidmore Owens & Merrill	Turner
1 N Y. Plaza	International Nickel Co.	J F N Associates	Direct
Off Bldg. 1 State St.			Diesel
Beekman Downtown Hosp	Beekman Downtown Hosp	Owner	Diesel
Standard Oil Bldg.	Rockefeller Center	Harrison & Abramowitz	Fuller
Brookdale Hospital	Brookdale Hospital	Owner	H Sand - Keone
Central Island Hospital	Central Island Hospital	Owner	March Construction
Playhouse Theatre	Paramount - Gulf Western	Owner	Direct
Apt Hse 82 St & East End	L I. Properties - Lifwin	Philip Birnbaum	82nd St Devel Cor
Screen Gems Generator Rm	Screen Gems	Owner	Direct
Mt Sinai Hospital	Mt. Sinai	Skidmore Owens & Merrill	Diesel
Morningside Old Age Home	Morningside House	Philip Johnson & J Burgee	Crow Construction
Operation Breakthrough - Summit Modular Apts	H U D.	Shelly Systems, Inc	Kinney Const Cor



Host of Houston, Houston, Texas
Architect: William B. Tabler
Insulation Contractor:
Western Waterproofing Co., Inc.



Walston Building, 77 Water Street, N Y C., N Y.
Architect: Emery Roth & Sons
General Contractor: Diesel Construction Co., Inc.

Chanin Building 1411 Broadway, N Y C., N Y
Architect: Irwin S. Chanin
General Contractor: Chanin Construction Corp

SUN RAY ENERGY CORP.,
Casper, Wyo., April 12, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.
Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: In regards to the Energy Conservation and Conversion Act, H.R. 6860, we would highly recommend at least two changes.

(1) This bill be revised so as to permit a tax credit to be given to any commonly used insulation material that meets local building code requirements or national building codes.

(2) We also feel that this bill should include a national tax credit provision for any homeowner installing solar heating and cooling equipment.

Sincerely,

JOE I. MORRISON.

SPRAY INSULATIONS, INC.,
DIVISION OF PAUL J. KERZ CO.,
Skokie, Ill., April 14, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: With one exception, I strongly support the home insulation tax credit provision of the proposed H.R. 6860 bill.

The insulation materials approved for tax credit in H.R. 6860 should not be restricted to the materials listed in the National Bureau of Standards: "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit"; NBSIR 75–795, which was prepared for the Federal Energy Administration.

Our company installs all types of insulation materials in both residential and commercial buildings. To limit the tax credits to the use of specific insulation materials would be detrimental to both our customers and the public.

I strong urge that the energy conservation bill, H.R. 6860, allow tax credit for any commonly used insulation material meeting local or national building code requirements.

Very truly yours,

DANA CHIAPPINELLI.

STATEMENT BY THE JOINT GOVERNMENT LIAISON COMMITTEE OF THE ASSOCIATION OF BRASS & BRONZE INGOT MANUFACTURERS, BRASS & BRONZE INGOT INSTITUTE, ROBERT V. MAUDLIN, EXECUTIVE DIRECTOR

This statement in opposition to a proposed "recycling tax credit" is made by the joint government liaison committee on behalf of the members of the Association of Brass & Bronze Ingot Manufacturers

and the Brass & Bronze Ingot Institute. The members of these two associations recycle thousands of tons of copper base scrap each week to produce over 90 percent of the brass and bronze ingot manufactured and consumed in the United States. Brass and bronze ingot is manufactured by smelting and refining copper base scrap, primarily old scrap, and therefore firms in this industry would be eligible to receive the proposed recycling tax credit that was considered by the Committee on Finance for inclusion in the energy tax bill, H.R. 6860, last summer.

Even though the brass and bronze ingot producers would be beneficiaries of a "recycling tax credit" they recommend and urge that a tax credit for the use of copper base scrap not be included in the tax revision legislation for the following reasons:

1. Tax credit would cause a large loss in tax revenues without any corresponding benefit.
2. Tax credit would cause severe dislocations in scrap market.
3. Copper base scrap prices are extremely sensitive to changes in demand and tax credit would increase price of scrap and articles produced for scrap.
4. Ultimate consumers of products produced from copper base scrap would not benefit from lower prices due to tax credit.
5. Large fluctuation in copper base scrap prices have not significantly affected the supply of scrap.
6. Tax credit does not assure most economic use of scrap versus alternate sources of copper.
7. Lack of demand for copper base scrap in the United States is not a problem. One of the first items reclaimed from a junked car is the radiator. It has been necessary in the past for the United States to control exports of copper base scrap.

On July 18, 1975, representatives of the National Association of Recycling Industries (NARI) testified before the Senate Committee on Finance in support of a recycling tax credit. Unfortunately, the testimony [1] was vague and cast in generalities about savings in energy and did not explain the specifics of the proposed recycling tax credit. The testimony did condemn the House of "unwisely" deleting the recycling tax credit when H.R. 6860 was before the other body "apparently" as a result of "misunderstanding" and "misinformation."

The action taken by the House of Representatives on the recycling tax credit was decisive. First, the Ways and Means Committee before reporting the bill deleted copper base scrap from the recycling credit and severely limited the use of the credit for all other scrap and waste materials. Then the House of Representatives by a vote of 249 to 170 deleted the complete watered-down recycling tax credit provisions from H.R. 6860. This was not the result of the alleged "misunderstanding" on the part of 249 Members of Congress; it was a result of them seeing the tax credit for what it is—an unjustified windfall, a ripoff.

Members of the Ways and Means Committee said it very well in the committee's report as follows:

"The recycling tax credit (sec. 533) is a particularly bad provision. It will cost us about $1 billion in tax revenues lost over the next 5

[1] Hearings before the Committee on Finance, Energy Conservation and Conversion Act of 1975, H.R. 6860, pt. 2, pp. 849–878.

years, yet it will probably increase recycling by only 2 percent! It would provide tremendous windfalls to those connected with this industry. Even the environmentalists, who strongly support recycling, oppose this giveaway."[2]

It was pointed out during the debate on the House floor that the recycling tax provision is opposed by environmental groups such as the Sierra Club, the Environmental Action Organization, the Friends of the Earth, the Conservation Congress and the Environmental Policy Center as well as the AFL-CIO and the Department of the Treasury. It was also pointed out during the House debate that it is opposed by major recycling groups such as the Aluminum Recycling Association and the American Iron & Steel Institute.

The recycling tax credit is too important and costly to be rammed through Congress on an unsubstantiated claim of equity because of certain tax advantages enjoyed by virgin materials. Congress legislated depletion allowances and if they are wrong they should be changed rather than adding to the tax laws new special interest tax loopholes. The attempt to use the energy crisis or tax reform to justify this unwise tax credit is a farce.

Attached to the NARI statement presented to the Committee on Finance on July 18, 1975, were five exhibits showing energy savings by recycling metals rather than using competing ores. There is no question of the energy savings by recycling and the brass and bronze ingot industry is today saving large quantities of energy by recycling copper base scrap. However, it is interesting to see the comments in these exhibits on the use of taxes to encourage increased recycling. For example, on page 198 of the Ford Foundation's Energy Conservation Papers[3] on changes in taxes it is stated "Whether or not 'reform' would lead to significant increases in the recovery of metals in mixed wastes is still undemonstrated."

What will be the actual effect of the recycling tax credit? Senator Fannin asked a question at the July 18, 1975, hearing about the effect of the credit on foreign purchases of U.S. scrap. The sponsors of this tax credit replied that it would keep material in the United States by increasing prices.[4] This is just what we need—higher prices and more inflation.

Senator Nelson also put his finger on a major inequity in the proposed recycling tax credit between established recyclers and new recyclers.[5] The full credit would apply only to recycling purchases that exceed the amount of purchases during the base year (1975). This would be a definite advantage for a taxpayer going into recycling because his base year volume would be his first year purchases and no doubt very small. Purchases in subsequent years would no doubt be much larger and the increase would qualify for the full tax credit—a decided advantage for the new recycler as opposed to one that has been recycling for years.

The members of the joint government liaison committee agree that the United States must conserve energy and natural resources and, as

[2] H. Rept. 94-221 on H.R. 6860, May 15, 1975, p. 225.

[3] Exhibit D to the NARI statement—not printed in the hearings but placed in the committee files.

[4] Hearings before the Committee on Finance, Energy Conservation and Conversion Act of 1975, H.R. 6860, pt. 2, pp. 857-858.

[5] Ibid., pp. 860-861.

recyclers, have been doing this for years. The brass and bronze ingot industry justifies its existence by the fact that its members can produce ingot from copper base scrap at a cost lower than the same ingot could be produced from virgin metals. This is done through our free market system without windfalls and ripoffs.

The brass and bronze ingot industry urges that if the recycling tax credit is considered by the Senate Committee on Finance that it specifically provide that it not include copper base scrap.

Respectfully submitted on behalf of the joint government liaison committee.

STATEMENT OF WILLIAM M. DOLAN, PRESIDENT, GEOTHERMAL RESOURCES COUNCIL IN SUPPORT OF S. 2608

Mr. Chairman and members of the committee, my name is William Dolan. I am chief geophysicist and manager of geothermal exploration for AMAX Exploration, Inc., a diversified natural resources corporation. I hold a masters degree in geophysics and have 20 years worldwide experience prospecting for minerals, and more recently, geothermal energy resources. I am submitting my statement to you in my capacity as president of the Geothermal Resources Council.

The GRC is a 5-year-old organization with some 400 members drawn from public agencies, research organizations, academia, environmental organizations, media, contract engineering firms, electric utilities, and the resources industry. On behalf of the GRC, I urge you to favorably report S. 2608 to the full Senate.

S. 2608 will provide needed tax incentives for the geothermal industry. Geothermal resources are abundant in the United States, are comparatively attractive environmentally, and, in contrast with many energy alternatives, have been successfully exploited throughout the world.

The development at the Geysers, 60 miles north of San Francisco, of 522 megawatts electric generating capacity, makes the United States the ranking world producer of geothermally fueled electric power. There is reason to believe that the generating capacity of the Geysers will eventually exceed 2,000 megawatts, enough to supply 2 million people.

Geothermal energy is not new. Italy has enjoyed geothermally fueled electricity for 70 years, New Zealand for 25 years, and the United States for 15 years. Electric power from geothermal resources is in existence or is being developed in New Zealand, Mexico, Russia, the Philippines, El Salvador, Ethiopia, and Japan.

The U.S. Geological Survey, employing conservative criteria, has projected that the United States has exploitable geothermal resources, both discovered and undiscovered, which are sufficient to supply up to one-third of our present 450,000 megawatt electric power requirement.

My point in enumerating the foregoing is to make clear that, notwithstanding common misconception, geothermal power is of significant consequence, is not exotic, and is not in an experimental stage. Geothermal resources are an existing power source which must be encouraged. Passage of S. 2608 would provide the needed encouragement.

Presently, geothermal resources are denied tax incentives enjoyed by other fuels. The net consequence of this failure to provide an adequate and equitable tax incentive is that would-be developers find it nearly impossible to compete for risk capital against oil, gas, coal, or uranium. There are, for example, about 25 oil or gas wildcat wells completed per day in the United States, versus about 1 geothermal wildcat per month.

The 1974 Geothermal Research, Development and Demonstration Act attempted to provide balance by authorizing government support of geothermal research and by creating a geothermal guaranteed loan program. Despite high hopes, the 1974 program has not significantly stimulated the development of U.S. geothermal. Unfortunately, this probably will continue to be the case in the future for the following reasons:

(1) Many of the operators who possess the requisite expertise to develop geothermal resources will be excluded from the program due to their size and the income limits imposed.

(2) The highest risk money must be obtained before the applicant will qualify for a loan.

(3) The required detailed examination of potential borrowers makes the program unattractive to lending institutions.

(4) The effectiveness of the guarantee requires meticulous adherence to the regulations on the part of the lender.

The Tax Reduction Act of 1975 essentially eliminated the percentage depletion allowance for the oil and gas industries. These are mature industries. They can and do generate risk capital without their former tax inducements. However, the fact that these inducements are no longer required does not detract from the laudable legislative foresight which contributed to the development of dozens of healthy resource companies. Geothermal, a promising, but young industry, deserves tax incentives similar to those which encouraged America's vigorous oil and gas industries.

It is widely believed that geothermal energy equates with oil and gas in terms of exploitation procedures. Undoubtedly, that belief derives from the visible activity of several major oil companies in geothermal. Only one fundamental dissimilarity need be cited to dispel that belief. One producing oil or gas well constitutes a commercial success as contrasted with geothermal where a number of very expensive producing wells need be established before power generation facilities and transmission lines are justified. One important consequence is the long time between initial employment of risk capital and eventual revenues that can easily exceed 10 years, much as in the case of the mining industry. This factor serves as a deterrent to investors who are accustomed to the relatively rapid return on investment in oil and gas. This is doubly true in the absence of tax incentives.

Geothermal resources vary in grade as do ore bodies. Dry steam, such as that found at the Geysers and at existing Italian and Japanese plants, compares to high grade ore. The present lack of available risk capital means that only these high-grade geothermal sources can be profitably exploited. With tax inducement, the lower grade but vastly more plentiful geothermal waters (wet steam) will be developed, thus significantly expanding the Nation's practical energy reserve.

The tax inducements of S. 2608 which will permit the development of lower grade geothermal resources are as important to the growth of the geothermal industry as were those similar tax incentives which permitted secondary and tertiary recovery of oil and the mining of low grade metal deposits.

Geothermal energy qualifies in every manner for the tax treatment which would be accorded by S. 2608. It is a wasting (depleting) subsurface resource, and much of the capital investment in exploitation procedures is intangible, that is, not salvagable, thus, rightfully considered an expense rather than a capital expenditure.

Our petroleum and natural gas resources, our uranium resources and our hydro resources are into their declining phases. Fusion, solar, oil shale, municipal waste, breeder reactors, tar sands, tides, winds, and certain synthetic fuels all hold great promise, but the promise in most instances lies far in the future. Coal and geothermal are readily available. The technology is extent, or nearly so, for priority exploitation of both.

In order for geothermal to significantly assist in meeting the Nation's future energy needs, there must be a prompt acceleration of exploration drilling. If past patterns in the extractable resource industries are to be maintained, the bulk of that drilling will be carried out by independent operators. They will also account for the majority of the discoveries. This will only happen if they can attract risk financing. Such financing will not be forthcoming without the inducements provided by the bill before you.

S. 2608, more than any Federal program heretofore implemented, will provide the impetus for geothermal to pick up an important share of the U.S. energy load. The equivalent of 3 million barrels of oil per day by the end of the century is a realistic objective. I encourage your favorable consideration of this bill.

Thank you for your attention.

WASHINGTON, N.C.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As a consumer and insulation contractor, I would like to express a few brief comments concerning H.R. 6860.

I have not been able to follow the progress of this bill and the deliberations on the final form that the bill will be presented in, except for some brief information supplied by my insulation supplier. Certainly, the Long committee and the membership of that committee and the full House are going to push this bill to fruition. Apparently, there are some insulation materials that might not be listed as eligible for earning the tax credit. I would like to ask that the committee and House be made aware of the fact that some fine insulation materials do not have a Federal specification or other qualification.

I have investigated the insulation materials market and recently became an applicator of U-F foam insulation. I am convinced that this insulator is of the highest quality and should be given a fair chance in the competition.

My product has superior qualities. If you chose my product because it fulfilled your needs, wouldn't you want to get the same tax break that was available to other consumers?

Regards,

MARK J. MCGRATH.

NATIONAL CLAY PIPE INSTITUTE,
March 12, 1976.

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

DEAR MR. CHAIRMAN: Please refer to the Committee on Finance press release dated February 5 concerning the schedule of hearings on tax revision and other matters.

The interest of the National Clay Pipe Institute is related to the petroleum tax proposals outlined in title IV of H.R. 6860, The Energy Conservation and Conversion Act of 1975. We have previously stated our position on the inequities of this proposed tax in our statement submitted to the committee on July 15, 1975. In that statement we asserted that it is technologically infeasible for our industry to convert to coal. Enclosed with this letter is a recently completed energy usage report confirming that conclusion for the ceramics industry, of which the clay pipe industry is a vital component.

We request that our previous statement and the enclosed report be made a part of the official record of the proceedings of the committee as it considers this important subject.

Also enclosed is an amendment to title IV to effect an appropriate and equitable exemption from the tax for the ceramics industry, as consistent with the facts disclosed in the enclosed report. We respectfully seek its adoption.

Sincerely yours,

RICHARD H. HOLL,
Chairman of the Board, NCPI.

PROPOSED AMENDMENT TO H.R. 6860

On page 79, line 21, amend to read:

(H) in the process of *drying*, melting, fining, feeding, *firing*, conditioning, polishing, glazing, coating, annealing or other industrial finishing of glass *and ceramic* manufactured products.

Correcting words are italicized.

ENERGY USAGE IN THE CLAY PIPE INDUSTRY

(By J. O. Everhart, emeritus professor, The Ohio State University, registered professional engineer)

INTRODUCTION

The extent of manufacture of vitrified clay pipe in the United States is indicated in figure 1. The industry furnishes a product which

is used exclusively in sanitary sewers for the collection and disposal of domestic and industrial wastewater. These operations are essential elements in the national program to abate and to prevent the pollution of our Nation's waters.

To manufacture vitrified clay pipe in today's market, the industry requires substantial quantities of natural gas or fuel oil. A recent survey (November 1975) of the industry reveals that its total annual energy requirements, expressed in natural gas (mcf) equivalents, amount to approximately 22 million mcf. This equivalency is used because natural gas is the primary fuel used in 35 of the 37 plants in existence; the other two utilize liquid petroleum as primary fuels.

The manufacture of vitrified clay pipe is a ceramic process comparable to that in use in the glass industry, as explained later in this report. The precise temperature controls required in the analagous manufacturing processes can only be achieved under current technology with liquid or gaseous petroleum fuels.

VOLUME OF BUSINESS [1]

Year	Shipments (short tons)	Dollars
1972	1,718,051	$143,094,000
1973	1,648,459	137,129,000
1974	1,461,068	134,720,000

[1] U.S. Bureau of Census.

FIGURE 1—CLAY PIPE MANUFACTURING IN THE UNITED STATES

Total number of plant employees, 5,068.

GEOGRAPHY OF PRODUCTION

There are 37 plants manufacturing vitrified clay pipe and located as follows: Alabama (1), Arizona (1), California (6), Colorado (1), Florida (2), Georgia (2), Illinois (1), Indiana (2), Iowa (2), Kansas (1), Kentucky (1), Michigan (1), Mississippi (1), Missouri (1), North Carolina (1), Ohio (8), Pennsylvania (2), and Texas (3).

FOREWORD

The use of clay pipe is as old as civilization itself. Early mid-Eastern and Roman cultures made elaborate use of the availability, acid-imperviousness, and strength of fired clay in water and waste water distribution systems. Because of the natural durability of this material, many of these systems are still in existence, and in some areas, are even today performing their original function. Following a long period of general neglect of sanitation methods, the awareness of the need for protection of the public health led to the development in the mid-19th century of urban waste water collection systems. This revival of interest in sanitation coincided with the application of industrial systems for the forming of clay pipe, a significant advance to mass production from the slow hand-turning of the potters's wheel.

Coincident with the introduction of clay-forming machinery came the development of the coal-fired periodic or beehive kiln. This per-

mitted the firing of the formed ware in greater quantities to coordinate with the extensive demands of the waste collection systems, the modern hallmark of urban expansion in Western Europe and the United States.

Initially, and for many years thereafter, the pipe were manufactured in short lengths of approximately 2 feet. Among other factors restricting length were the firing difficulties associated with the periodic kiln design and with the use of coal as a fuel. The latter, in particular, resulted in an inability to control firing temperatures with the precision required to produce longer pipe with other required dimensional constants.

Following World War II, the clay pipe industry turned to the tunnel kiln, fired by natural gas or oil. Its purposes in so doing were to conserve energy and to continue its efforts to maintain a competitive level with those manufacturers who were producing longer length and controlled-diameter sewer pipe from a variety of substitute materials. This adaptation of the liquid petroleum/gas-fired tunnel kiln enabled the industry to remain competitive by producing an assured-dimension, competitive product of lengths as great as 8 feet.

Specifications for modern sewer pipe, such as those promulgated by the American Society for Testing and Materials (ASTM), impose severe standards on the industry. Close tolerances of diameter, socket size and shape, strength, length, absorption, acid-resistance, and straightness must be met. The present state of the art in the manufacture of clay pipe which satisfy these requirements is such that the industry is totally dependent upon liquid or gaseous petroleum fuels. Conversion to other sources of energy is impossible, as explained in the following pages. If reconversion to coal, for example, is ever proved to be feasible, it will be done only after the expenditure of much time and many millions of dollars in research and development. While it is true that the cylindrical shape of clay pipe demands more precise temperature control than may be required for differently configured ceramic products, it is a fact that coal cannot be effectively and economically used under the present state of technology for the industrial production of a host of other ceramic materials, including vitrified clay pipe.

THE MANUFACTURE OF VITRIFIED CLAY PIPE

A. The raw material

The most important factor determining the end use of clay is the relative percentage of the materials of which it is composed in its natural state. Clays contain 85 to 95 percent mineral oxides and silicates, with silica and alumina totaling 80 to 85 percent. Of the remaining components, iron oxide, lime magnesia, and titania are most predominant. Chemically combined water and various organic and inorganic impurities in varying amounts are also found in the natural clay material.

The silica and alumina combined in mineral form are considered to be the clay material itself. The ratios in which these compounds are present and their crystalline forms are the two factors which usually define the clay type. Other oxides as a group are considered as the flux or glassy phase formers. The types of clay and flux determine the use that can be made of the clay material.

The principal attributes affected by the clay composition (i.e., the silica/alumina ratio) are refractoriness and plasticity. As a rule, the temperatures, will increase with increasing alumina content.

B. Processing the raw material

The raw material is commonly mined by open pit methods using environmentally acceptable procedures. The material is crushed, ground, and pulverized to fine grain size. When combinations of different materials are used, each is reduced to fine size and they are then blended in the proper proportions.

The pulverized material is mixed with enough water to make it plastic and workable, and then forced through an annular die either by a large propelling auger or a piston. Air entrapped in the preformed mass is removed prior to forming by evacuation to produce a denser product. Most pipe are formed with a socket on one end into which the spigot end of the adjoining pipe is inserted. Formed pipe are cut, trimmed to exact size, and finished by complex machines specifically designed for each required operation.

The water used for plasticizing is removed prior to firing. About 20 percent of the total formed mass is water, and it requires about 20 percent as much heat energy to remove the water by the drying process as it does to bring the ware to finishing temperature by firing.

After drying, the "green" (unfired) ware enters the periodic or tunnel kiln for firing. All kilns today are fueled by natural gas or oil. After firing, the ware is prepared for the jointing process. This involves the application of compression materials to one or both ends of the fired pipe to insure a watertight connection in the construction trench.

Electricity is the primary source of energy expended in the crushing, grinding, forming, and jointing operations.

C. Dryer design

Dryers used in the clay pipe industry are either continuous tunnel or periodic compartment types. A process schematic for a typical dryer is shown in figure 2. In the continuous type, the ware is suspended on racks, set on drier cars or on kiln cars. In each case, they are then moved counter to the stream of heated air. In the compartment type dryer, the formed ware is set in closed rooms through which heated air with controlled humidity is circulated. The heat for either type is provided by the direct burning of fuel or as waste heat from the firing process. The use of waste heat is preferred because of the obvious fuel economy.

When freshly formed ware is set directly on kiln cars, the kiln is provided with a preheater section through which the loaded cars pass. The maximum drying temperature is kept below 100° C except in the case of the kiln preheater type where it may be as high as 230° C.

Hot gases used for drying must either be sulfur free or very low in sulfur. Sulfur combustion products have deleterious effects on the drying pipe surfaces. It is for this reason, among others, why coal cannot be satisfactorily used as a heat-producing source for the drying process.

Air flow through the dryer, the rate of drying, and the particular points of air entry into the dryer are controlled according to the dry-

ing schedule which depends upon the shape, moisture content, composition, and method of stacking of the ware. The ware shrinks 4 to 5 percent in drying. If the removal of the water is not done under carefully controlled conditions, the ware will warp or crack during the critical firing operation.

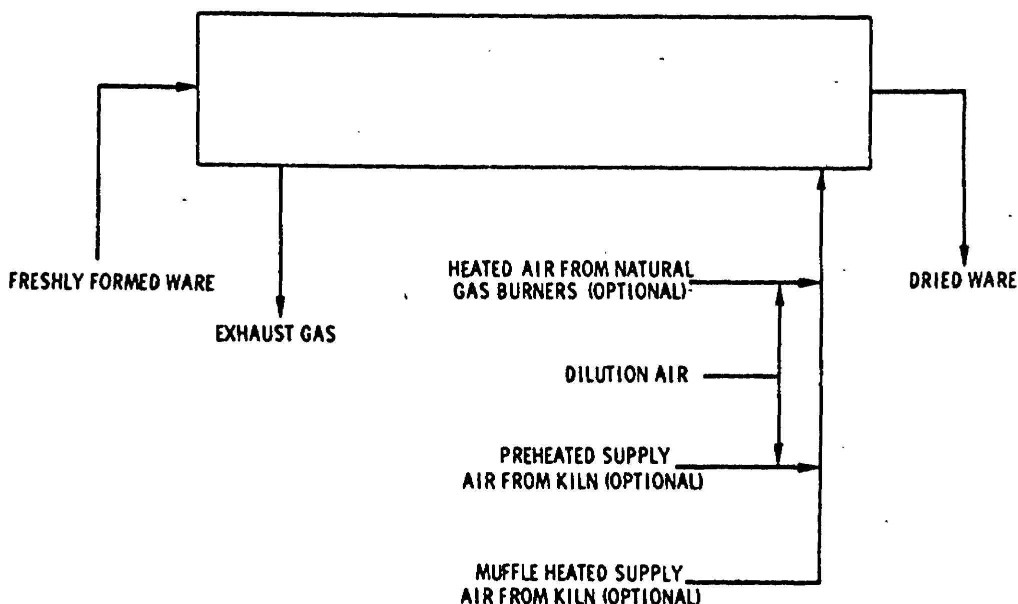


FIGURE 2.—Process schematic for dryers.

D. Kiln design

In the clay pipe industry, both the periodic and the tunnel kiln are in use today. Approximately 75 percent of all the ware is fired in tunnel kilns. There is a developing tendency to reduce reliance on the periodic kiln, principally because of its lesser fuel-efficiency. The tunnel kiln utilizes approximately 5 milion Btu/ton of clay pipe, whereas the average bottom-fired periodic kiln usage is approximately 2.5 times that ratio. A new development in periodic kilns, equipped with top-fired burners and heavily insulated features, has reduced this disparity by as much as 50 percent.

1. *The periodic kiln.*—Periodic kilns (also known as downdraft or beehive kilns) are operated as batch processes. The kilns are filled with green ware, slowly fired and cooled, and emptied. A process schematic of a typical periodic kiln is shown in figure 3.

Periodic kilns are circular, with a segmented hemispherical top, and constructed of refractory brick. Kiln diameter ranges from 9.14 to 16.5 meters (30 to 55 ft) with an average diameter of 11.2 meters (36 ft). Such kilns are fired by burners, normally located at the bottom of the outside wall, except as noted above. Burners may be fueled by oil or gas. The use of coal in modern, insulated, refractory-lined periodic kilns is not feasible inasmuch as the sulfur emissions from the combustion of coal attack the refractory brick and quickly destroy them. Hot air and combustion gases from the burners are directed to the top of the kiln by a wall inside of the kiln which is located parallel and slightly within the wall of the kiln itself.

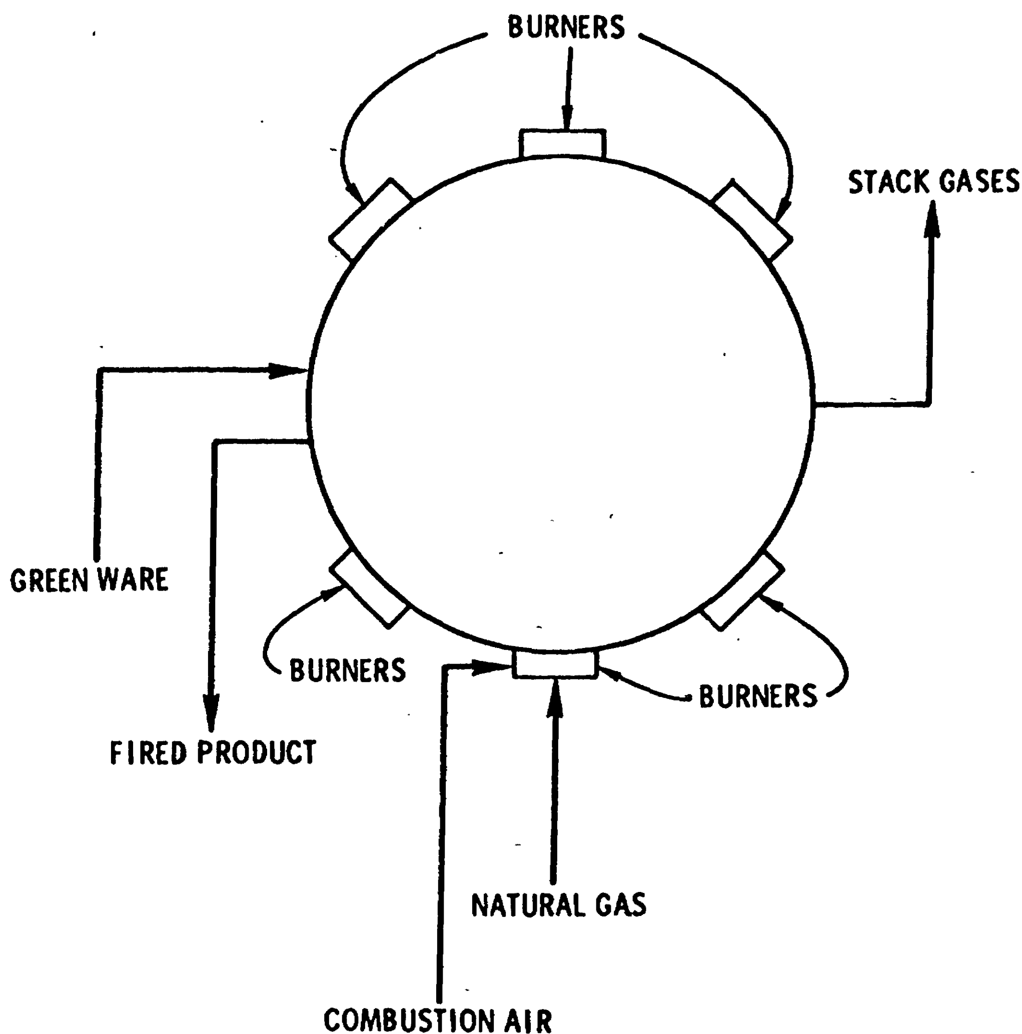


FIGURE 8.—Process schematic of a periodic kiln.

After being directed to the top of the kiln, hot gases pass downward through the stacked ware and into a flue located under the plenum floor of the kiln. This is a false floor made of refractory brick and constructed to both support the ware and to allow free passage of the waste gases. The flue under the floor is connected to a stack which exhausts the waste gases. As many as 10 kilns may be connected to the same stack. Temperature differences from top to bottom of the kiln are large (over 40° C in some instances) and this feature contributes to the difficulties of temperature control.

Periodic kilns are comparatively inefficient in terms of production and fuel usage. Low production rates are the result of hand setting and drawing (loading and unloading) of the kiln and the use of a natural draft system for air movement through the kiln. Many of these kilns have been converted to forced draft which has greatly shortened the time necessary to complete the firing cycle. The high fuel usage rate in these kilns results from the batchwise operation of the units and their inherent inability to reuse the waste heat generated during firing. Cycling of the kiln through wide temperature ranges also necessitates higher structural maintenance costs for this type of kiln.

Despite their inefficiency, periodic kilns do have certain advantages in that they may be used to (1) fire small orders of special products without upsetting production, (2) fire odd-sized and large-diameter ware which either would not fit into a tunnel kiln or would cause operating problems and (3) fire several products simultaneously.

2. *The tunnel kiln.*—Tunnel kilns have a number of characteristics which make them preferable to periodic kilns. Tunnel kilns provide for—

Continuous operation;

Possible elimination of the need for dryer cars and other equipment;

Increased flexibility in the setting and drawing of the kiln;

Constant operating temperature, which increases the life of the kiln;

More even burning, resulting in decreased amounts of overburned and underburned ware; and

Fuel economy.

The average modern tunnel kiln is 400 or 500 feet long and is equipped with a hundred or more gas or oil burners, a multitude of fans and ducts for draft and recirculation purposes, and an intricate system of temperature indicators and controls. Only natural gas or petroleum liquids can provide the combustion efficiency and the delicate response of control to insure against variations from the vitrification curve required, particularly near the critical point of vitrification.

A process schematic for a typical tunnel kiln, shown in figure 4, is comprised of: the preheating zone, the firing zone, and the cooling zone. The preheating and cooling zones are essentially large heat exchangers which are responsible for the fuel economy inherent in tunnel kilns. The preheating zone uses combustion gases from the firing zone to slowly heat and oxidize the impurities in the unfired ware which is moving countercurrent to the gases. Cooled gases are then exhausted through a fan into a flue or stack. Tunnel kilns may have from 1 to 20 flues leading to the stack. Multiple flues are used to control the rate and rate variations by which the ware is preheated. Most of these flues are also equipped with recirculating fans to equalize the temperature. The preheating schedule is dependent upon the raw materials, the methods of forming the ware, and the desired product. The temperature of the exhaust gases can range from approximately 70° C to 500° C and depends primarily upon the length of the preheating zone.

After being preheated, the pipe moves into the firing zone where the green ware is fired or "burned" to give it the desired properties. Depending upon kiln design and other factors, the temperatures in a firing zone may vary from a low of 1,050° C to a maximum of 1,200° C. The heat for firing the ware is supplied by oil or natural gas burners along the sides of the firing zone. Coal is not used in modern kilns because of feed problems, temperature control uncertainties, the production of ash and sulfur and the need to fire greater lengths of pipe and with precise dimensional control. Combustion air for the furnaces is drawn from the cooling zone and is present in amounts from 5 to

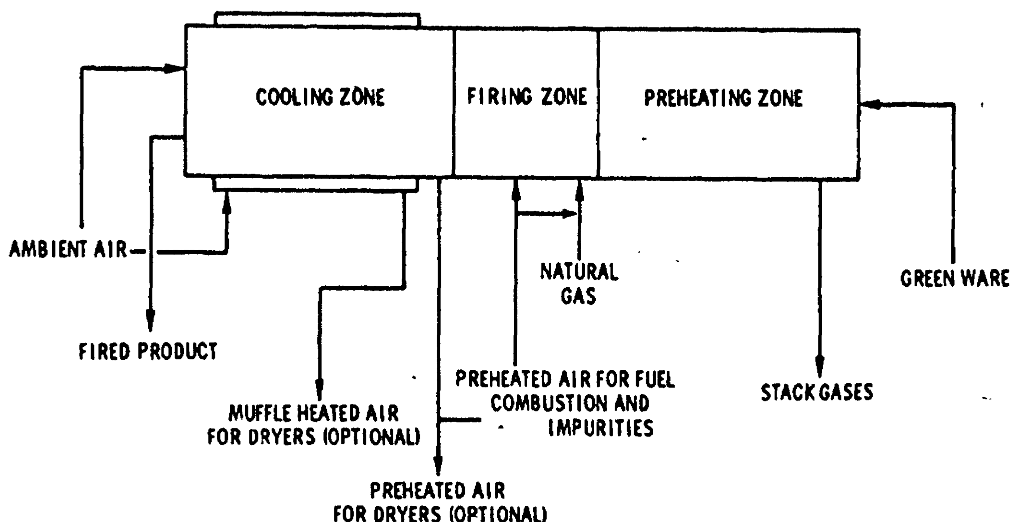


FIGURE 4.—Process schematic of a tunnel kiln.

100 percent in excess of that needed for combustion. The excess air is required to provide greater heat uniformity within the kiln, thereby resulting in less dimensional variability of the pipe.

The third zone of the kiln is the cooling zone. Cool air is blown into the kiln and flows countercurrent to the movement of the ware. As the air moves toward the firing zone, it cools the ware to a point where it can be handled, and is itself preheated prior to combustion. At the end of the cooling zone, the air is used in one of two fashions. In both cases, part of the air is drawn from the main stream for combustion of the fuel. The remaining or excess air then either is drawn directly through the kiln for reaction with the ware and subsequent preheating or is used in the dryers for driving off the free water in the freshly molded ware before the latter enters the kiln.

Residence time of the ware in the kiln may vary from 12 to 150 hours, depending principally upon the length and diameter of the finished product, and on the nature of the raw material.

E. Chemistry of firing

It is through firing that the clay pipe receives the strength and durability that are its unique characteristics. Thermochemical reactions occur in the firing process to produce a 50 to 75 percent glassy phase in the finished ware. This phase differs not at all from that of a completely glass product; it is this vitreous phase that bonds a crystalline framework together into an enduring product.

The high temperature reactions of firing produce some very real problems in achieving an acceptable end product. In the first place, the reactions are slow, and not rapid as in low temperature reactions. The glass phase at the top firing temperature (1,200° C) is a viscous liquid and the pipe in the kiln would collapse of its own weight were it not for the crystal phase skeleton supporting it. To maintain this structure requires an exact proportional balance between the two components. A temperature difference at this point of only a few degrees is critical to the development of a useful product.

The final product must be dense and nonporous. Surface tension of the liquid glass draws the structure together with the help of mass diffusion reactions on an atomic level. This results in volume and linear shrinkage. The amount is very closely related to exact temperatures, totalling about 4 to 6 percent depending on the body used. Any appreciable difference will result in pipe with different diameters, even from end to end of individual pipe. If control is not good enough one pipe may not fit the end of another. Specifications are so stringent that, if adequate control of temperature cannot be maintained, rejections will be a very high and operations will have to cease.

In the past, as indicated above in the foreward, when coal alone was the available fuel, the problems of unequal temperature distribution were so great that clay pipe lengths were limited to 2 feet, and on very rare occasions, 3 feet. If longer lengths were attempted, temperature differences from end to end were great and other dimensional differences were likewise adversely affected. Only with the advent of the more controllable fuels, such as natural gas/liquid petroleum was it possible to move successively to 3, 4, 5, 6, and even 7 or 8 foot lengths; attended by full dimensional control to permit the modern production of pipe from 3 inches to 42 inches in diameter.

A large number of chemical reactions and physical changes occur in the ware during firing because the materials fired are natural minerals. These efforts are independent of the type of kiln used, and may be separated into three groups: (1) the liberation of mechanical and chemically combined water from the ware; (2) the decomposition and/or oxidation of impurities; and (3) the recrystallization and vitrification of the clay materials.

Firing of the ware is carried out according to a predetermined firing schedule. The firing schedule allows for the above three groups of effects to take place without damage to the product and is dependent upon green (unfired) ware composition and desired product properties.

The first part of the firing schedule may provide a slow heating rate to complete the drying process if it has not been completed prior to firing. The free (or mechanical) water must be completely driven off before the ware reaches 100° C. The chemically combined water will not be complteely removed until the ware reaches temperatures in excess of 650° C, with the specific temperature depending upon the particular clay mineral or mixture of clay minerals being fired. The heating rate is continued until the ware reaches the final maturation temperature.

Figure 5 shows a typical firing curve for a continuous tunnel kiln in operation for the production of 8-inch sewer pipe. The maximum firing temperature in this particular case is 1,040° C. This temperature is reached in about 19 hours and is held for approxmiately 2 hours to effect maturation of the ware. The rate of firing during the heating cycle is slowed from approximately 500° to 800° C to assist in oxidation of carbonaceous materials. During the cooling cycle, the cooling rate is retarded slightly above and below 600° C to accommodate substantial dimensional changes due to quartz inversion. The maximum firing temperature, the time of maturation and the rate of cooling, may vary significantly with the nature of the raw material being processed.

Vitrification is the formation of glass bonds between crystalline particles and is responsible for the structural strength of the finished products. Vitrification of clays begins at about 900° C and is the result of the melting of the fluxing ingredients and reaction with alumina and silica of the clay to produce the glassy phase.

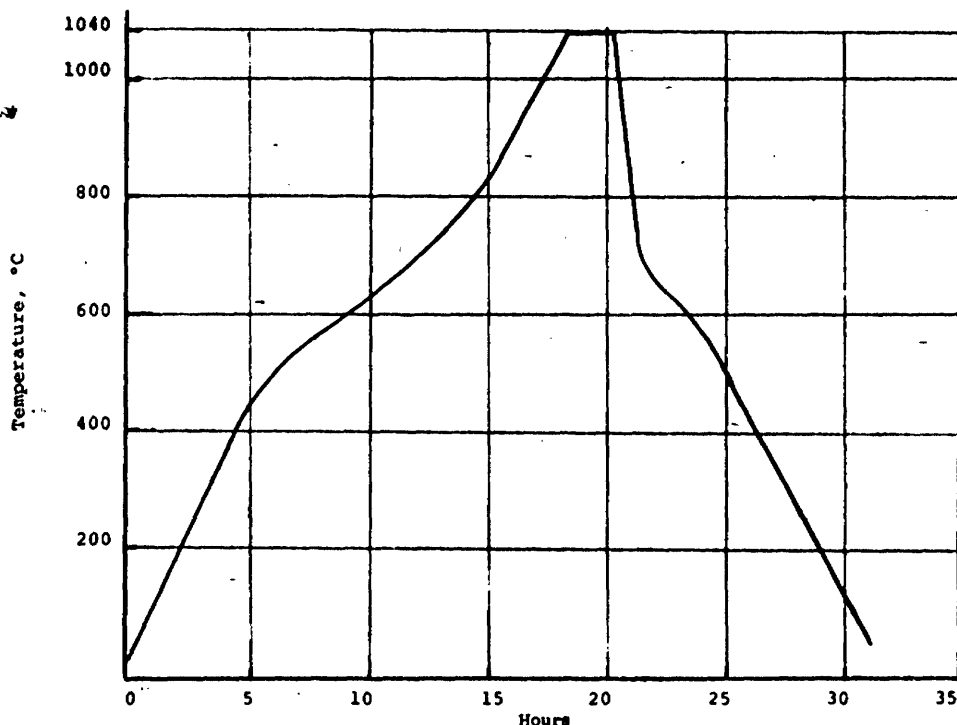


FIGURE 5.—Temperature firing curve for typical tunnel kiln.

ALTERNATIVE FUEL SOURCE POSSIBILITIES

A. *Coal.*—The present-day limited technology prohibits the use of coal in the production of vitrified clay pipe and most other ceramic products. In addition to the technological reasons identified herein, the use of coal, even if feasible, would be attended by currently insurmountable problems which include: high-labor opreation and maintenance costs, ecological damage, ash disposal and the large capital investment required for conversion. Insofar as the clay pipe industry is concerned, conversion to coal is today a practical, technological and economic impossibility; the industry must have natural gas/oil or close its plants.

B. *Other.*—Commercially available producers which convert coal to gas are, of course, a possible means of furnishing the gas for the dryers and the kilns. Unfortunately, despite some improvement in design, they are prohibitively expensive for most clay pipe plants with installation costs reaching into the neighborhood of $1 million per tunnel kiln. In addition, gas producers suffer from the obvious environmental difficulties associated with any coal usage; as well as special problems in handling volatile tars in the product gas, low Btu content and generally high SO_2 content. Producer gas is simply not a viable alternative fuel source for the clay pipe industry at the present time.

Electricity is used to a small extent in specialized operations in several units of the ceramic industry. These include: direct melting processes, firing thin porcelain enamel sheets and hobby pottery activity. No successful application has ever been made to the firing of massive quantities of large ware. The reason for this inability is that the transfer of heat from resistance elements to the ware in a uniform manner has always evaded and continues to defy technological solution.

SUMMARY AND CONCLUSIONS

The clay pipe industry manufactures a product vital to the national effort to control water pollution. To provide that product to the specifications required of all modern sanitary sewer pipe, the industry requires substantial quantities of natural gas or fuel oil as an energy source.

The processes for manufacturing vitrified clay pipe involve mining and blending high quality clays; grinding and screening these clays; mixing the processed clay with water to attain plasticity; by extrusion forming the material to the desired shape; and then drying and firing the product to the point of vitrification. All of the clay pipe in this country are fired in continuous tunnel kilns or in refractory brick periodic kilns.

The kilns are fired with natural gas or liquid petroleum, because the processing of the raw clay demands uniform moisture elimination and carefully controlled heat application for several days, following a preset curve to a maximum of as much as 1,200° C. It is in this upper range of temperatures that vitrification occurs, whereby the pipe attains its principal characteristics of rigidity, strength, and resistance to attack by the chemicals found in all sanitary sewers.

It is not technologically feasible for the industry to convert to any alternative fuel under the present state of the art. Neither coal nor electricity nor gas producers nor any other source of energy can be used to maintain the standard of the product whereby the industry is able today to compete with a significant number of substitute materials.

MONO THERMO INSULATION, INC.,
Great Falls, Mont., April 20, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am writing first of all to offer my endorsement of the home insulation tax credit provisions of the proposed H.R. 6860 bill. Passage of this bill could definitely promote significant nationwide energy savings. This would not only mean savings of natural resources, but financial savings for millions of American consumers. However, it has come to my attention that the present version of the new energy bill would make it difficult for some insulation materials to be eligible for a homeowner's tax credit.

I do not feel that the insulation materials that might be approved for such a credit should be restricted to the materials specified by the

National Bureau of Standards. This kind of restriction would be detrimental as well as prejudicial, and the person hurt most by such rulings is the American consumer.

The NBS recommended criteria would only approve inslating materials that have either a Federal specification number or an ASTM (American Society of Testing and Materials) product designation. It could take years to obtain either of these designations. Therefore any relatively new insulation product (and the consumer who believes in it) would be unfairly shut out of a tax credit for a considerable time, no matter how good the product.

I am referring specifically to urea-formaldehyde foam insulation. This is a proven home insulation that could be ruled out for a tax credit if the present NBS recommendations are adopted. Such action would be a classic example of how the best intentions of Government lead to serious injury to the consumer. U–F foam is a better insulator with a higher R-factor than most other insulations. It is fire resistant; and due to its unusual ability to flow around pipes, wires, and other obstructions in a wall cavity, it definitely provides the best, most convenient method of insulating existing homes.

It is only reasonable to ask, then, that the energy conservation bill, H.R. 6860 allow a tax credit for any commonly used home insulating material that meets local building code requirements, or meets the requirements of any national building code, or has clearly proven itself in actual use in houses.

No product that aids in energy conservation, such as U–F foam, should be left out of the tax credit approval. If I am not mistaken, the object of the bill is to promote energy savings and to benefit the taxpayer. Both objectives would fail if the present NBS recommendations are accepted. At this time more than 1,000 homes have been insulated with urea-formaldehyde in the greater Great Falls area. Every one of these satisfied homeowners would have been deprived of this quality product if the NBS standard were applied before insulating materials could be sold. Why then should these standards be applied now to deprive howeowners of the tax credit they deserve?

I am a local dealer of urea-formaldehyde foam insulation. Enclosed are two letters of endorsement from among my recent customers.

Sincerely,

DONALD E. BLACK, *President.*

GREAT FALLS, MONT.,
April 20, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As a homeowner, I have read the enclosed letter and offer my wholehearted support. Our home was insulated by urea-formaledhyde foam, and I know it is the only material that could have done the job. I read about a lot of different insulations, and U–F

foam is far superior to any other insulation made to be injected into existing wall cavities.

Therefore, I urge you to adopt the Home Insulation Tax Credit provisions of the proposed H.R. 6860 bill. However, include among those qualifying all recognized insulating materials that meet building code standards for effectiveness and safety. Do not impose the restrictive limitations recommended by the National Bureau of Standards.

Sincerely,

MICHAEL T. DOLAN.

GREAT FALLS, MONT.,
April 20, 1976.

Mr. MICHAEL STERN,
Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: It has come to my attention that H.R. 6860, which is designed to promote energy conservation and provide tax credit for home insulation as well as other structures, might include a provision for only those building materials presently having a Federal spec number or ASTM standard. Since it can take up to 4 or 5 years to obtain a Fed spec or ASTM standard, it would seem to exclude a lot of insulation materials presently being used. As long as these materials meet State and Federal building codes for safety and effectiveness that should be sufficient. Many, many homeowners in Montana and other northern States use urea-formaldehyde foam since it is a cavity-fill type and can be used in older homes or those with some, but an insufficient amount of insulation. It seems a little discriminatory to exclude commonly used materials if they carry building code approvals since most homeowners only look for safety and effectiveness when insulating their homes.

I urge your support of H.R. 6860 and vigilance to avoid the attaching of restrictions to include only those building materials with Federal specification number or ASTM standards.

Sincerely yours,

ARDIS MERRY.

SMATHERS, MERRIGAN & HERLONG,
Attorneys and Counsellors at Law,
Washington, D.C., April 26, 1976.

Re H.R. 10612—Tax Reform Act of 1975.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In line with the committee's original announcement governing hearings in connection with the above legislation, and a telegram subsequently received from the committee's staff director, Mr. Stern, we request on behalf of our client, National Association of Recycling Industries, Inc., that this letter and the documents

filed herewith be included in the committee's printed record of hearings.

You might recall that last year, the National Association of Recycling Industries, Inc. (NARI) appeared before your committee in connection with the then pending energy tax legislation, and testified in detail regarding the urgent need for enactment of a recycling tax incentive to equate tax benefits already provided by the Internal Revenue Code for large integrated manufacturers married to the depletion of our Nation's dwindling supplies of natural resource matrials which compete in the marketplace with their recyclable counterpart materials.

Shortly thereafter, during its markup of said energy tax legislation, the committee voted to enact a 10 percent recycling tax credit for manufacturers who utilize wastepaper as a papermaking raw material in their industrial operations. Because of time limitations then confronting the committee, consideration of the remainder of the recycling tax credit proposal was deferred for further study by the Joint Committee and Senate Finance Committee staffs.

The directed study thereafter ensued, and a modified recycling tax credit proposal was developed. The attached materials contain that modified proposal and a full explanation of its provisions and how it will operate.

The National Association of Recycling Industries requested permission to testify before your committee in connection with the pending tax reform legislation because originally, in 1974, the House Ways and Means Committee included the old recycling tax credit proposal in the Tax Reform Act of 1974. Clearly, because the purpose of the proposal is to reform or revise existing code provisions which restrict all tax benefits in this area to manufacturers committed to the use and depletion of virgin natural resource materials, it is absolutely urgent, proper, and necessary for your committee to complete its work on the recycling tax credit proposal and to include same in its final version of the Tax Reform Act of 1975 (or 1976, as the case may now be).

Accordingly, on behalf of its 775-member companies throughout the United States, NARI urges the Senate Finance Committee to consider the enclosed modified recycling tax credit proposal during its markup of H.R. 10612 and to approve same for inclusion in that legislation. Indeed, it is NARI's understanding that the committee fully intends to resume its consideration of the aforementioned energy tax legislation as part of its markup of H.R. 10612, so certainly it would be desirable and appropriate for the committee to complete its work on the recycling tax credit proposal at this time.

The attached documents contain full and complete information regarding the modified recycling tax credit proposal developed after the Joint Committee staff study, and of course, the national recycling industry stands ready to supply any further information the committee might deem useful.

With appreciation for your consideration, I am,

Very truly yours,

EDWARD L. HERLONG,
Counsel, National Association of Recycling Industries, Inc.

H.R. 10612: Tax Reform Act of 1975

EXPLANATORY STATEMENT IN SUPPORT OF RECYCLING TAX CREDIT

In July 1975 the Senate Finance Committee approved a 10-percent recycling tax credit for manufacturers who use wastepaper as a raw material in their industrial operations. The committee deferred action on the remainder of the proposal pending further study by the staff of the Joint Committee on Internal Revenue Taxation and the Finance Committee staff.

As a result of these studies, a modified recycling tax credit proposal was developed in cooperation with the Joint Committee staff. Essentially, it seeks to provide an incentive to manufacturers who use recyclable solid waste materials in their industrial operations instead of competing natural resource materials which have historically enjoyed favorable income tax benefits through depletion allowances and capital gains treatment of profits derived from their utilization.

This modified proposal limits as fairly as possible any credit to manufacturers for their current utilization of recyclables, and it restricts the credit to purchases of postconsumer recyclable solid waste materials and industrial waste materials not presently recycled to any substantial degree.

Moreover, the modified credit proposal reduces the estimated gross revenue loss to $135 million, without consideration of any of the inherent offsetting revenue gains. Thus, in actual operation, the modified proposal should result in only a relatively negligible net revenue loss—possibly even a revenue gain.

By comparison, revenue losses for fiscal 1977 resulting from the depletion allowance on virgin ores and capital gains treatment of profits derived from the cutting of trees are projected by the budget to exceed $1.2 billion.[1]

Adoption of the modified proposal as part of the tax revision package presently before the Senate Finance Committee is urgently necessary because currently our national recycling rates are at all time lows, and the recycling industry has been engulfed by a devastating recession.[2] The 1975 report of the Council on Environmental quality warns (at page 91), that presently only—

16.5 percent of postconsumer wastepaper is recycled.
2.1 percent of postconsumer glass is recycled.
1.4 percent of postconsumer scrap iron and steel is recycled.
4 percent of postconsumer aluminum is recycled.
Negligible percentage of postconsumer textiles are recycled.

CEQ's 1975 report goes on to state (at p. 92): "According to EPA projections, total wastes are expected to increase significantly by 1990."[3]

---

[1] The special analysis of the budget for fiscal 1977, p. 125, reports projected revenue losses for corporate percentage depletion allowance on ores of $1.02 billion; on depletion allowance for individuals of $575 million; capital gains treatment of timber income, $230 million; and capital gains treatment of royalties on coal and iron ore of $70 million. Thus, a $1.2 billion projected revenue loss for 1977 is conservative.

[2] CEQ's 1975 report to Congress states (at p. 93) that, during 1974, wastepaper prices "plummeted from $60 to $5 a tons, and sometimes a buyer would not be found at any price." The report continues:

"The recycling boom of the early 1970's appears to be over and many volunteer recycling centers went out of business. Some municipal collection systems were discontinued. Others sent the collected paper on to landfills."

[3] EPA projects total postconsumer waste discards will increase from 144 million tons in 1973 to 225 million tons by 1990.

Enactment of an effective recycling tax credit to stimulate resource recovery is also urgently important because use of recyclable solid waste materials in manufacturing operations in place of competing virgin natural resource materials, or as industrial fuel in place of or as a supplement to gas, oil, or coal results in—

(1) Conservation of precious, dwindling supplies of critical natural resources;[4]

(2) Reduced U.S. reliance on foreign cartels for critical natural resources, and substantial benefits to our balance-of-payments position;[5]

(3) Conservation of industrial energy;[6]

(4) Reduction in industrial air and water pollution and industrial water utilization;[7] and

(5) Reduction in solid waste management and disposal costs and burdens for cities and States throughout the United States.[8]

In this connection, CEQ's 1975 report states (at pp. 97 and 98):

> . . . We will have to dispose of about 23 percent more post consumer wastes in 1990 than we now do. By then, if current waste disposal practices continue, many municipalities will have exhausted their capacity to deal with solid waste and new disposal arrangements will be necessary.
>
> It seems inevitable that large municipalities will be looking to other jurisdictions for landfill sites. So far the few cities that have tried to persuade other communities to become the depositories of their refuse have had limited success.

In an effort to deal with these growing "mountains of solid waste," citizens and States in various parts of the United States are building resource recovery plants to extract recyclable materials from garbage.[9] The cities of New Orleans and Milwaukee and the States of Connecticut, California, Delaware, Massachusetts, New York, Ohio, and Tennessee are in the lead.

CEQ's 1975 report states that "total public and private sector spending for solid waste management over the 1974–83 decade will reach $54.4 billion." and it projects that "annual costs for solid waste management will nearly double by 1983." Connecticut's allout effort to cope with the problem is described by CEQ as follows (1975 report, p. 94):

> Connecticut is nearest to a State-operated system. As a result of the comprehensive plan developed by the Connecticut Department of Environmental Protection, the legislature created the Connecticut Resources Recovery Authority. The plan sets a 1985 date for completion of 10 facilities that will process 84 percent of the State's waste. These are energy resource facilities that will prepare

---

[4] The Bureau of Mines reports that, by 1985, the United States will depend on foreign nations for more than 50 percent of its supplies of nine of its most critical metals. By the year 2000, the list will increase to all 13 basic metals.

[5] The Department of the Interior states that if current trends are allowed to continue unabated, imports of foreign metals, which presently adversely impact our balance of payments by $6 billion a year, will result in an adverse impact of $36 billion a year by the 1990's.

[6] EPA and the Atomic Energy Commission have proved that use of recyclable aluminum in place of virgin ore saves 95 percent of the energy required to make the same aluminum products. Use of wastepaper in place of pulpwood, coppor scrap in place of virgin ore, and scrap iron in place of virgin ore results in 66, 65, and 55 percent industrial energy savings.

[7] EPA reports to Congress that use of recyclable materials in place of virgin ores and pulp results in 60 to 86 percent less air pollution; 44 to 76 percent less water pollution: 105 to 165 percent less postconsumer wastes generated; 40 to 61 percent less industrial water utilisation.

[8] Today, cities and States spend between $6 and $36 a ton to dispose of solid waste through incineration or landfill methods. Each ton recycled saves a major portion of those casts.

[9] At the end of 1974. 11 States were constructing resource recovery plants; 12 were involved in planning; and 6 had statutory authority to go ahead with planning.

municipal wastes for use as a fuel in utility boilers, leaving the unburnable residue for recycling.

However, all experts in the solid waste management field agree: The ability of these new State and municipal resource recovery plants to operate successfully depends entirely on the ready availability of markets and customers for the recyclable materials they produce from waste. Those markets will not be available as long as the present discriminatory tax treatment of competing virgin and recyclable materials is allowed to continue. Absent total elimination of the existing virgin tax benefits, enactment of the modified recycling tax credit is absolutely essential.

H.R. 10612: Tax Reform Act of 1975

SUMMARY: RECYCLING TAX CREDIT AMENDMENT

Section A(I), (II).—Congressional findings and declaration of purpose supporting enactment of recycling tax credit.

Section B(a), (b).—Provides recycling tax credit for taxpayers who purchase recyclable solid-waste materials for (1) manufacturing utilization or (2) use as industrial fuel. The allowable credit for each recyclable material is established to equate as precisely as possible the tax benefits historically provided for competing virgin natural resource materials.

Section B(c).—Defines the terms "recyclable solid waste materials"; qualified purchase"; "manufacture"

Section B(d).—Limits the allowable credit as follows:

(1) *Existing purchaser of recyclables.*—They qualify for the credit only if they continue, in each taxable year, to purchase a quantity of recyclables equal in volume to their "base year" (1975) volume. The credit is then computed on only one-third of the price paid, in each taxable year for that "base year volume." The full credit is allowed, in each year, for only the incremental increase in purchases of recyclable solid waste materials.

(2) *New purchasers of recyclables.*—Their first full year purchase volume of recyclable materials shall be their 'base year volume." In subsequent years, the credit is computed on one-third of the price paid for the base year volume; the full credit is allowed on only the taxpayer's increased purchases of recyclable materials.

Section B(e). Provides for the termination of the recycling tax credit if Congress repeals the tax benefits provided by the Internal Revenue Code for users of competing natural resource materials (depletion allowance on ores; capital gains treatment of profits derived from timber and iron ore).

RECYCLING TAX CREDIT

TITLE

"Sec. — Recycling Tax Credit.—

(A) Congressional Findings and Declaration of Purpose.

(I) The Congress finds—

(1) That utilization of recyclable solid waste materials in manufacturing operations in place of competing virgin natural

resource materials results in (*a*) conservation of our Nation's dwindling supplies of vitally important natural resources; (*b*) alleviation of our growing dependence on foreign sources of supply for such natural resource materials—a trend which threatens to produce unacceptable balance-of-payments consequences for the United States and unnecessary reliance on foreign cartels for these critical raw material supplies in the years immediately ahead; (*c*) conservation of extremely significant volumes of industrial energy; (*d*) substantial reduction of industrial air pollution, water pollution, water utilization and in the volume of industrial solid wastes produced for disposal; and (*e*) elimination of some of the growing solid waste management and disposal costs and burdens presently confronting States and municipalities throughout the United States; and

(2) That our national resource recycling rates are presently at extremely low levels, and this condition is materially aggravated and adversely affected by the Federal income tax structure which has historically provided important income tax benefits exclusively to large integrated manufacturers committed to the continuous utilization and depletion of virgin natural resource materials that compete with their recyclable counterparts in the market place.

(II) The purpose of this section therefore is to realize at the earliest possible date the numerous important national benefits which will result from increased, consistent utilization of recyclable solid waste materials in manufacturing operations by providing a recycling income tax credit to manufacturers who maintain and significantly increase their current utilization of such materials and to manufacturers who switch, in whole or in part, from their present utilization of virgin natural resources to recyclable solid waste materials in their manufacturing operations.

(B) ALLOWANCE OF CREDIT.—Part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954, as amended (relating to credits against income tax) is hereby further amended by adding at the end thereof the following new section:

"SEC. —. CREDIT FOR AMOUNTS PAID TO ACQUIRE RECYCLABLE SOLID WASTE MATERIALS.—

"(a) IN GENERAL.—There shall be allowed as a credit against the tax imposed by this subchapter for the taxable year the percentages specified in subsection (b) of the amounts paid during the taxable year by the taxpayer to make qualified purchases of recyclable solid waste materials (as defined in subsection (c)) for manufacture by the taxpayer into useful new materials or saleable products or for use as an industrial fuel.

"(b) PERCENTAGES ALLOWED.—The percentages referred to in subsection (a) are as follows:

(1) 11 percent for recyclable metals other than gold, silver, platinum, copper, iron and steel recovered from solid waste.

(2) 10 percent for recyclable wastepaper, including old newspapers, boxes and cartons, and textile wastes recovered from solid waste.

(3) 7½ percent for recyclable copper, iron and steel recovered from solid waste.

(4) 5 percent for recyclable glass recovered from solid waste.

The percentage allowed for purchase of wastepaper and textile wastes shall be increased by rule or regulation of the Secretary of the Treasury to provide a minimum credit of $10 per ton for any taxable year in which the Administrator of the Environmental Protection Agency certifies to the Secretary in writing that such allowance is essential to accomplish effective recycling of the lower grades of these particular recyclable solid waste materials.

(c) DEFINITIONS.—For purposes of this section—

(1) The term "recyclable solid waste materials" means wastepaper, boxes, cartons, textile wastes and old clothing, glass, nonferrous metals (other than gold, silver, and platinum) which have been used by an ultimate consumer or which constitute waste materials after utilization in the course of any industrial or manufacturing process, and which have no significant value or utility except as solid waste materials. The term "recyclable solid-waste materials" does not include industrial or manufacturing solid waste materials which are regularly recycled for use or reuse "inplant" or "in-house" by the creator of such waste or by any person, firm or corporation related to or affiliated with the creator of such waste;

(2) The term "qualified purchases" means, with respect to any taxable year, those transactions within the United States whereby the taxpayer buys and acquires recyclable solid-waste materials recovered from solid waste in the United States for domestic manufacture into new materials or salable products or for use as an industrial fuel in the United States. Such term does not include transactions outside the United States, or whereby the taxpayer acquires recyclable solid-waste materials recovered from solid waste outside the United States, or whereby the taxpayer acquires recyclable solid-waste materials in the United States for export; and

(3) The term "manufacture" means any process or treatment that alters the composition or physical properties of a recyclable solid-waste material and transforms it into a salable, useful material, product or property. The term does not include a process of merely sorting, shredding, stripping, compressing, or packing a recyclable solid-waste material for storage or shipment.

(d) LIMITATION ON ALLOWABLE AMOUNT OF RECYCLING TAX CREDIT.—

The amount of the credit allowed by this section for any taxable year shall be limited as follows:

(1) In the case of any taxpayer who was engaged in qualified purchases of any recyclable solid-waste material or materials as defined in subsection (c)(1) prior to the date of enactment of this section, the credit shall be allowed only if the taxpayer makes qualified purchases during the taxable year of a volume of the same or similar recyclable solid-waste material or materials at least equal by weight or other applicable volume measurement to the qualified purchases made by the taxpayer during the taxable year 1975, which shall be the

taxpayer's "base year volume." In the event the credit is thus allowable, it shall be limited and computed as follows:

(i) On only 33⅓ percent of the amounts paid during the taxable year for qualified purchases of the volume equal to the taxpayer's base year volume; and

(ii) On 100 percent of the amounts paid during the taxable year for qualified purchases of the same or similar recyclable solid-waste material or materials in excess of the taxpayer's base year volume.

(2) In the case of any taxpayer who was not engaged in qualified purchases of a recyclable solid-waste material or materials prior to the date of enactment of this section but who thereafter makes a qualified purchase during any taxable year, the allowance of the credit shall be determined on the following basis: The year in which the taxpayer makes the first qualified purchase of any recyclable solid-waste material or materials or of a different recyclable solid-waste material shall be taxable's "base year," and the qualified purchases during that year shall be the "base year volume." The allowable credit shall be limited and computed as follows:

(i) For the taxpayer's base year, on only 33⅓ percent of the amount or amounts paid during that year for qualified purchases of that recyclable solid-waste material or materials.

(ii) In subsequent taxable years, the credit shall be allowed only if the taxpayer makes qualified purchases during the taxable year of a volume of the same or similar recyclable solid-waste material or materials at least equal by weight or other applicable volume measurement to the qualified purchases made by the taxpayer during the "base year".

(3) In the event the credit is found to be allowable, it shall then be computed as follows:

(i) On only 33⅓ percent of the amounts paid during the taxable year for qualified purchases of the volume equal to the taxpayer's base year volume, and

(ii) On 100 percent of the amounts paid during the taxable year for qualified purchases of the same or similar recyclable solid-waste material or materials in excess of the taxpayer's base year volume.

(e) TERMINATION OF CREDIT.—The credit allowed by this section shall terminate simultaneously with any action hereafter taken to repeal the income tax benefits provided by existing sections of the Internal Revenue Code (Title 26 U.S.C. §§ 611 et seq. and 631 et seq.) which allow taxpayers a deduction for the depletion of virgin ores, minerals and timber and capital gains treatment of profits derived from use within a taxpayer's business of virgin timber or iron ore owned by the taxpayer.

MASTIC CORP.,
South Bend, Ind., April 23, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: There are more than 30 million underinsulated houses in the United States, according to the Federal Energy Admin-

istration. In all, home heating and cooling accounts for a sizable 13 percent or so of total annual energy use in the country today, also according to FEA.

Thus, passage of H.R. 6860 could promote significant energy savings nationally. Among other things, it could also mean significant financial savings for many millions of American consumers.

However, the insulation materials that might be approved for a tax credit in H.R. 6860 should not be restricted to the materials specified in the National Bureau of Standards: "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit"; NBSIR 75--795, prepared for the Federal Energy Administration, Washington, D.C.

If you restrict insulation materials for tax credit only to those in the NBS recommended criteria, it would be detrimental to the public for several reasons. The NBS recommended criteria, in effect, approves only old long-established insulation materials. It would approve, in other words, only insulation materials that have either a Federal specification number or an ASTM (American Society of Testing and Materials) product designation.

Obtaining a Federal specification or ASTM designation for any building product today requires as long as 4 to 5 years. On this basis, any relatively new insulation product would be shut out of a tax credit for a considerable time, no matter how excellent it may be.

In addition, some perfectly satisfactory products, long used in housing, do not necessarily have either a Federal specification number of ASTM designation simply because such products are used chiefly in private housing and not for Government or other standards use where a Federal specification number or ASTM designation may be desirable.

Your assistance will be appreciated.

Sincerely,

CHARLES M. MATTES,
Executive vice president and general manager.

ADVANCED CONCEPTS INSULATORS,
DIVISION OF CORROSION CONTROL, INC.,
Omaha, Nebr., April 21, 1976.

Re Energy Conservation & Conversion Act H.R. 6860.

MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: As our present sources of energy become depleted the thought of energy minded citizens are turning towards insulation.

It is with this in mind that I endorse the home insulation tax credit provisions of the proposed H.R. 6860 bill.

If a bill such as this were passed more and more people would turn towards insulation to cut down on their heating and cooling costs and would consequently promote energy savings nationally.

I do not believe, however, that the insulation materials approved for tax credit under this bill should be limited to those materials specified in the National Bureau of Standards: "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit". NBSIR

75-795, prepared for the Federal Energy Administration, Washington, D.C. 20461.

To offer tax credits to only those materials in NBS recommended criteria would only allow credit for those materials that are long established and old. These would be the insulation materials that have an ASTM product designation or a Federal specifications number.

To fulfill these requirements nowadays takes from 4 to 5 years and new products no matter how adequate would not qualify for several years after their introduction.

Urea Formaldehyde foam insulation (U-F) foam is an insulation material that could be eliminated from the tax credit roster should the NBS criteria be adopted. U-F foam, however, does have a higher insulating efficiency than most insulation materials. It is fire resistant, nontoxic, and can be applied in most preexisting homes here in our part of the country. As a result fuel costs can be cut by the homeowner and energy can be saved by the entire country.

Products that can help our country save energy, such as Urea Formaldehyde foam, should not be deprived of tax credit approval because they have not met NBS recommended criteria. This criteria would serve to rule out other new and innovative products that might be introduced in the years to come.

I am an insulation contractor and U-F foam is one of the many insulating materials I use in my business. I believe in it because it is good and I believe it along with the other materials should be approved for tax credit because it will save my customers money but most importantly will help our country conserve energy.

LARRY J. ORTT, *Manager.*

STATEMENT OF MICHAEL D. DINGMAN, PRESIDENT OF WHEELABRATOR-FRYE, INC.

Mr. Chairman and members of the committee, pursuant to the opportunity afforded by your press release of February 5, 1976, this statement sets forth the views of Wheelabrator-Frye Inc. on tax incentives to further the national objective of developing energy sources other than oil and gas, including those incentives contained in title IV of the Energy Conservation and Conversion Act of 1975 (H.R. 6860), pending in your committee.

I. INTRODUCTION

Wheelabrator-Frye, Inc. is a recognized world leader in the design, construction and operation of environmental and energy systems. As a company, we are deeply committed to both the development of energy sources other than oil and gas and the preservation of environmental quality.

It is the stated policy of the United States to reduce its dependence on foreign oil and gas. To a considerable degree, this can be done by developing alternative energy sources that are available domestically. Among those of greatest and most immediate promise are the conversion of coal to clean fuels through gasification and liquefaction (in-

cluding the solvent refined process), and the conversion of solid wastes to energy. Wheelabrator-Frye has extensive experience with these systems.

Based on our experience, we are confident that, with the help of Government incentives, there will be a dramatic increase in the construction of solid waste energy facilities and a more rapid development of commercially viable clean coal conversion plants. The technologies have been largely proven, and Wheelabrator-Frye and other private companies are presently prepared to construct, own, and operate such facilities. In the case of solid waste energy systems, the missing ingredient is appropriate tax incentives to improve the economics of financing such facilties. Appropriate tax incentives, coupled with loan guarantees such as those proposed in H.R. 12112, would also assist in financing the enormous cost of constructing clean coal conversion plants.

Accordingly, we are in general agreement with the provision of H.R. 6860 dealing with the 5-year amortization of capital expenditures for "qualified energy use property." We believe, however, that the House provision should be amended to permit the qualification of eligible property for a full (10 percent) investment tax credit.

In addition to the House rapid amortization provision or as an alternative to our amended rapid amortization provision, Wheelabrator-Frye urges Congress to enact the following incentive:

Twelve percent investment tax credit for a minimum of 10 years for solid waste energy systems and clean coal plants.

II. NEW SOURCES OF CLEAN ENERGY

The United States has been made acutely aware of the need to reduce its dependence on foreign oil and gas and to rapidly develop alternative sources of energy. Both the administration and leaders in Congress have proposed various means of encouraging the Nation's conversion to alternative sources of energy.

These proposals have emphasized, in particular, the need to exploit our abundant reserves of domestic coal, and recognize that additional energy supplies from coal will not be available as a substitute for other fuel sources unless an effort is made by the Government to promote their development. Most authorities now agree that, because of the pollutants which are discharged into the environment when coal is burned directly, the only way to significantly increase the use of coal is to develop more economic ways to convert coal to clean synthetic fuels. Coal cleaning by gasification is commercially available now; coal cleaning by liquefaction is on the threshold of commercial application.

These proposals also recognize the potential contribution of solid waste energy systems and the need for Government incentives to realize this potential.

Solid waste energy

If the municipal refuse collected annually in the United States were burned in solid waste energy systems, the energy produced would equal about 6 percent of the present U.S. power generation. While not all municipal refuse can be considered for energy extraction, a reason-

able estimate is that 100 plants processing 1,200 tons of refuse a day (one-third of the annual collection) could provide the energy equivalent of more than 50 million barrels of oil annually.

Solid waste energy systems have been operating in Europe and Japan for more than twenty years and a number of systems have been installed in the United States. More are under construction and in the planning stage. For example, Wheelabrator-Frye has recently completed construction of a refuse-to-energy plant in Saugus, Massachusetts. The plant is expected to dispose of 1,200 tons of refuse daily and to produce steam energy equivalent to approximately 600,000 barrels of oil per year.

Clean conversion of coal

Pollutants can be removed either after the coal is burned by cleaning the flue gas and disposing of the ash residue, or by cleaning the coal prior to burning. Wheelabrator-Frye, along with many utilities and industrial users, believes cleaning the coal before it is burned is both a potentially more efficient form of pollution control and of energy production.

Although some suggestions indicate that synthetic fuels production would not be meaningful until 1985, we believe that if appropriate incentives are provided, commercial development of clean coal plants would be substantially accelerated. Coal gasification technology has existed for 40 years and is in wide use in Europe and South Africa. A realistic goal for the United States is the construction by 1985 of 50 medium-size coal gasification plants each with a daily capacity of 2,000 tons of coal. These plants, costing approximately $70 million each, could produce clean fuel equivalent to 146 million barrels of oil per year.

The feasibility of coal liquefaction technology is now being proven. Under the auspices of the Office of Coal Research, a demonstration facility which processes 50 tons of coal per day was opened in Fort Lewis, Wash., in September 1974. A number of major utilities are interested in building commercial-size installations, and Wheelabrator-Frye is involved in planning a $100 million demonstration plant which after its economics are proven will be expanded to a $350 million facility to process 25,000 tons of coal per day. The completed facility could produce clean fuel equivalent to 36 million barrels of oil per year.

III. THE NEED FOR INCENTIVES

Private industry unaided would find it very difficult at this time to provide or obtain the large sums required to construct solid waste energy and coal gasification plants based on proven technology in the numbers required to meet our energy need. The capital cost of the Wheelabrator-Frye refuse-to-energy plant was $35 million and plants costing as much as $160 million are being planned. Medium-size coal gasification plants cost $70 million each.

The difficulty of attracting capital is even more acute for coal liquefaction plants because of the larger costs and the risks involved in commercializing new technology. The complete coal liquefaction facility projected by Wheelabrator-Frye and a major utility would take

over 3 years to build at an estimated cost of $350 million. There are few private companies which can finance sums of this magnitude on their own credit.

In addition, the risk of investing large sums in the search for alternative sources of energy is particularly great at this time. The price of oil in the world market, while presently exorbitant, is precarious. A sudden drop in the price of oil might render investments in other sources of energy worthless.

While the private sector would probably sometime in the future furnish the necessary capital without Government-created incentives, we need such incentives to encourage private investment now.

The Energy Conservation and Conversion Act of 1975, H.R. 6860

H.R. 6860, as passed by the House, recognized the desirability of providing government financial assistance in the development of new energy sources and recognizes to some extent the need for incentives to encourage private investment in such development.

Title III of the act would establish an energy conservation and conversion trust fund funded by net revenues from the several conservation taxes contained in the bill. These revenues would be used to provide priority financing of various energy conservation and conversion research and development programs.

Wheelabrator-Frye believes that appropriate tax incentives will provide sufficient impetus for the construction and development of solid waste energy facilities and that the loan guarantee program currently proposed in H.R. 12112 provides a more appropriate incentive for the development of commercially viable clean coal conversion plants than does the energy trust fund concept set forth in title III of H.R. 6860.

Wheelabrator-Frye, however, favors 5-year amortization of qualified energy use property. Unfortunately, from a practical economic standpoint, the rapid amortization rules set forth in title IV of H.R. 6860 would be of limited benefit in stimulating the development of most categories of such property.

Under the House rapid amortization rules, taxpayers would be faced with a choice of (*a*) 5-year straight-line amortization and two-thirds of an investment tax credit, or (*b*) double-declining balance depreciation over the period of the property's guideline life (or shorter ADR life), plus full investment tax credit. Under current conditions, it would appear that the latter alternative is more advantageous than the former in the case of property with guideline lives of less than 14 years. Consequently, since most qualified energy use property would not have guideline lives as long as 14 years, rapid amortization would not be elected for most of the property eligible for such treatment under title IV.

Accordingly, Wheelabrator-Frye favors 5-year amortization of qualified energy use property combined with qualification of such property for a full 10 percent investment tax credit.

Moreover, we believe that certain definitions in title IV should be amended to more accurately reflect the intent of the House as to the type of facilities to be included within the meaning of "qualified energy use property."

Title IV establishes a new section 189 to the Internal Revenue Code—Amortization of Qualified Energy Use Property. Section 189(b)(1) provides that "qualified energy use property" means:

(a) Qualified waste equipment;
(b) Qualified shale oil conversion equipment;
(c) Qualified coal processing equipment;
(d) A qualified coal pipeline;
(e) Qualified solar energy equipment; or
(f) Qualified deep-mining coal equipment.

The term "qualified waste equipment" is defined in section 189(b)(2)(B) to include any machinery or equipment "used to process waste into a fuel." As drafted, this language might be construed not to include a more efficient facility such as the refuse-to-energy plant in Saugus, Mass. which uses waste as a fuel and which converts the fuel directly into usable energy.

We suggest that section 189(b)(2)(B) be amended to read: "used to process waste into a fuel or directly into usable energy." This amendment would clarify the definition of "qualified waste equipment."

The term "qualified coal processing equipment" is defined in section 189(B)(4) to mean "any machinery or equipment (of a character subject to the allowance for depreciation) for processing coal into a liquid or gaseous state." The problem with this language is that it might not include one of the principal liquefaction processes, that is, solvent refining process produces a clean solid fuel by removing most of the sulfur and ash from coal. While the process involves the liquefaction of coal, the final product is coal in a clean solid state.

We suggest that section 189(b)(4) be amended to read as follows:

(4) Qualified coal processing equipment—The term "qualified coal processing equipment" means any machinery or equipment (of a character subject to the allowance for depreciation) *for use in the liquefaction (including the solvent refined process) or gasification of coal.*

This amendment would include in the definition of "qualified coal processing equipment" any machinery or equipment used in the liquefaction (including the solvent refined process) or gasification of coal regardless of the state (liquid, gaseous, or solid) of the final product.

12-percent investment tax credit

Since, as explained hereinbefore, the rapid (5-year) amortization rules proposed in H.R. 6860 would only be of benefit in the case of a limited category of eligible property; (i.e. qualified energy use property with guideline lives of 14 years or more), Wheelabrator-Frye favors a 12-percent investment tax credit in addition to the rapid amortization provisions proposed by the House or as an alternative to the amended rapid amortization provision suggested by Wheelabrator-Frye.

In either event, because of the long leadtime involved in financing and constructing most categories of qualified energy use property, we believe that the 12-percent investment tax credit should be made applicable to all expenditures for such property on which construction commences during the next 10 years.

We would like to express our appreciation to the committee for considering our views on energy tax incentives.

THERMO FOAM INSULATION CO.,
Lompoc, Calif., April 23, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

Mr. STERN: Thermo-Foam Insulation Co., of Lompoc, Calif. was formed October 24, 1974, foreseeing the need of insulating existing structures to conserve the Nation's energy. A thorough engineering evaluation of all insulating materials was conducted to assure the best product selection and being able to offer the consumer the best return on his insulating investment.

Urea-Formaldehyde foam by RAPCO Inc. for wall applications, and cellulose fiber by Mono-Therm Inc. for ceiling applications are presently the best engineering selections. Only one other material offers superior insulating characteristics—polyurethane; however, it is not selected because of the fire hazard. Rapco and Mono-Therm brochures are enclosed for your review.

Enclosed are actual heating fuel savings achieved by the above insulating method. Even though our area is one of the mildest climates in the Nation, citizens are responding to President Ford's request to conserve energy. They have done so anticipating a tax credit as stated by President Ford in his first state of the Union message.

Some people of our Nation have responded more rapidly than legislation can act and now Conversion Act—H.R. 6860 as written would deny credit for good citizenship by—

(1) Having an initiation date (March 17, 1975) three months later than President Ford's request;

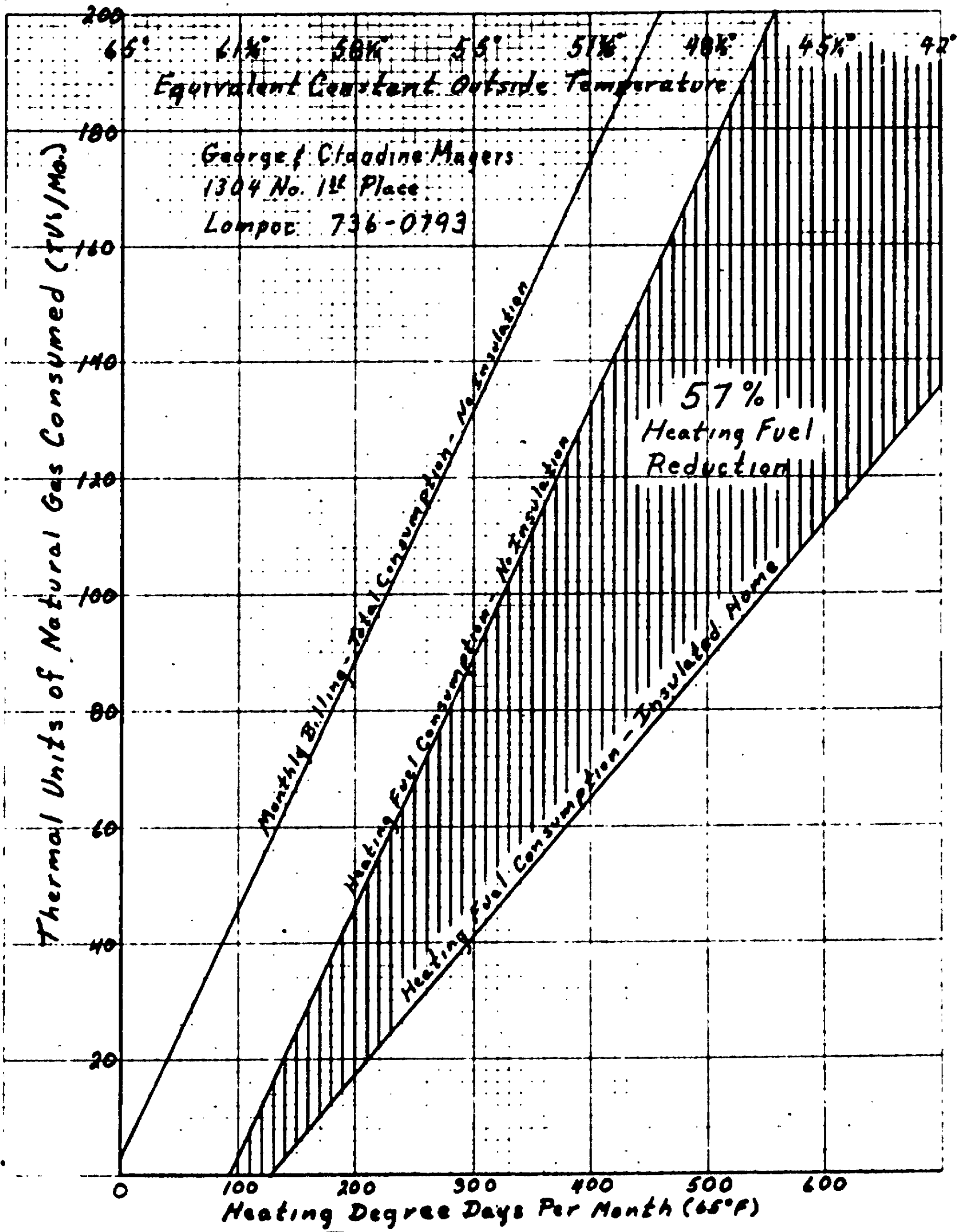
(2) Having a termination date (January 1, 1978) which would require a home insulation rate greater than the industries capability. A 5-year program would keep consumer costs down by restraining demand to that of supply; and

(3) Having a limitation placed on what insulation materials may be used. This forces use of inferior insulation, ignores product development, and places an undesirable limitation upon consumer freedom of choice. It is also noted storm windows, weatherstripping and caulking materials are not so restrained. The argument against limiting insulation material selection is primarily one of time necessary to obtain the specific approval. A more reasonable approach would be published standards and have the manufacturer prove compliance via independent means.

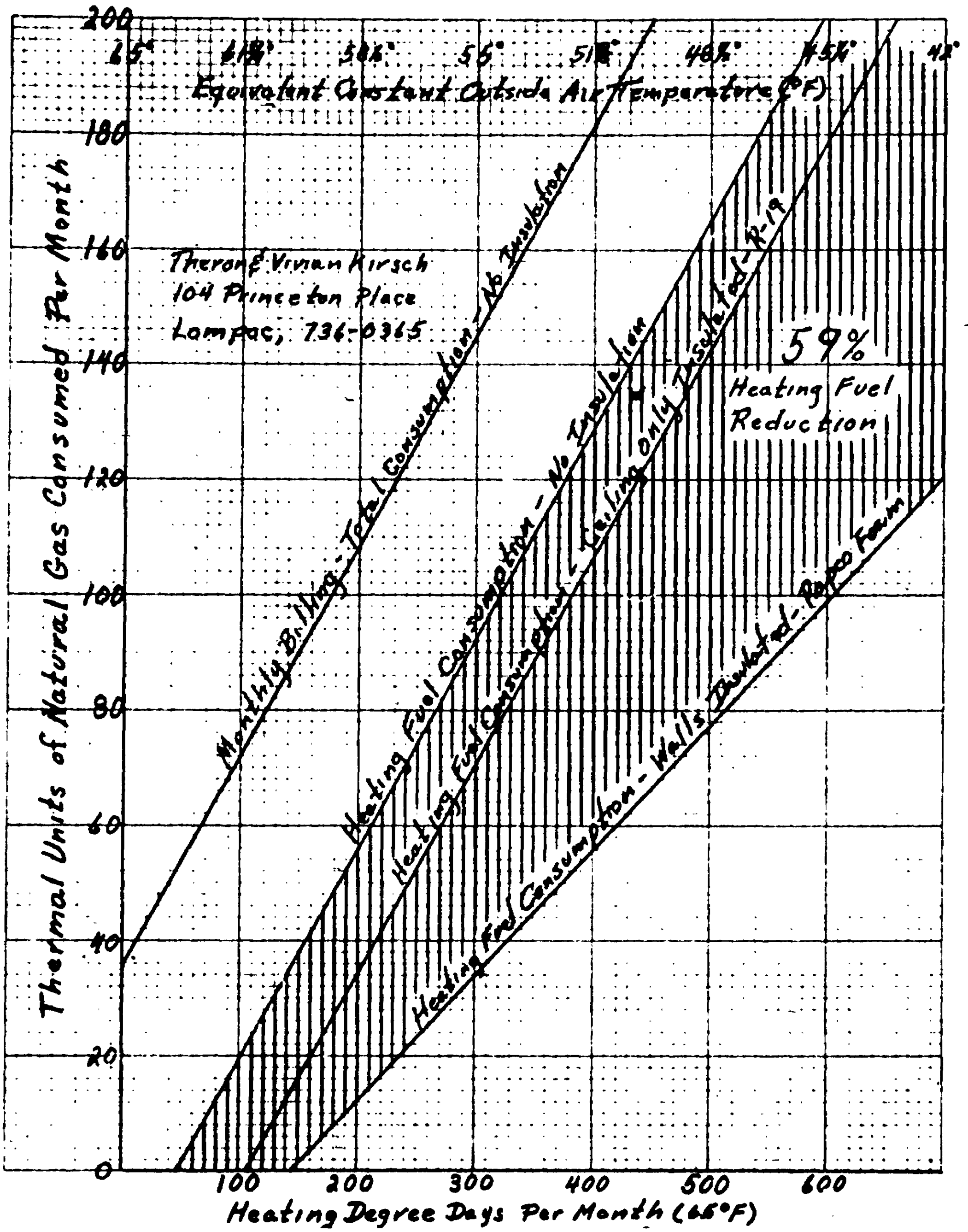
The Nation's governing body is commended for this very important legislation to overcome past construction deficits. We thank you for the opportunity to express our views on behalf of the 200 homeowners we have served.

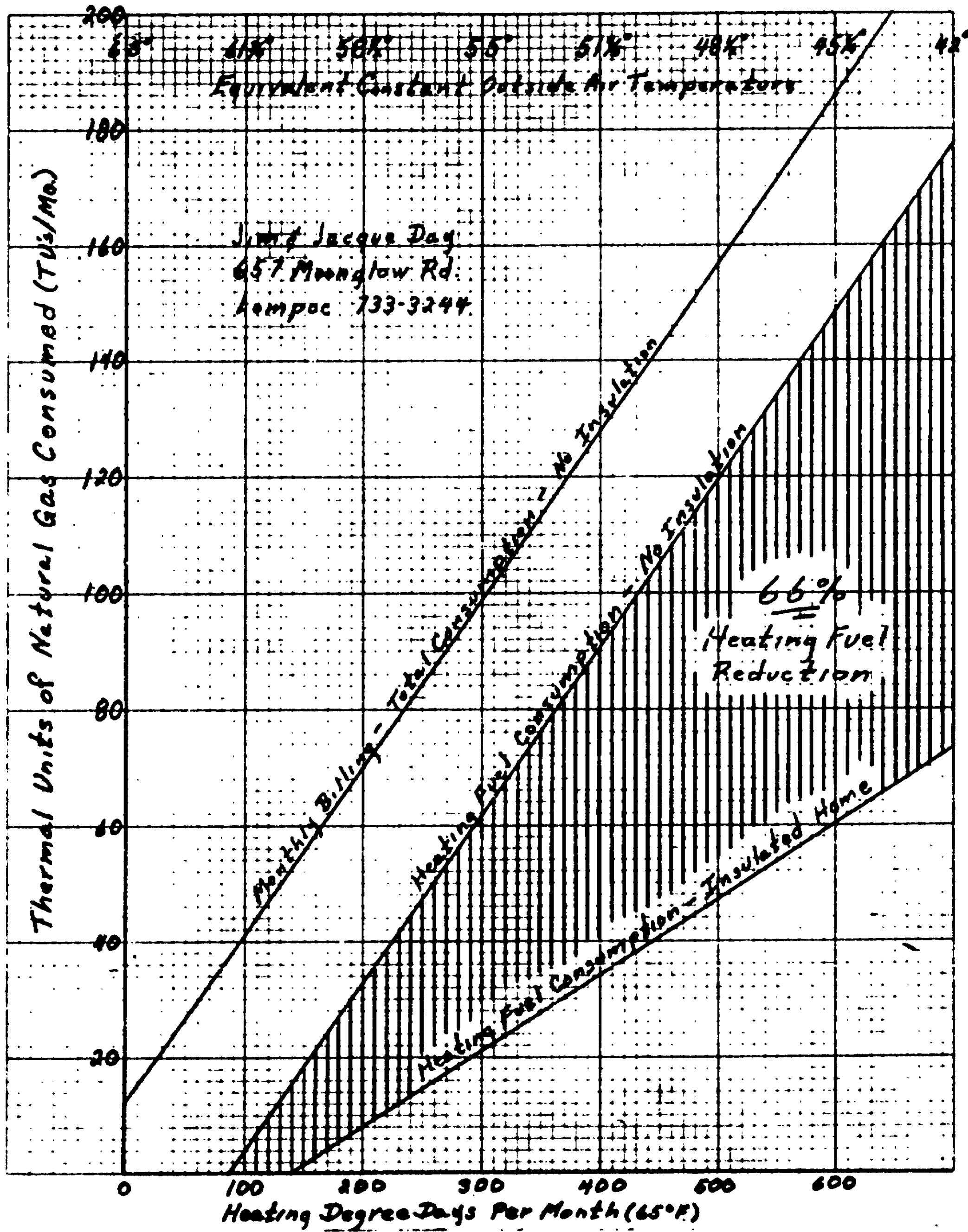
Sincerely yours,

JOHN C. RAMSEY,
Product Manager.



65°
55°
42°
Equivalent Constant Outside Temperature
George & Claudine Magers
1304 No. 1st Place
Lompoc 736-0793
57%
Heating Fuel Reduction
Monthly Billing - Total Consumption - No Insulation
Heating Fuel Consumption - No Insulation
Heating Fuel Consumption - Insulated Home
Thermal Units of Natural Gas Consumed (TU's/Mo.)
200
180
160
140
120
100
80
60
40
20
0
100
200
300
400
500
600
Heating Degree Days Per Month (65°F)


55°
42°
Equivalent Constant Outside Air Temperature (°F)
Thermal Units of Natural Gas Consumed Per Month
200
180
160
140
120
100
80
60
40
20
0
Theron & Vivian Kirsch
104 Princeton Place
Lompac, 736-6365
Monthly Billing - Total Consumption - No Insulation
Heating Fuel Consumption - No Insulation
Heating Fuel Consumption - Ceiling Only Insulated - R-19
Heating Fuel Consumption - Walls Insulated - Rapco Foam
59%
Heating Fuel
Reduction
100
200
300
400
500
600
Heating Degree Days Per Month (65°F)


Equivalent Constant Outside Air Temperature
Jim & Jacque Day
657 Moonglow Rd.
Lompoc 733-3244
Thermal Units of Natural Gas Consumed (TU's/Mo.)
Monthly Billing - Total Consumption - No Insulation
Heating Fuel Consumption - No Insulation
Heating Fuel Consumption - Insulated Home
66%
Heating Fuel Reduction
Heating Degree Days Per Month (65°F)
0
100
200
300
400
500
600
20
40
60
80
100
120
140
160
180
200
55°
42°

LLOYD WALKER REAL ESTATE,
Greenville, Mich., April 27, 1976.

Re Energy Conservation and Conversion Act H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: It is my understanding that the Senate Committee on Finance is considering an Energy Conservation Act which would provide a home insulation tax credit.

As a member of the Air Pollution Control Commission, I think I have grasp of the seriousness of the energy crisis in this country. I believe H.R. 6860 would help significantly to virtually freeup vast new sources of energy which would result from the conservation program.

However, I do have a vested interest in the conservation program proposed in act H.R. 6860.

We started an insulation company this year. Because we realized the importance of insulation, we decided this would be a business of increasing importance in the coming years. We made every effort to obtain an insulating material which we felt would provide a relatively high "R" factor, be as near fireproof as possible, permanent, and moisture repellent. We believe we found the product in urea-formaldehyde foam insulation. We have used U-F foam in approximately 20 homes in west central Michigan since being in business. Fuel savings reported to us by our customers have exceeded our expectations and theirs.

Unfortunately, insulation which might be approved for a tax credit in H.R. 6860 is restricted to materials specified in the National Bureau of Standards: "Recommended criteria for Retrofit Materials and Products Eligible for Tax Credit"; NBSIR 75-795, prepared for the Federal Energy Administration, Washington, D.C. 20461.

In effect this means insulation materials that have a Federal specification number or an ASTM (American Society of Testing and Materials) product designation would be eligible for a tax credit.

It is my understanding that it takes 4 to 5 years to obtain a Federal specification or ASTM designation. Thus, any new product would not qualify no matter how excellent that product may be.

May I suggest that energy conservation bill H.R. 6860 should permit a tax credit to be given to any commonly used home insulation material that meets local building code requirements; or meets the requirements of any national building code; such as the International Committee of Building Officials Code (ICBO); or has clearly proven itself in actual use on houses.

Thank you for your consideration of this important matter.

Sincerely,

LLOYD E. WALKER, *President.*

Re Energy Conservation and Conversion Act H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We are pleased to see congressional action on this important energy conserving legislation. However, we are disap-

pointed to find that some of us will be excluded from the tax credits, because of our use of a product that has not yet been approved by the National Bureau of Standards (NBS). The product we used is a combination of Urea-Formaldehyde foam manufactured by Rapco, Inc. in the walls and cellulose fiber by Mono-Therm, Inc. in the attic to supplement the fiberglass batting previously installed.

Approximately 3 years ago we installed the 4-inch fiberglass batting and our fuel bills decreased approximately 15 percent when compared to the previous 5 years average fuel bills. This past November we contracted the Thermo Foam Insulation Co., a State-licensed company, to insulate the walls with Rapco foam and increase insulation in the attic to a R-19 plus rating with Mono-Therm. In the months that followed we have seen approximately a 25-percent decrease in our fuel bill when comparing it to our neighbors.

We urge Congress to be fair with those who are willing to conserve energy and not limit this credit to those products approved by the NBS.

Sincerely,

Mr. and Mrs. ROBERT C. HENDERSON.

STATEMENT OF RICHARD M. COOPERMAN, EXECUTIVE DIRECTOR, ALUMINUM RECYCLING ASSOCIATION

PROPOSED RECYCLING TAX CREDIT PROVISION

The Aluminum Recycling Association is opposed to any recycling tax credit as it may apply to secondary, or as they are known today, recycled aluminum producers whose product, specification aluminum alloy, is sold almost exclusively to the diecasting, sand and permanent mold casting markets and is not a substitute for virgin metal or alloy of virgin metal.

The association is comprised of 31 companies with 44 plants throughout the United States. These companies represent over 83 percent of the Nation's capacity to produce secondary aluminum. For over 70 years, they have applied technology capital, and equipment to process aluminum scrap into recycled aluminum for American industry. Since records were first kept, starting in 1913, secondary aluminum producers have recovered and produced aluminum in their furnaces from over 45 billion pounds of scrap. This scrap was purchased from industrial sources, from scrap collectors, dealers and brokers. For almost eight decades we have been environmentalists and conservators of energy and resources.

We provide secondary aluminum specification alloy ingot for use by over 800 diecasters who produce components for automobiles, large and small household appliances, business machines, stationery motors and hundreds of other industrial, commercial and consumer uses.

The ingot we produce from reclaimed scrap represents over 20 percent of this Nation's annual aluminum supply. Our furnaces recycle over 70 percent of all aluminum scrap generated, of which incidentally, can scrap is only about 13 percent.

There are two types of scrap indigenous to our industry: New scrap produced by primary aluminum companies and by fabricators of

primary aluminum products and components, and postconsumer, or old scrap. Virtually all new scrap is recovered and recycled. As recently as 3 and 4 years ago, certain kinds of old scrap were too contaminated to be used effectively in the recycling process. However, we developed the technology necessary to recycle it and to produce aluminum alloy from it. Now our industry is reaching beyond its historical sources of raw material and we are exploring the Nation's municipal wastes because much postconsumer scrap is too widely dispersed for collectors to bring it in and market it economically.

Aluminum recyclers in the United States have the productive capacity to process annually 2.236 billion pounds of scrap into recycled ingot. Last year, we produced approximately 1.4 billion pounds of recycled ingot. That was the full extent of the demand for our product in 1975. We recycle in response to diecasters' and end-users' demands.

During the year of greatest demand for recycled aluminum alloy, 1973, we had to scratch to get enough scrap to produce approximately 1.9 billion pounds of alloy. Scrap became so scarce at the peak of the production curve that we sought an embargo against aluminum scrap exports from this country to preserve our supply. The Nation's production capacity for recycled aluminum at that time was 2 billion pounds. There was not enough scrap to produce to that level.

Today, we have the capacity to produce 2¼ billion pounds of secondary aluminum. We need no incentive to do our job; we have been doing it since 1904. As total demand for aluminum increases and expansion of primary aluminum capacity becomes increasingly expensive requiring primary companies to recover and use more and more new scrap in their plants, we would like to see scrap from municipal waste and widely dispersed postconsumer scrap become a dependable source of raw material.

Perhaps herein is the area for tax incentive to go either to the municipality or the ultimate consumer. As recyclers we are concerned with buying scrap as a raw material and not with the gathering, storing, or distribution of scrap.

In closing I cite reports of a Federal Agency whose concern with and impact upon the concept and practice of recycling is considerable. The U.S. Environmental Protection Agency, page 56, of its second report to Congress in 1974, said the major constraint to aluminum recycling is supply of scrap. In its third and most recent report to Congress, September 1975, page 59, EPA stated that the future of aluminum recovery depends on the rate of expansion of collection centers and in the development of technology to extract aluminum mechanically from solid waste.

We have made tremendous strides in recycling scrap; we know there are further technical and scientific developments ahead of our industry. We yield to no one in our understanding either of the various processes or of the economics of our industry or of our marketplace. No industrial association other than the Aluminum Recycling Association speaks for the secondary aluminum producers. ARA, as the representative of the secondary aluminum industry, declares that we neither need nor wish a recycling tax incentive. A proposed tax credit will not expand our use of aluminum base scrap since we produce only in response to demand for our product.

Statement of Magma Power Co.

S. 2608

Magma Power Company respectfully requests favorable consideration by the Senate Committee on Finance of Senate Bill 2608, introduced by Senator Fannin and others, relating to geothermal resources.

Magma Power Company pioneered development of geothermal resources in North America and in early 1955 drilled and completed at The Geysers in Northern California the first commercial geothermal well in North America. Our company, together with Thermal Power Company and Union Oil Company owns and operates the only project developing geothermal resources for sale to a utility, Pacific Gas and Electric Company, to be utilized in the generation of electricity for commercial sale. We do not have interests in any other energy fuel sources and have limited our activities to the development and utilization of geothermal resources.

Magma Power Company has also been the leader in the development of technology for use of geothermal resources in its various forms. One of our primary present projects is exploration of the geopressurized zones which occur extensively in the States of Texas and Louisiana (and perhaps in other Gulf Coast states) and testing the commercial feasibility of developing and utilizing this geothermal resource for the generation of electric power. We have recently undertaken a major effort to raise the necessary capital to engage in this multimillion project.

Although it is generally believed, and although the various studies of the USGA and others indicate, that geothermal resources, when developed, can potentially supply a very substantial portion of our country's energy requirements, the development and use of this resource has proceeded at a snail's pace. One of the major reasons for this delay in development has been the absence of a tax program which is appropriate to geothermal resources. Geothermal resources are not like any other energy fuel in that they must be utilized at or in close proximity to the places of their occurrence. The facilities for generation of electric power must be constructed at these locations and the power must be transported to the market. Before facilities will be constructed there must be proof of a sufficient reservoir and proof, also, of the life of the reservoir. This involves a long waiting period between the expenditure of funds and the receipt of proceeds from the sale of the resource. This delay can extend to as long as ten years, because even if a resource is discovered, additional wells must be drilled to confirm the discovery and to attempt to ascertain the extent of the reservoir. Then a period of time must elapse for the testing of the resource to determine its characteristics, possible life and other important factors. It is only after these questions are answered that engineering of the kind of generating facility can commence. The actual construction of the power generating plant takes an additional few years. Before construction of a power generating plant, the utility must ascertain that there is a sufficiently major resource so as to warrant the construction of transmission lines from the plant to the market. During this long period of delay, the developer must continue to spend money without any return.

Another problem for the developer is the inability to ascertain any degree of certainty as to what the life of the geothermal reservoir will

be, nor is he able to ascertain until he has engaged in extensive drilling of an area what his actual costs will be.

The foregoing delays and uncertainties have very severely limited, and will continue to severely limit, the availability of capital for the development of geothermal resources. There are other energy fuels about which more is known and which are more attractive to the capital that is available. It is, therefore, essential that a tax program be adopted which will encourage the investment of capital and enable the buildup of capital for exploration and development of geothermal resources. Senate Bill 2608 will do just that.

At the Geysers in California, the electric power generated from geothermal steam has continued to be the cheapest power in the Pacific Gas and Electric Company system. If geothermal resources can be extensively developed and used in the generation of electric power, it is obviously in the public interest, and such activity should be encouraged.

As to the potential of geothermal resources in the Gulf Coast area, it is generally agreed that the fluids will contain natural methane gas, which would not ordinarily be produced, and that this gas will provide an additional energy source and an additional means of making the development of geothermal resources of the Gulf Coast region economically feasible. As a matter of fact, the recently enacted statute of the State of Louisiana relating to geothermal resources specifically includes within the definition of geothermal resources natural methane gas produced in association with geothermal fluids. We, therefore, respectfully suggest that there be added to Senate Bill 2608 as an amendment to Section 189, subdivision (d)(1) where "geothermal steam and geothermal resources property" are defined, the following words:

> Natural methane gas contained in, or produced in association with, geothermal steam or geothermal fluids shall be deemed to be geothermal steam and geothermal resources property for the purposes of this section.

I would like to point out to the Committee that although the United States Court of Appeals for the Ninth Circuit did in 1972 sustain a Tax Court decision holding that geothermal steam was entitled to intangible drilling cost deductions and to depletion allowances under the laws and regulations existing at that time [Reich vs. Commissioner and Rowan vs. Commissioner (1972), 454 Fed 2d 1157 et seq.], and although the Congress in the Tax Reduction Act of 1975 evidenced its concurrence in that decision, the Internal Revenue Service has refused to accept that decision and that congressional declaration of policy. This is another indication of the importance of firm and clear congressional action which will apply to all geothermal resources in whatever form they may be found.

FEBRUARY 27, 1976.

RAPPERSWILL CORP.,
March 29, 1976.

Re Energy Conservation and Conversion Act H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: With one strong exception, my company officers and employees all heartily endorse the Home Insulation Tax Credit

provisions of the proposed HR 6860 bill. It would strike a major blow for national energy conservation.

There are more than 30 million under-insulated houses in the U.S., according to the Federal Energy Administration. In all, home heating and cooling accounts for a sizable 13 percent or so of total annual energy use in the country today, also according to FEA.

Thus, passage of H.R. 6860 could promote significant energy savings nationally. Among other things, it could also mean significant financial savings for many millions of American consumers.

However, the insulation materials that might be approved for a tax credit in H.R. 6860 should not be restricted to the materials specified in the National Bureau of Standards: "Recommended Criteria for Retrofit Materials and Products Eligible for Tax Credit"; NBSIR 75-795, prepared for the Federal Energy Administration, Washington, D.C. 20461.

If you restrict insulation materials for tax credit only to those in the NBS recommended criteria, it would be detrimental to the public for several reasons. The NBS recommended criteria, in effect, approves only old long-established insulation materials. It would approve, in other words, only insulation materials that have either a Federal Specification Number or an ASTM (American Society of Testing and Materials) product designation.

Obtaining a Federal Specification or ASTM designation for any building product today requires as long as four-to-five years. On this basis, any relatively new insulation product would be shut out of a tax credit for a considerable time, no matter how excellent it may be.

In addition, some perfectly satisfactory products, long used in housing, do not necessarily have either a Federal Specification Number or ASTM designation simply because such products are used chiefly in private housing and not for government or other standards use where a Federal Specification Number or ASTM designation may be desirable.

Urea-Formaldehyde foam insulation, U-F foam, is an example of a proven home insulation that could be ruled out for a tax credit should the NBS recommended criteria be adopted. Yet U-F foam has a better insulating conductivity; i.e., high insulating efficiency, than most common insulations. Unlike other plastic insulation foams, it is fire-resistant. U-F foam has been installed in more than 50,000 houses. And it offers certain special and unique characteristics that make it particularly desirable for insulating existing houses.

For example, injected into the closed cavity walls of an existing house, it will flow around, behind or over pipes and wires and other obstructions inside walls, and entirely fill the cavity spaces. Other common insulations used for retrofitting, tend to be hung up by the same interior wall obstructions, thus resulting in incomplete insulation application.

U-F foam also has been used in commercial and industrial structures. A partial list of such uses, including office skyscrapers and hospitals, is enclosed with this letter. A technical specification on U-F foam is also enclosed.

I strongly urge that the Energy Conservation Bill, H.R. 6860, permit a tax credit to be given to any commonly used home insulation material that meets local building code requirements; or meets the requirements of any national building code; such as the International Committee of Building Officials Code (ICBO); or has clearly proven itself in actual use in houses.

No building product that can serve well for energy conservation, such as urea formaldehyde foam, should be deprived of tax credit approval simply because it does not meet the rigid NBS recommended criteria. These criteria would also rule out other good products and also new innovative products that might be introduced at any time.

I am president of Rapperswill Corporation, largest manufacturer of U-F foam in the United States and Canada. We have the exclusive license to manufacture and sell U-F foam in North America according to the patented Isoschaum Process.

Sincerely,

RAPPERSWILL CORPORATION,
CHARLES H. STILLMAN,
President.

Enclosure.

PROJECTS COMPLETED
USING UREA FORMALDEHYDE

RAPCO FOAM

RAPPERSWILL
corporation

Project	Owner	Architect	Contractor
No. 1 Liberty Plaza	U.S. Steel	Skidmore Owens Merrill	Turner Const.
Standard Oil Bldg.	Rockefeller Center	Harrison & Abramowitz	Fuller Const.
1633 Broadway	Uris-Capital	Emery Roth	Uris Bros.
77 Water Street	Kaufman Organization	Emery Roth	Diesel Const.
127 John Street	Kaufman Organization	Emery Roth	Diesel Const.
747 Third Avenue	Kaufman Organization	Emery Roth	Diesel Const.
1411 Broadway	Chanin	Owner	Chanin Const.
St. Clair Place Devel.	Columbia Univ. State of N.Y. Dormitory	Brown Gunther Bataglia & Galvin	
Bard Haven Devel.	Columbia Univ. State of N.Y. Dormitory	Brown Gunther Bataglia & Galvin	Cauldwell Wingate
Philharmonic Hall	Lincoln Center		Philharmonic Hall
R.C.A. Recording Studios	R.C.A. Studios	Acoust. Eng. Mr. Stevens	R.C.A. Studios
Police Headquarters	City of New York	Dept. Public Works	Jarcho, Inc.
Downstate Hospital	New York State	Seelye Stevenson Value & Knect	
Staff Residence	Roosevelt Hospital	Frost Associates (Arch.)	Afgo Eng.
Park Slope North	City Day Care	Byer Blinder Belle	Raeburgh
Early Child Center	N.Y. Housing Auth.	Hausman & Rosenburg	Marson Const.
Queens Family Court	City of New York	Dept. Public Works	Direct
AMF Headquarters	Shulman Invest.	Thomas J. Hannino	Shulman
Indust. Park 555 Tarrytown Road	Halpern	Owner	Halpern Bldg.
Pt. Pleasant Fire House	Same (Fire Co. No. 2)	Carl Feltz	Birdsall Const.
1 N.Y. Plaza	International Nickel Co.	J.F.N. Associates	Direct
Beekman Downtown Hosp.	Beekman Downtown Hosp.	Owner	Diesel
Standard Oil Bldg.	Rockefeller Center	Harrison & Abramowitz	Fuller
Brookdale Hospital	Brookdale Hospital	Owner	H. Sand - Keone
Central Island Hospital	Central Island Hospital	Owner	March Const.
Playhouse Theatre	Paramount-Gulf Western	Owner	Direct
Apt. Hse. 82 St & E.End	L.I. Properties - Litwin	Philip Birnbaum	82nd St. Devel.
Screen Gems Gen. Rm.	Screen Gems	Owner	Direct
Mt. Sinai Hospital	Mt. Sinai	Skidmore Owens & Merrill	Diesel
Summit Apts. Summit NJ	Barcon Construction	Bottelli Associates	Barcon Const.
RCA Global Comm Ctr.	R.C.A.	Rotwein & Blake	Evans Shure Const
Ocean Ct. Reg. Sew.	N.J. Reg. Sew. Auth.	Chas. J. Kupper, Inc.	Vicon Const.
Restored Chap. of the Good Shepherd	U.D.C.	Giorgio Cavaglieri	Calcedo Const.
Man. Ford Lincoln	Ford Motors	Direct	Direct
Jamaica Hosp. Staff Res.	Jamaica Hospital/N.Y.S. Housing Auth.	Vogel & Skrunk	Blitman Const.

69-516 O - 76 - pt.7 - 40

RAPPERSWILL CORP.,
New York, N.Y., April 20, 1976.

Re Energy Conservation Act HR 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: This letter is an addendum to my letter of March 29, 1976 to you, urging that the Energy Conservation Bill, H.R. 6860, not be rigidly restrictive in the kind of materials approved for an energy conservation tax credit.

An example of home insulation that might be ruled out for tax credit, should the bill be enacted as now written, would be urea formaldehyde foam insulation. Yet U-F foam insulation is sharply reducing home heating and cooling energy consumption in upwards of 50,000 houses throughout the country.

It should be added that urea-formaldehyde insulation has an energy ratio of approximately 12 to 1. In other words, for each unit of energy required to manufacture U-F insulation, one dozen units of energy are saved as a result of its use as a thermal insulation. Such savings result within approximately twelve months after installation in the typical house.

The exact savings and exact time in which the savings accrue will vary, naturally, according to sizes and type of house, local climate conditions and other such variables.

Of course, after the first year following installation of U-F foam in typical houses, the energy savings continue every year afterward at the same rate; i.e., an additional dozen units of energy all saved each year for each unit of energy used in the manufacture of U-F foam.

My company is, as previously mentioned, the leading manufacturer of U-F foam insulation in the United States. We are, however, only a small and relatively new company. Our annual sales last year were $2.8 million. Our estimated sales for fiscal year 1976 will be $4.5 million.

Our insulation is distributed by prime distributors located in various parts of the country, and it is sold and installed to consumers by more than 600 applicators located in every part of the country.

Sincerely,

RAPPERSWILL CORP.,
CHARLES H. STILLMAN,
President.

RICE CONTRACTING CO.,
Cartersville, Ga., April 13, 1976.

Re Energy Conservation and Conservation Act H.R. 6860.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I would like to voice my endorsement of the proposed Energy Conservation and Conversion Act H.R. 6860. The Home Insulation Tax Credit provisions provided in this bill would greatly encourage Homeowners to insulate their homes, thereby conserving our precious energy resources.

I take exception, however, to the restrictions placed on the type of insulation which the National Bureau of Standards recommends, therefore, making my insulation ineligible for Tax Credit.

Urea-Formaldehyde insulation, my product, is a superior insulation. It meets all local and national building code requirements. This product has proven to be an effective insulation. But, not only this product would be effected by these restrictions. Any new innovative product would be excluded from tax credit for several years for the simple reason that it takes that long to obtain a Federal Specification or ASTM designation.

I urge the Committee on Finance voting on Bill H.R. 6860 to permit tax credits for any home insulation material that meets the International Committee of Building Officials Code, or has proven its effectiveness in home insulation.

Sincerely yours,

WINSTON RICE.

STATEMENT OF RONALD P. BALDWIN, PRESIDENT, GEOTHERMAL RESOURCES INTERNATIONAL, INC.

Mr. Chairman and Members of the Committee, my name is Ronald P. Baldwin and I am President of Geothermal Resources International, Inc. of Marina del Rey, California. GRI is a small-business firm which provides equipment leasing services and is engaged in the production of geothermal energy. We hold title or leasehold interests in substantial geothermal acreage, including some Government lands. Our geothermal properties containing discovered deposits at The Geysers in California are in an active stage of development. We hope to participate fully in the Government-sponsored program of geothermal energy research and development and to assist otherwise in the over-all goal of making geothermal energy an important national contributor toward meeting the people's energy requirements within the next decade.

My statement is in response to the Committee's invitation of February 5 addressed to persons interested in energy tax proposals suggesting that they submit their views in writing for inclusion in the record of hearings on tax revisions of expiring tax-cut provisions. The statement consists of two parts: (1) a summary and up-dating of views previously expressed to the Committee on the matters of a discovery allowance and the treatment of intangible drilling and development costs in the case of geothermal wells; and (2) a request for specific amendment of Section 208 of H.R. 10612, the House-passed tax reform bill, to eliminate the adverse impact that certain language in the section apparently would have upon the Government's loan guarantee program for the development of geothermal energy.

With regard to the first matter, we have petitioned your Committee several times before, and I wish to incorporate our previous statements into this present statement by reference.

On March 12, 1975, we testified in regard to the then pending energy tax bill (H.R. 2166), requesting amendment appropriate to provide a discovery incentive for geothermal resources; also to provide that intangible drilling and development costs could be deducted in the

case of geothermal wells in the same manner as had long been provided in the case of oil and gas wells. We said at that time in part as follows:

The Tax Code originally recognized the importance of natural resource discoveries by allowing for "discovery depletion". Such depletion was usually based upon the fair market value of the discovered deposit as determined within 30 days after discovery.

Percentage depletion was first introduced by a 1926 amendment, limited at the time to oil and gas wells. The innovation was intended as a substitute for "discovery depletion", which was causing legal and practical problems of administration.

The Executive Branch tried for several decades (1933 to 1941) to eliminate or reduce percentage depletion but the legislative response, at least until recent years, was steadily to the opposite . . .

Geothermal energy can and must provide a significant contribution toward meeting the Nation's energy requirements during the present decade and beyond. The research and development program which is getting under way through ERDA will aid in the longer run. But an immediate need exists to provide Federal support for the development of geothermal resources based upon known technology or technology that will become available to private industry within a reasonable period of time . . .

If, as part of H.R. 2166, the depletion allowance for oil and gas is to be eliminated or curtailed, and if at the same time a clear and comprehensive provision is not made for a depletion allowance for geothermal deposits which are depleting in nature, then the result would be the discriminatory treatment of geothermal energy production, inasmuch as percentage depletion would be continued in effect for other competing forms of energy such as coal, oil shale and uranium. Such discrimination would be unfair and would be incompatible with the stated policy of the Congress to aid and assist private industry to develop geothermal energy . . .

Shortly after the time our statement was presented to the Committee, the Senate by Floor action amended H.R. 2166 so as to place in effect a discovery allowance and to provide a deduction for intangible drilling and development costs in the case of all forms of geothermal resources. However, the Conference Committee unfortunately struck out the Senate's language and substituted a provision that merely maintained the status quo with respect to the "steam" form of geothermal energy. The result, in our judgment, has been an even greater degree of discrimination than that predicted in our March 21, 1975 amendment. Such greater degree of discrimination derives from the fact that percentage depletion has been continued in effect for oil and gas wells under certain kinds of circumstances, and the deduction for intangible drilling and development costs has been continued fully in effect for oil and gas, whereas the "hot water" and "hot brines" forms of geothermal energy have thus far been given no equivalent treatment in the Tax Code. In addition, congressional action was interpreted by the Internal Revenue Service as an invitation to attack even the "steam" form of geothermal energy in that the IRS non-acquiesced in the Reich case in which the circuit court held that "steam" was gas

entitled to the same depletion allowance and intangible well cost write offs.

Then on July 9, 1975, we submitted a statement for inclusion in the record of the Committee's hearings on H.R. 6860, the Energy Conservation and Conversion Act which had been passed by the House of Representatives. We recommended at that time that the Senate Committee amend the bill so as to include all of the provisions of H.R. 6238, a bill which had been introduced in the House on April 22, 1975 by Congressman John J. McFall. The McFall bill would provide a depletion allowance and a deduction for intangible drilling and development costs in the case of geothermal resources, broadly defined.

Our statement at that time provided further justification for the tax treatment envisioned in Congressman McFall's bill reference to a letter dated June 13, 1975, addressed to us by the Acting Administrator of the Federal Energy Administration, which reads in part as follows:

We have determined that income derived from geothermal development should be accorded the same tax treatment as income derived from oil and gas exploration and development. Accordingly we feel that the percentage depletion allowance should apply to the same extent it applies to oil and gas exploration and development.

By the same token, we have taken the position that intangible drilling and development costs for geothermal resource exploration and development should obtain the same treatment accorded such costs in the case of oil and gas drilling development. We have made our views known in this area both within and without the Administration. We hope that legislation will soon be passed putting the tax treatment of geothermal resource development on a par with the tax treatment of oil and gas drilling and development. . . .

We also asked the Committee at that time to note that the Geothermal Energy Research, Development, and Demonstration Act of 1974 (Public Law 93-410) has set up a goal of producing electricity from only 6 to 10 pilot plants by the year 1980, each having a capacity of from 1 to 10 megawatts. The remainder of the capacity needed to meet the Government's geothermal energy goals must be provided by private industry outside of the Government's R. & D. program. It is our view that legislation to give fair and appropriate tax treatment to geothermal resources is a prerequisite if the Government's geothermal energy production goals are to be met within the designated time limits.

Subsequently, Senator Fannin has introduced his geothermal tax bill, S. 2608. As the Committee knows, that bill would provide for a deduction for the exhaustion of geothermal steam and other forms of geothermal resources, as defined. The bill also would provide a deduction in the case of intangible drilling and development costs incurred in connection with geothermal wells, thus extending the present deduction applicable to "steam" to certain other forms of geothermal deposits.

We strongly concur with Senator Fannin that now is the time to accord geothermal resources a separate and independent treatment in

the Tax Code and to remove the source of confusion and discrimination embodied in the present unsatisfactory treatment.

As I have earlier advised the Committee in my letter addressed to the Chairman on January 19, 1976, we recommend that the Committee amend the pending tax reform legislation (H.R. 10612) so as to incorporate therein the substance of Senator Fannin's bill, H.R. 6238.

Secondly, in regard to the provisions of Section 208 of the pending bill, H.R. 10612, I wish to repeat in this form several statements contained in my letter to the Chairman dated January 19, 1976.

As I stated in that letter, Section 208 would add the following new sentences to Section 263(c) of the Internal Revenue Code, which concerns the deduction for intangible drilling and development costs in the case of oil and gas wells:

The deductions described in this subsection with respect to any property shall not be allowed until the taxpayer is at risk with respect to such property, and then only to the extent of such risk. Under regulations prescribed by the Secretary, any amount not allowable for any taxable year by reason of the preceding sentence shall be allowable for the first taxable year for which (after taking into account deductions arising in such subsequent taxable year the allowance of such amount was not prevented by the operation of the preceding sentence.

We believe that, under the principles of the case of *Reich* v. *Commission of Internal Revenue*, 454 F.2d 1157, 9th Cir., 1972, these proposed sentences in Section 208 would apply not only to oil and gas wells, in the usual sense of those terms, but also to geothermal wells which relate to "steam" resources.

The House Committee's report (No. 94-658) at pages 111-115 describes Section 208 as having been directed toward situations in which oil and gas developers have obtained part of their financing from non-recourse loans. The purpose of the section, according to the House report, is to prevent the borrowers of such loans from deducting from their current incomes any more of the overall intangible drilling and development costs of such projects than is attributable to the borrower's proportionate share of the contributed assets, defined in the section as the extent to which the borrower-taxpayer is "at risk". The report goes on to say that the borrower-taxpayer is not to be considered "at risk" with respect to his share of any non-recourse liability.

We know of no instances in which such a kind of non-recourse loan has heretofore been obtained in connection with geothermal resources. We have no plans in our company to obtain any such kind of loan from private sources, nor do we have any plans to engage in any kind of drilling for oil or natural gas resources. However, we definitely plan on applying to a lender or lenders for loans which would be guaranteed by the United States under provisions of the Geothermal Energy Exploration, Research, and Development Act of 1974 (Public Law 93-410). And we have reason to believe that Section 208 of the pending bill (H.R. 10612), if enacted into law without suitable amendment, would apply to drilling and development costs associated with projects financed in part under such Government-guaranteed geothermal loans. Any such applicability of the proposed legislation, as under

the House bill, would be detrimental to the Government's program of financial assistance which was contemplated by the Congress in the 1974 Act.

Such applicability, which we are convinced should be prevented by action of the Senate Committee, would seem to derive from certain provisions in the 1974 Act. Specifically, that Act provides that borrower's liability under a Government guaranteed loan shall be limited to the extent of his own assets which are connected with the particular project. It is plain from the Act, as well as the implementing regulations which have been proposed to be issued by ERDA (Federal Register, Vol. 40, No. 208, October 26, 1975, at page 50106), that the geothermal borrower would not be liable above and beyond the extent of his own contribution of assets, in case of loan default. Thus the borrower-taxpayer, in the case of a Government guaranteed loan, could not deduct his intangible drilling and development costs in the same manner as other geothermal developers could do, but would be limited in such deductions as to the extent of his own share of the "risk" in the project, assuming Section 208 is enacted as passed by the House.

Obviously this result would impinge upon and hinder the progress of the Government's guaranteed loan program in the case of geothermal wells, and might well render the program ineffective. In the case of our own company, we very likely would discontinue our interest in seeking a Government guaranteed loan under the 1974 Act in case the House-passed version of Section 208 should be retained. Unless a conventional loan should become available, under which we could retain our ability to deduct our intangible drilling and development costs, we very likely would have to abandon or postpone our proposed geothermal exploration and development program to such extent.

We suspect that this undesirable geothermal energy implication of Section 208 has come about, not from any conscious purpose on the part of the House Committee, but rather from failure of those who were concerned with drafting the Section to recognize that the term "gas" as used in the Section undoubtedly also extends to "steam" at the present time under the *Reich* case, and probably would extend to additional kinds of geothermal resources in the event S. 2608 or similar legislation is passed.

As I concluded in my January 19, 1976 letter, if Section 208 of H.R. 10612 is to be enacted into law, the Committee on Finance by all means should amend it so as to exempt from its provisions any applicability to Government guaranteed loans in connection with geothermal energy.

In conclusion, Mr. Chairman, I want to express my personal appreciation for this opportunity to express our views; also to thank you for your own individual consideration of our previous expressions to the Committee and specifically your assurances, echoed by other Committee members as well, that the Committee on Finance will want to give prompt and favorable consideration to Tax Code provisions that will encourage the production and use of geothermal energy.

As Congressman McFall has so well stated, the development of geothermal energy is not, as some assume, held back by technology or lack of adequate natural geothermal deposits. It is hindered particularly by inappropriate Tax Code provisions; and only if proper in-

centives are provided will the geothermal industry be able adequately to develop so as to contribute significantly to America's energy requirements.

HOMERITE CO., INC.,
Milford, Conn., April 8, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Senator ABRAHAM RIBICOFF,
Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR: I would like you to make sure this bill would include in the material list, Rapco-Foam insulation. This is made up of Urea-Formaldehyde or U-F Foam. It is a proven product and now specified by the Navy Department for use in the government property at Groton. This property consists of about 1,400 government homes and the product has passed the most rigid standards.

The way the bill reads now it would exclude all but ASTM designation, which designation would take 4 or 5 years. Meanwhile our insulation has passed many rigid State and local codes such as New York, Chicago and Los Angeles to name a few. My concern is as a Connecticut resident and an installation contractor for this product, I am one of many contractors throughout the United States and Canada who have installed this material in over 50,000 homes. The product is fire resistant, offers higher thermal and acoustical efficiency and has special and unique characteristics that make it particularly desirable for insulating existing homes.

It would seem, the larger manufacturers of insulating products such as Owens-Corning would love to see this bill go through as-is to eliminate competition. This foam insulation is now in use in such places as Mt. Sinai Hospital, Rockefeller Plaza, Lincoln Center, R.C.A. Sound Studios and the Water Tower Building in Chicago which is the largest poured concrete building in the world—all of this with success I might add.

Any consideration you might give us and the product would be a boon to the consumer and gratefully appreciated by the writer.

Sincerely,

PAUL C. RYAN,
President.

HOFE'S INSULATION,
Martinsburg, W. Va., April 10, 1976.

Re Energy Conservation and Conversion Act, H.R. 6860.

Mr. MICHAEL STERN, *Staff Director,*
Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. STERN: As a small businessman in the home insulating business I am concerned about the passage of the proposed H.R. 6860. The home insulation tax credit proposal is the part that concerns my customer's interest and mine.

The insulation materials that might be approved for a tax credit in H.R. 6860 should *not* be restricted to the materials specified in the national bureau of standards: "recommended criteria for retrofit

materials and products eligible for tax credit:" NBSIR 75-795, prepared for the Federal Energy Administration, Washington, D.C. 20461.

If you restrict insulation materials for tax credit only to those in the NBS recommended criteria, it would rule out other good or even better products and also new innovative products that might be introduced at any time.

I strongly urge that the energy conservation bill H.R. 6860 permit a tax credit to be given to any commonly used home insulation material that: (1) meets local building code requirements; (2) meets national building code requirements; and (3) has clearly proven itself in actual use.

Sincerely,

JOSEPH R. HOFE.

STATEMENT OF DR. CAREL OTTE, UNION OIL CO. OF CALIFORNIA

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: My name is Carel Otte. I have been actively engaged in geothermal work since 1962 and have personally participated in both research and operating activities in most of the major geothermal areas of the country. I have also been active in scientific and geothermal industry association affairs. I am Vice President and Manager of the Geothermal Division of Union Oil Company of California and recently served as Chairman of the Geothermal Industry Liaison Group of the Federal Interagency Panel for Geothermal Energy Research.

On July 18, 1975, I submitted a statement to the Committee in which I pointed out the potential significance that geothermal energy has to our country's energy resource needs and the problems which must be resolved in order to stimulate an accelerated and increased level of geothermal energy production. A copy of that statement is attached hereto. I would like to amplify that statement briefly.

If geothermal energy is to make the substantial contribution to domestic U.S. energy which it is capable of making within the last quarter of this century it is imperative that encouraging tax legislation be enacted and that appropriate tax incentives be established. There are other barriers which must be overcome, but I wish to address myself herein to the question of the economics impact of tax considerations and incentives. Without such incentives, the tremendous amounts of capital required for the realizable contribution of geothermal energy production will simply not be invested.

At the present time geothermal development is being held back because of the uncertainty which has resulted from the Treasury Department's and the Internal Revenue Service's decision to disallow intangible drilling cost expensing treatment and percentage depletion in respect of all geothermal activity. This disallowance policy continues in spite of the decision of the United States Court of Appeals for the Ninth Circuit in the *Reich* and companion cases allowing such treatment. (*Reich et al.* v. *Commissioner*, 454 Fed. 2d 1157 (9th Circuit 1972); affirming 52 T.C. 700 (1969).) This continued attack on percentage depletion and the right to deduct as expenses all intangible drilling and development costs for geothermal energy means that many of the geothermal resource projects required to achieve the 1985

and later goals will not be undertaken because the prospect of losing such tax allowances makes geothermal production noncompetitive with coal and other alternative sources of energy with which geothermal energy must compete and which currently have the benefit of more favorable tax treatment.

The language included in the Tax Reduction Act of 1975 (Public Law 94–12) does not and will not provide a satisfactory solution. The Tax Reduction Act of 1975 provides merely that percentage depletion is to be continued at the rate of 22 percent for any geothermal deposit, but only if such deposit is ultimately determined by the courts to be covered by the term "gas well" within the meaning of that term as used in Section 613(b). The legislative history at that time indicated that Report on this subject (93rd Congress, 2nd Session, House of Representatives Report No. 93–1502, p. 54), after referring to the issues peculiar to geothermal steam should be considered at a later time. Such "later time" is now clearly at hand. The litigation will probably continue for many years before these issues can be finally resolved by the courts. And there is no certainty that its outcome will be favorable to the geothermal industry. Moreover, if water instead of steam (vapor) dominated geothermal systems become the prevalent type of geothermal production, a further round of protracted litigation and consequent delays in establishing certainty of tax treatment will be encountered.

Because of this uncertainty and of the need of this infant high-cost industry for assured tax incentives, specific legislation is required. A bill, S. 2608, has been introduced and is before your Committee with the objective of accomplishing these stated objectives. I strongly urge favorable consideration and adoption of S. 2608. In the face of the industry's uncertain tax treatment, geothermal resource development is being critically curtailed and valuable time in the frame of our schedule to achieve a greater degree of domestic energy independence continues to be irretrievably lost.

JULY 18, 1975, STATEMENT OF CAREL OTTE, VICE PRESIDENT, GEOTHERMAL DIVISION, UNION OIL CO. OF CALIFORNIA

Mr. Chairman and Members of the Committee: The prompt development of geothermal energy can be of major importance in meeting the future energy needs of the nation. It is urged, therefore, that in its consideration of H.R. 6860, the Energy Conservation and Conversion Act of 1975, the Committee consider appropriate legislation designed to assist and promote the development of geothermal energy.

BRIEF HISTORY OF GEOTHERMAL ENERGY DEVELOPMENT

The only major U.S. geothermal energy development is The Geysers field located about 90 miles north of San Francisco in California's Sonoma County. The development began in 1960 with a 12.5 megawatt generating plant. In 1973, it became the largest geothermal development in the world, with a capacity of 400 megawatts. The installed generating capacity now exceeds 500 megawatts, sufficient to supply electrical requirements of a city of 500,000. The Geysers eventually is

expected to achieve a capacity of more than 1,500 megawatts, but it will have required more than 20 years to achieve it.

Other areas which have promise for early development in the near future—given the needed incentives—are in north central New Mexico and the Imperial Valley of California, and active exploration is also being carried on in other parts of California and New Mexico and in Nevada, Oregon, Idaho, Utah, and Arizona. The geopressured areas of Louisiana and Texas hold promise for the long range future.

Everything accomplished in the geothermal energy field up to the present time has been financed by private companies. There have been no grants or encouragement from the Federal government; however, although The Geysers itself is of commercial significance, the industry is still clearly in its infancy.

PRACTICAL UTILIZATION AND POTENTIAL ROLE IN NATIONAL ENERGY PICTURE

Geothermal energy undoubtedly has the potential for a fairly wide range of use in coming decades, and even today in some nations it is utilized for space heating and industrial process heat, such as in the New Zealand paper industry. However, the immediate and near-term practical use in the United States is and will almost certainly continue to be primarily for electrical power generation. A pound of steam from the earth is indistinguishable from a pound of steam from a fossil-fuel-charged boiler and has been proven to be as effective in powering conventional electrical generating equipment.

The outlook for geothermal energy production has been studied extensively in recent months by the Federal Interagency Panel for Geothermal Energy Research, the Energy Research and Development Administration and its industry liaison group. The consensus emerging from this review of all factors is that there is the geological opportunity for up to 20,000 megawatts of electrical generating capacity by 1985. Indeed, the Project Independence report has set this 20,000 megawatts as a 1985 goal for the Nation. Such capacity—equal to 5 percent of current national electrical capacity—represents the equivalent of almost 300 million barrels per year of low sulfur crude oil. And this amount of energy could be developed in an acceptable environmental manner.

But there are tremendous economic barriers which this industry must overcome: the tremendously high costs of drilling for geothermal deposits in hard rocks, with high temperatures and corrosive fluids; the very large capital investments required several years before revenues can begin for a geothermal project; the requirement for drilling many replacement wells at each development site to maintain a constant stream of energy; and the present discouraging Federal income tax treatment.

The projected investment for achieving the 1985 goal includes the costs of drilling at least 800 exploratory wells and 6,000 development wells at a minimum cost of $500,000 per well, or a total of $3.4 billion in 1975 dollars in drilling costs alone. Depreciable investment in hook-up facilities will add another $2 billion. Moreover, some 2,000 replacement wells will be required, with the attendant depreciable

investment, bringing the total investment requirement to about $10 billion.

TAX CONSIDERATIONS

It is extremely unlikely that the 1985 goal of 20,000 megawatts of geothermally-generated electric power will be achieved unless encouraging tax legislation is enacted and tax incentives thereby clearly established.

At the present time the Federal income tax treatment of geothermal well costs and production is in doubt. In spite of the decision of the Circuit Court of Appeals in the *Reich* and companion cases (*Reich et al.* v. *Commissioner*, 454, F. 2d 1157 (9 Vir. 1972), affirming 52 T.C. 700 (1969)) and the clear scientific evidence that geothermal energy is an exhaustible natural resource, the national office of the Internal Revenue Service is disallowing intangible drilling cost treatment and percentage depletion in respect of all geothermal activity and has announced its intention to press its position in the courts.

Discouraging uncertainty has resulted from this IRS position, and geothermal development is consequently being held back. Loss of the right to expense intangible drilling costs would itself involve an estimated $2.5 billion in after-tax costs to the industry in achieving the 1985 goals.

As a fledging industry, geothermal energy must compete with the lowest cost alternative energy available to electrical power utilities. In the west, where geothermal resources are most prevalent, the alternative is low-cost, strip-mined coal. Loss of percentage depletion and the right to deduct intangible drilling and development costs for geothermal energy would mean that many of the geothermal resources needed to achieve the 1985 and later goals would be noncompetitive with coal and other alternative sources of energy which have the benefit of more favorable tax treatment. As a result, the nation's geothermal resources would remain largely undeveloped.

The language included in the Tax Reduction Act of 1975, as enacted, will not provide a satisfactory solution because of expressed Congressional intention, as evidenced, in the report of the House Ways and Means Committee on this subject (93rd Congress, 2nd Session, House of Representatives Report No. 93–1502, p. 54). The Ways and Means Committee, after referring to the probability of future litigation of the tax issues, indicated that no inference was to be drawn from the language of the Act that the depletion deduction for geothermal steam under present law had been approved by the Committee or by Congress, and further stated that the issues peculiar to geothermal steam should be considered at a later time.

Thus, because of the present position of the Internal Revenue Service and the need of this infant high-cost industry for assured tax incentives, specific legislation is now required. It is proposed that the Congress adopt an amendment to the Internal Revenue Code to provide percentage depletion and to provide for the current deduction of intangible drilling and development costs for geothermal energy. It is further proposed that such amendment include the option to expense geothermal exploration costs, similar to such treatment now applicable to mining exploration costs.

A copy of proposed draft legislation to accomplish these objectives is attached.

Enclosure.

A BILL To amend the Internal Revenue Code of 1954 with respect to the taxation of income from the production and sale of geothermal steam and associated geothermal resources

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Subsection (c) of section 263 of the Internal Revenue Code of 1954 (relating to intangible drilling and development costs in the case of oil and gas wells) is amended to read as follows:

"(c) Intangible drilling and development costs in the case of oil and gas wells, or geothermal deposits—Notwithstanding subsection (a), regulations shall be prescribed by the Secretary or his delegate under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress. [.]*; and such regulations shall be extended so as to apply in the case of wells drilled for geothermal steam and associated geothermal resources as defined in the Geothermal Steam Act of 1970 (30 U.S.C. 1001).*"

Section 2. Subparagraph (C) of section 613 A(b)(1) of the Internal Revenue Code of 1954 (relating to exemption for certain domestic gas wells) is amended to read as follows:

"(C) any geothermal deposit in the United States or in a possession of the United States which is determined to be [a gas well within the meaning of section 613(b)(1)A.] *producing geothermal steam and associated geothermal resources as defined in the Geothermal Steam Act of 1970 (30 U.S.C. 1001).*"

Section 3. Section 617(a)(1) of the Internal Revenue Code of 1954 (relating to deduction and recapture of certain mining exploration expenditures) is amended by adding at the end thereof the following new sentence: "*Notwithstanding any other provision of this section, this subsection shall apply with respect to expenditures paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any deposit of geothermal steam and associated geothermal resources as defined in the Geothermal Steam Act of 1970 (30 U.S.C. 1001).*"

Section 4. The amendments made by the first three sections of this Act shall apply to taxable years beginning after December 31, 1974.

GROUP FOR RECYCLING IN PENNSYLVANIA,
Pittsburgh, Pa., March 24, 1976.

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

DEAR SENATOR LONG: Word has reached our office that H.R. 6860 is to be marked up.

GRIP is a citizen group which operates 16 volunteer recycling centers in the Greater Pittsburgh Area. We use these centers as the

visible focus toward our true purpose, namely, bringing about the conserving of raw materials and energy by wise use and reuse to meet growing demands, as opposed to simply uncovering new and ever more remote sources for these materials. To put it another way: We welcome any move that would justify shutting our volunteer centers down, other than being licked.

At first glance, H.R. 6860 would seem to be a significant step in the direction of removing the great stumbling block to large scale, manufacturing level recycling, which is the fact that salvage industries cannot ever grow until their competitiveness with industries using virgin materials is equalized. Extractive industries enjoy depletion allowances, manufacturing industries enjoy investment tax credits and both types enjoy advantages in freight rates. Salvage industries enjoy none of these subsidies and are therefore doomed to stagnate, prevented from growth and at the mercy of a wildly fluctuating market. (To operate a salvage business, one must have the soul of a gambler.)

Nevertheless, questions arise in our minds:

Why does the bill provide for a TEN percent tax credit on the purchase of a ton of post consumer waste paper? Why not 9 percent or 11 percent? The fact that this provision parallels the 10 percent of the investment tax credit seems to make no sense. Are the two models equivalent to each other? Why?

It seems to us, the bill should be considered only if its proposals are backed up by a study which justifies the number 10 percent as one promising an incisive, significant impact on the recycling business.

A peripheral point in this connection: All waste paper of all kinds are lumped into the same 10 percent tax credit. There are great differences in supply, usefulness, ease of collection, ease of repulping among the many types of papers which will be affected. To provide for all of them by one blanket 10 percent credit will probably not mirror reality. Is 10 percent credit the same incentive for recycling bond and ledger paper as it might be for the lower grade but more abundant newspaper and cardboard? Again, the bill ought to be backed up by a study.

We have other reservations:

1. If conservation of materials and energy is to be the serious goal of this bill, one ought to discontinue the subsidy of virgin material use. The subsidies were instituted to help a young country develop an untouched continent. The conditions which justified the original subsidies no longer prevail. Will a 10 percent tax credit to salvagers provide that similar encouragement, originally intended for virgin materials industries?

Recycling has declined recently. If it is to increase, some capital investment will certainly be necessary. Paper mills will have to add de-inking facilities, coupled to pollution control equipment. Some plants will actually have to be built near urban centers, not away from them where they are presently located. We very much doubt that the 10 percent tax credit will have the desired effect.

The provisions of H.R. 6860 look to us more like a polite nod toward the public who very much support recycling. At the same time, the public gets burdened with a new tax, not to mention a Tax Code that gets still more complicated.

2. A tax credit to used paper purchasers would accomplish nothing toward reversing the throw-away habits foisted on the public in the last 15 to 20 years. On the contrary, overuse of materials and the solid waste stream might even grow, further increasing consumption of energy.

3. Passage of H.R. 6860 might give the *illusion* of action intended to remedy a fundamental misalignment in American industry but will most probably not accomplish any. Worse yet, the illusion of action may very well preempt any measures attempted later which would be a real reform.

On balance, we think 6860 had better await a study to accompany it—at the very least. We would prefer to see the bill defeated, however much as it hurts us to have to say this, and await a bill which promises a more significant change for the wiser use of our depleting raw materials and energy.

We sincerely hope you will regard our criticism of this bill as the impetus toward writing another, better bill.

Thank you very much for letting us share our thoughts with you.

Sincerely yours,

LORE S. KEFFER, *President.*

NATIONAL TIRE DEALERS & RETREADERS ASSOCIATION, INC.,
Washington, D.C., March 23, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: As you know, the Senate Finance Committee has previously approved in an amendment to H.R. 6860 a provision which would eliminate the 5 cents per pound excise tax on tread rubber. Tread rubber is the raw material used in retreading recyclable tire casings.

We wish to reiterate our strong support for this action because we believe that this will result in a stimulus for retreading and oil conservation.

For every passenger retread sold, 4½ gallons of oil are saved when compared to the production of a new tire. For every truck retread sold, 21 gallons of oil are saved as compared to the production of a new truck tire.

Our study of productive capacity of the retreading industry shows that the industry has a capacity within a 15-18 month period to provide one million more truck retreads and 25 million more passenger retreads. This could be done by increasing the number of shifts to 3 per day. This would provide 22,000 more jobs and the oil savings would be about 133 million gallons of oil per year.

Not only would there be oil conservation, but the greatest economic benefit would come to those who have the least to spend on tires. Retreads cost approximately half the price of an equivalent new tire.

Today passenger retreads are warranted by most retreaders against defects and workmanship in materials as well as road hazards. All passenger retreads are certified to meet Federal Retread Standard 117 whose contents include requirements in casing selection and strength.

Today there are some 45 million passenger and truck retreads on the road.

The elimination of the excise tax on tread rubber would have no effect on the General Fund. It would simply reduce the Highway Trust Fund by only $24 million per year.

We believe the elimination of the 5 cents per pound excise tax on tread rubber would provide a strong stimulus to retread sales and to oil conservation.

We hope that you will support this effort to eliminate this tax either through the energy legislation or in the tax reform legislation now under consideration by the Senate Finance Committee.

Sincerely,

PHILIP P. FRIEDLANDER, Jr.,
General Manager.