MISCELLANEOUS TAX BILLS IV

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 246, S. 541, S. 555, S. 999, S. 1488, S. 1542, S. 1543, S. 1628, S. 1703, and S. 1846

OCTOBER 31, 1979

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MISCELLANEOUS TAX BILLS IV

WEDNESDAY, OCTOBER 31, 1979

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT GENERALLY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:28 p.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd (chairman of the subcommittee) presiding.

Present: Senators Byrd, Nelson, Talmadge, Bentsen, Dole and Chafee.

[The press release announcing this hearing and the bills S. 246, S. 541, S. 555, S. 999, S. 1488, S. 1542, S. 1543, S. 1628, S. 1703, S. 1846 follow:]

[Press Release Oct. 17, 1979]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr. (I., Va.) Chairman of the Subcommittee on Taxation and Debt Management announced today that a hearing will be held on Wednesday, October 31, 1979, on miscellaneous tax bills.

The hearing will begin at 2:30 p.m. in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation will be considered:

S. 246, sponsored by Senator Bentsen. The bill would permit taxpayers to exclude from gross income up to $500 ($1,000 in the case of a joint return) of interest income earned from a savings account.

S. 1488, sponsored by Senator Nelson. This bill would provide an exclusion from gross income for interest earned from a savings account but only for that amount of interest that exceeds the amount earned the previous year. Up to $500 ($1,000 in the case of a joint return) is the maximum amount excludible.

S. 1846, sponsored by Senator Talmadge. This bill would raise the dividend exclusion contained in present law from $100 to $250 and permits the exclusion to apply to interest from savings accounts.

S. 1628, sponsored by Senator Roth. The bill would provide an election for a business to treat start up expenses as deferred expenses to be amortized over a 60-month period. Revenue estimates are not available at this time. The measure would benefit taxpayers beginning a new business.

S. 1703, sponsored by Senators Chafee, Cochran, Matsunaga, Moynihan, Jepsen, Ribicoff, Boren and Long. This bill would amend section 911 of the Internal Revenue Code to permit American employees of charitable organizations the option of using the $20,000 income tax exclusion now available only to corporate employees working in remote camps. Revenue estimates on this measure are not available at this time. The measure will benefit employees of charitable organizations who are working abroad.

S. 541, sponsored by Senators Baker and Sasser. This bill would permit executors of an estate to elect the alternate valuation date (6 months after decedent's death) for estate assets even though the estate tax return is filed after the due date. This measure would have negligible revenue effect. Although only one estate has been identified as benefiting from this measure, the amendment would benefit any estate

that wanted to elect the alternate valuation date but was not permitted to do so because the estate tax return had already been file.

S. 999, sponsored by Senators Bentsen and Cochran. This bill would exempt taxpayers who make late payments of tax from penalties, provided the failure to make payment was due to reasonable cause and not willful neglect. It is estimated that this measure will reduce revenues by $14 million in fiscal year 1980 and by $25 million thereafter. This measure would benefit any taxpayer making a late payment of tax due to reasonable cause.

S. 555, sponsored by Senators Morgan, Baker, Sasser, Percy, Inouye, Schmitt, Mathias, Riegle, McGovern, Ford, Cohen, Pell, Helms, Pressler, Durkin, Cochran, Levin and Stewart. The bill would permit the owners of independent local nwspapers to make tax deductible contributions to trusts established for the eventual payment of estate tax. It is estimated that this measure would reduce revenues by $10 million per year. The measure would benefit owners of independent local newspapers.

S. 1543, sponsored by Senators Nelson and Bentsen. This bill would defer current Federal income tax on dividends reinvested in original issue stock of a company. This bill would primarily benefit any stockholder receiving dividends from a company.

Requests to testify.—Persons desiring to testify during this hearing must make their requests to testify to Michael Stern, Staff Director, Committee on Finance, Room 227, Dirksen Senate Office Building, Washington, D.C. 20510, *not later than the close of business on Wednesday, October 24, 1979.*

Witnesses will be notified as soon as possible after this date as to when they are scheduled to appear. If for some reason the witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance.

Consolidated.—The Subcommittee strongly urges all witnesses who have a common position or the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain Further, all witnesses should exert a maximum effort to coordinate their statements.

Legislative Reorganization Act.—The Legislative Reorganization Act of 1946 requires all witnesses appearing before the Committees of Congress to "file in advance written statements of their proposed testimony and to limit their oral presentations to brief summaries of their argument." In light of this statute, the number of witnesses who desire to appear before the Subcommittee, and the limited time available for the hearing, all witnesses who are scheduled to testify must comply with the following rules.

1. All witnesses must include with their written statements *a summary of the principal points included in the statement.*
2. The written statements must be typed on lettersize paper (not legal size) and at least *100 copies* must be delivered to Room 2227 Dirksen Senate Office Building not later than 5:00 p.m. on the day before the witness is scheduled to appear.
3. *Witnesses are not to read their written statements to the Subcommittee,* but are to confine their oral presentations to a summary of the points included in the statement.
4. *No more than 5 minutes will be allowed for any oral summary.*

Witnesses who fail to comply with these rules will forfeit their privilege to testify.

Written statements.—Persons not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Senate Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, *not later than Friday, November 23, 1979.*

96TH CONGRESS
1ST SESSION

S. 246

To amend the Internal Revenue Code of 1954 to encourage greater individual savings.

IN THE SENATE OF THE UNITED STATES

JANUARY 29 (legislative day, JANUARY 15), 1979

Mr. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to encourage greater individual savings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by redesignating section 124 as 125, and by inserting after section 123 the following new section:

"SEC. 124. INTEREST.

"(a) IN GENERAL.—In the case of an individual, gross income does not include any amount received as interest or dividends on a time or demand deposit with—

"(1) a commercial or mutual savings bank the deposits and accounts of which are insured by the Federal Deposit Insurance Corporation or which are otherwise insured in accordance with the requirements of the law of the State in which the bank is located,

"(2) a savings and loan association, building and loan association, or similar association, the deposits and accounts of which are insured by the Federal Savings and Loan Insurance Corporation or which are otherwise insured in accordance with the requirements of the law of the State in which the association is located, or

"(3) a credit union, the deposits and accounts of which are insured by the National Credit Union Administration Share Insurance Fund or which are otherwise insured in accordance with the requirements of the law of the State in which the credit union is located.

"(b) LIMITATION.—The amount of interest excluded under subsection (a) for the taxable year shall not exceed $500 ($1,000 in the case of a husband and wife who make a joint return under section 6013).".

SEC. 2. The table of sections for part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by striking out the last item and inserting in lieu thereof the following items:

"SEC. 124. Interest.
"SEC. 125. Cross references to other Acts.".

SEC. 3. The amendments made by this Act apply to taxable years beginning after December 31, 1978.

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96TH CONGRESS
1ST SESSION

S. 541

To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return that is filed late.

IN THE SENATE OF THE UNITED STATES

MARCH 5 (legislative day, FEBRUARY 22), 1979

Mr. BAKER (for himself and Mr. SASSER) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return that is filed late.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 2032(c) of the Internal Revenue Code of 1954 (relating to election of alternate valuation) is amended to read as follows:

"(c) TIME OF ELECTION.—The election provided for in this section shall be exercised by the executor on his return not later than the time such return is filed.".

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) of this Act shall apply with respect to estates of decedents dying after December 31, 1977.

(2) TRANSITIONAL RULE.—At the election of an executor (made within 90 days after the enactment of this Act in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe), the amendment made by subsection (a) of this Act shall apply with respect to an estate of a decedent dying before January 1, 1978, if an election under section 2032(c) of the Internal Revenue Code of 1954 (relating to election of alternate valuation) had been indicated on the first estate tax return filed with respect to the estate of the decedent. If an election is made under this paragraph and if the assessment of any deficiency for estate tax is prevented on the date of such election, or at any time within 90 days after such election, by the operation of any law, or rule of law, such assessment may, nevertheless, be made within 90 days after such election.

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96TH CONGRESS
1ST SESSION

S. 555

To amend the tax laws of the United States to encourage the preservation of independent local newspapers.

IN THE SENATE OF THE UNITED STATES

MARCH 7 (legislative day, FEBRUARY 22), 1979

Mr. MORGAN (for himself, Mr. BAKER, Mr. SASSER, Mr. PERCY, Mr. INOUYE, Mr. SCHMITT, Mr. MATHIAS, Mr. RIEGLE, Mr. MCGOVERN, Mr. FORD, Mr. COHEN, Mr. PELL, Mr. HELMS, Mr. PRESSLER, Mr. DURKIN, Mr. COCHRAN, Mr. LEVIN, and Mr. STEWART) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the tax laws of the United States to encourage the preservation of independent local newspapers.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE: ETC.

(a) SHORT TITLE.—This Act may be cited as the "Independent Local Newspaper Act of 1979".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or

repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) TABLE OF CONTENTS.—

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SEC. 2. CERTAIN ADVANCE ESTATE TAX PAYMENT TRUSTS.

(a) IN GENERAL.—Subchapter F of chapter 1 (relating to exempt organizations) is amended by adding at the end thereof the following new part:

"PART VIII—CERTAIN ADVANCE ESTATE TAX PAYMENT TRUSTS

"SEC. 529. INDEPENDENT LOCAL NEWSPAPER ADVANCE ESTATE TAX PAYMENT TRUST.

"(a) REQUIREMENTS FOR QUALIFICATION.—A trust created or organized in the United States for an individual

who has an interest in an independent local newspaper business shall constitute a trust qualified under this section if—

"(1) the trust is created pursuant to a plan adopted by such independent local newspaper business;

"(2) the plan adopted requires the creation, for one or more individuals having an interest in such independent local newspaper business, of trusts for such individuals conforming to the requirements of paragraph (3) requires contributions to be made to such trusts by such independent local newspaper business during the period described in subparagraph (3)(D) exclusively for the purpose described in subparagraph (3)(E) and limits the aggregate contributions to such trusts for any taxable year to 50 percent of the taxable income derived from the independent local newspaper (determined as provided in subsection (e)); and

"(3) the written governing instrument creating each such trust meets the following requirements:

"(A) the contributions to and income of the trust will be invested solely in obligations of the United States of America except for cash on hand or in bank accounts pending such investment;

"(B) the trustee is a bank (as defined in section 401(d)(1)) or such other person who demonstrates to the satisfaction of the Secretary that

the manner in which such other person will administer the trust will be consistent with the requirements of this section;

"(C) the assets of the trust will not be commingled with other property except in a common trust fund;

"(D) the contributions to the trust will be made exclusively by such independent local newspaper business during the lifetime of the individual for whom such trust is created, and after his death during the period (including any extension period) prior to payment of the tax imposed by section 2001;

"(E) the assets of the trust will be devoted exclusively to the prompt payment of the tax imposed by section 2001 which is attributable to the interest in such independent local newspaper business includable in the gross estate of such individual, except to the extent of any excess funding of the trust; and

"(F) any excess funding of the trust will be distributed to such individual if living or if deceased to his estate within 65 days of the determination of such excess funding.

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"(b) LIMITATION.—In the case of an individual who has an interest in more than 1 independent local newspaper business, a trust qualified under this section may be created or organized only with respect to the interest in 1 (and not more than 1) such independent local newspaper business includable in the gross estate of such individual.

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) DEFINITIONS.—For purposes of this section—

"(A) INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term "independent local newspaper business" means—

"(i) a proprietorship which publishes an independent local newspaper;

"(ii) a partnership which publishes an independent local newspaper and which has none of its outstanding partnership interests traded in an established securities market; or

"(iii) a corporation which publishes an independent local newspaper and which has none of its outstanding capital stock traded in an established securities market.

"(B) INTEREST IN AN INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term 'interest in an independent local newspaper business' means—

"(i) the interest of the proprietor in a proprietorship described in subparagraph (1)(A)(i) to the extent the value of such interest is attributable to the independent local newspaper published by such proprietorship;

"(ii) the interest of a partner in a partnership described in subparagraph (1)(A)(ii) to the extent the value of such interest is attributable to the independent local newspaper published by such partnership; or

"(iii) the stock of a corporation described in subparagraph (1)(A)(iii) to the extent the value of such stock is attributable to the independent local newspaper published by such corporation.

"(C) INDEPENDENT LOCAL NEWSPAPER.—The term 'independent local newspaper' means a newspaper publication which is not one of a chain of newspaper publications and which has all of its publishing offices (containing its principal editorial, reportorial, circulation, and business staff) in a single city, community, or metropolitan area, or, on January 1, 1979, within one State.

"(D) A CHAIN OF NEWSPAPER PUBLICATIONS.—The term 'a chain of newspaper publica-

tions' means 2 or more newspaper publications which are not published in a single city, community, or metropolitan area or, on January 1, 1979, within one State and are controlled, directly or indirectly, by the same person or persons.

"(E) EXCESS FUNDING.—The term 'excess funding' means the excess of the face value of the assets of a trust qualified under this section over:

"(i) 70 percent of the value of the interest in an independent local newspaper business includable in the gross estate of the individual for whom such trust was created; or

"(ii) in the case of a decedent, the tax imposed by section 2001 which is attributable to the interest in an independent local newspaper business included in the gross estate of such decedent.

"(F) ATTRIBUTABLE ESTATE TAX.—The term 'the tax imposed by section 2001 which is attributable to the interest in an independent local newspaper business' means the excess of the tax imposed by section 2001 over the tax which would have been imposed if the interest in an independent local newspaper business had not been included in the gross estate of the decedent.

"(2) SPECIAL RULES.—For purposes of this subsection—

"(A) TIME FOR DETERMINATIONS.—Except as otherwise provided by subsection (d) or (g)—

"(i) in the case of an individual, all determinations shall be made as of December 31 of each calendar year, and

"(ii) in the case of a decedent, all determinations shall be made as of the time the tax imposed by section 2001 is finally determined.

"(B) CONTROLLED GROUP OF CORPORATIONS.—In applying subparagraphs (1)(A)(iii), (1)(C), and (1)(D) of subsection (c), if a corporation is a member of a controlled group of corporations (as defined by section 1563 but substituting the phrase '50 percent' for the phrase '80 percent' each place appearing therein), the determination whether such corporation is publishing an independent local newspaper shall be made by treating all members of such controlled group as a single corporation.

"(C) VALUE ATTRIBUTABLE TO INDEPENDENT LOCAL NEWSPAPER.—In applying subparagraph (1)(B) (ii) or (iii) of subsection (c), the deter-

mination of the value of an interest in a partnership or the stock of a corporation which is attributable to an independent local newspaper shall, except in the case of a decedent, be made by apportioning the net fair market value of such independent local newspaper (determined as a separate going business concern) proportionately among all the outstanding interests in such partnership or proportionately among all the outstanding shares of the capital stock of such corporation, as the case may be, except that the apportionment made to a partnership interest or corporate preferred stock possessing limited equity participation rights shall not exceed such limited equity participation rights.

"(D) CERTAIN INDIRECT INTERESTS.—In applying subparagraph (1)(B) of subsection (c), if an individual is the grantor of a trust which holds an interest in an independent local newspaper business and is treated as the owner of such interest by section 671(a), or is the beneficiary of a trust which holds an interest in an independent local newspaper business and a deduction was allowed with respect to such interest by section 2056(a), such individual shall be treated as

owning the interest held by such trust to the extent such interest is includable in the gross estate of such individual.

"(d) TAX TREATMENT OF QUALIFIED TRUST AND THE INDIVIDUAL FOR WHOM ESTABLISHED.—

"(1) EXEMPTION FROM TAX UNDER THIS TITLE.—

"(A) QUALIFIED TRUST.—Any trust qualified under this section is exempt from taxation under this title except to the extent otherwise provided by paragraph (2) of this subsection (d).

"(B) INDIVIDUAL FOR WHOM ESTABLISHED.—Except to the extent otherwise provided by paragraph (2) of this subsection (d), any individual for whom there is created a trust qualified under this section, and the estate of any such individual, is exempt from taxation under this title with respect to—

"(i) such trust and the contributions made to, the gross income earned by, and the payments of the tax imposed by section 2001 made by, such trust in accordance with its governing instrument, and

"(ii) the distributions, if any, made by the independent local newspaper business to

any other person who has an interest in such independent local newspaper business on account of the contributions made to such trust.

Any other person who has an interest in such independent local newspaper business shall also be exempt from taxation under this title with respect to such trust (including the contributions to, gross income of, and payments made by such trust).

"(2) TERMINATION OF TAX EXEMPT STATUS.—

"(A) EVENTS CAUSING LOSS OF QUALIFICATION.—If a trust qualified under this section is not administered in conformity with any of the requirements specified in subsection (a) and the regulations prescribed by the Secretary to carry out the purposes of this section, then the trust shall cease to be exempt from taxation under this title and the assets of the trust shall be distributed to the individual by or for whom such trust was created if he is then living or if he is then deceased shall be distributed to his estate.

"(B) DISPOSITIONS AND OTHER EVENTS CAUSING EXCESS FUNDING.—If at any time—

"(i) any part of the interest in an independent local newspaper business is sold, ex-

changed, or otherwise disposed of (other than under the individual's will or applicable law of descent and distribution) or becomes traded in an established securities market, and such event results in the excess funding of a trust qualified under this section;

"(ii) the local independent newspaper ceases to be published or is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications; or

"(iii) there is for any other reason an excess funding of a trust qualified under this section;

then the amount of such excess funding shall be distributed to the individual for whom such trust was created if he is then living or if he is then deceased shall be distributed to his estate.

"(C) TAXATION OF DISTRIBUTED AMOUNTS.—

"(i) INDIVIDUAL.—Any amount distributed to the individual for whom such trust was created shall be included in the gross income of such individual for the taxable year of distribution.

"(ii) ESTATE.—Any amount distributed to the estate of a decedent shall be included in the gross income of the estate for the taxable year of distribution as an item of income in respect of a decedent subject to section 691, and shall be included in the decedent's gross estate in determining the tax imposed by section 2001.

"(e) TAX TREATMENT OF INDEPENDENT LOCAL NEWSPAPER BUSINESS.—

"(1) DEDUCTION FOR CONTRIBUTIONS.—Any contribution made by an independent local newspaper business to a trust qualified under this section in accordance with the terms of the governing instrument of such trust shall be deductible under section 162 provided such contribution is paid to the trust during the taxable year and at a time when the trust is exempt from taxation this title. For purposes of this paragraph, an independent local newspaper business shall be deemed to have made a payment on the last day of the taxable year if the payment is on account of such taxable year and is not made later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

"(2) LIMITATIONS ON DEDUCTION FOR CONTRIBUTIONS.—

"(A) EXCESS FUNDING.—No deduction under section 162 shall be allowed for any contribution to the extent such contribution results in the excess funding of a trust qualified under this section.

"(B) 50 PERCENT OF TAXABLE INCOME.—No deduction under section 162 shall be allowed for any contribution to the extent the aggregate contributions made during the taxable year exceeds 50 percent of the taxable income derived from such independent local newspaper (determined on a separated basis and without regard to such contributions) for the taxable year.

"(3) RECAPTURE OF DEDUCTIONS FOR PRIOR CONTRIBUTIONS.—If at any time a trust qualified under this section is required to make a distribution described in paragraph (2) of subsection (d) and if an independent local newspaper business realized a tax benefit as a result of prior contributions to such trust, then such independent local newspaper business (and in the case of a deceased proprietor his estate) shall include in its gross income for the taxable year ending with or during the taxable year of such distribution or

if none, for the taxable year immediately preceding the taxable year of such distribution an amount equal to the lesser of—

"(A) the amount required to be distributed under paragraph (2), or

"(B) the prior contributions made to such trust as to which a tax benefit was realized.

"(f) INADVERTENT EXCESS FUNDING.—If there is excess funding of a trust qualified under this section for any calendar year and such excess funding is due solely to a decrease in, or to a good faith dispute concerning, the value of the interest in an independent local newspaper business held by or includable in the gross estate of the individual for whom such trust was created, then the determination of the amount of such excess funding shall be postponed to, and shall be made as of, the last day of the fifth calendar year immediately following such calendar year (or in the event of such individual's earlier death, the date of the determination of the tax imposed by section 2001) and the amount of any excess funding existing on the last day of such fifth calendar year (or the date of such determination) shall be distributed to such individual (or if he is then deceased shall be distributed to his estate).

"(g) TAX TREATMENT OF DISPOSITIONS BY HEIR OR LEGATEE.—

"(1) RECAPTURE OF ESTATE TAX BENEFITS.—If, at any time within 15 years after the death of the individual for whom a trust qualified uner this section was created—

"(A) a trust described in subparagraph (2)(D) of subsection (c), or any person receiving under such individual's will or applicable law of descent and distribution, sells, exchanges, or otherwise disposes of any part of the interest in the independent local newspaper business with respect to which the qualified trust was created, or

"(B) the local independent newspaper is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications,

then the estate tax of such individual shall be redetermined, as of the date of such disposition or other event, by including as part of the gross estate of such individual an amount equal to the payment made by such trust of the tax imposed by section 2001 which is attributable in the case of such a disposition to the interest disposed of, or in the case of any such other event to the interest, in the independent local newspaper business included in the gross estate of such individual. For purposes of this paragraph, the term "sells,

exchanges, or otherwise disposes of" does not include—

"(C) an exchange of stock pursuant to a plan of reorganization described in subparagraph (E) or (F) of section 368(a)(1),

"(D) a distribution or exchange of stock pursuant to a plan of reorganization described in subparagraph (D) of section 368(a)(1) or a distribution to which section 355 (or so much of section 356 as relates to section 355) applies by reason of subsection (h), or

"(E) a transfer or distribution to an executor or trustee, or by an executor or trustee, or a person entitled to receive such interest, under a will, applicable laws of descent and distribution or governing trust instrument,

but the person receiving the interest in the independent local newspaper business with respect to which such qualified trust was created shall be subject to this section.

"(2) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTIONS.—Any additional estate tax owing as a result of such redetermination shall be immediately due and payable by the person making such disposition, or the persons holding the interest in the inde-

pendent local newspaper business as of the date of such other event, as the case may be, and the periods of limitations provided in sections 6501 and 6502 on the making of assessments and the collection by levy or a proceeding shall with respect to any deficiency (including interest and additions to the tax resulting from such redetermination) include 1 year immediately following the date on which the Secretary is notified of such disposition or other event in accordance with regulations prescribed by the Secretary; and such assessment and collection may be made notwithstanding any provision of law or rule of law to the contrary.

"(3) PHASEOUT OF ANY ADDITIONAL ESTATE TAX.—If the date of disposition or such other event occurs more than 120 months and less than 180 months after the death of such individual, the amount of any additional estate tax shall be reduced (but not below zero) by an amount determined by multiplying the amount of such tax (determined without regard to this paragraph) by a fraction—

"(A) the numerator of which is the number of full months after such individual's death in excess of 120, and

"(B) the denominator of which is 60.

"(h) SPIN-OFF OF UNRELATED BUSINESS.—

"(1) GENERAL REQUIREMENTS.—If an independent local newspaper business described in subparagraph (1)(A)(iii) of subsection (c) adopts a plan described in subsection (a) and is engaged in the active conduct of a trade or business in addition to the publication of an independent local newspaper, each of which satisfies the requirements of section 355(b)(2), then the distribution to its shareholders of stock of a controlled corporation (as defined in section 355(a)(1)(A)) engaged in the active conduct of such other trade or business or of such newspaper, so that the determination of the value of its stock attributable to its independent local newspaper is facilitated, shall be treated as satisfying the requirements of section 355(a)(1)(B) (including the required corporate business purpose) provided that the following conditions are satisfied:

"(A) The distributee shareholders do not, prior to the fifth anniversary of the date of distribution, sell, exchange or otherwise dispose of the stock of either the distributing corporation (as defined in section 355(a)(1)(A)) or the controlled corporation except—

"(i) pursuant to a redemption described in section 303 or a plan of reorganization described in section 368(a)(1) (D), (E), or (F),

"(ii) by will or by the laws of descent or distribution, or

"(iii) in the case of a distributee corporation or trust, by distribution to its shareholders or beneficiaries;

"(B) The distributee shareholders (including the successors-in- interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) retain control (as defined in section 368(c)) of the distributing corporation and controlled corporation throughout the 5-year period ending on the fifth anniversary of the date of distribution; and

"(C) The distributing corporation and the controlled corporation each continue to be engaged in the active conduct of the trade or business conducted on the date of distribution throughout the 5-year period ending on the fifth anniversary of the date of distribution, except for a change of trade or business resulting from an involuntary conversion, an order of a governmental regulatory agency or a contested or consent order of any Federal court provided that such trade or business is actively conducted by the distributing corporation or controlled corporation, as

the case may be, for the remainder of the 5-year period ending on the fifth anniversary of such distribution.

"(2) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTION.—If the distributing corporation or controlled corporation fails to meet the conditions contained in subparagraph (1)(C) of this subsection (h) or if the distributee shareholders (including the successor-in-interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) fail to meet the conditions contained in subparagraphs (1)(A) or (1)(B) of this subsection (h) during any taxable year within 5 years from the date of distribution, then the periods of limitations provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding shall, with respect to any deficiency (including interest and additions to the tax) resulting from such failure, include 1 year immediately following the date on which the distributing corporation, the controlled corporation or a distributee shareholder (including the successors-in-interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) notifies the Secretary of such failure in accordance with regulations prescribed by the Secre-

tary; and such assessment and collection may be made notwithstanding any provision of law or rule of law to the contrary.

"(i) APPLICABILITY.—This section shall be applicable to trusts created on or after January 1, 1979.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to the application of this section.

"(k) CROSS REFERENCES.—

"(1) BASIS.—See section 1023 concerning the carryover of the basis of an interest in an independent local newspaper business as a result of payment of estate tax by a trust qualified under this section.

"(2) ESTATE TAX.—See section 2046 relating to the exclusion from the gross estate of a decedent of a trust qualified under this section.

"(3) INCOME IN RESPECT OF DECEDENT.—See section 691 relating to the taxation of income in respect of a decedent.".

(b) CLERICAL AMENDMENT.—The table of parts for subchapter F of chapter 1 is amended by adding at the end thereof the following new item:

"Part VIII. Certain advance estate tax payment trusts.".

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) AMENDMENT OF SECTION 1023(C).—The first sentence of subparagraph (c) of section 1023 (relating to increase in carryover basis of appreciated property for estate taxes) is amended by striking out "The" and inserting in lieu thereof "Except as provided in subsection (i), the".

(2) AMENDMENT OF SECTION 1023(D)(1).—The first sentence of paragraph (1) of section 1023(d) (relating to the $60,000 minimum for the aggregate basis for carryover basis property) is amended by striking out "If" and inserting in lieu thereof "Except as provided in subsection (i), if".

(3) AMENDMENT OF SECTION 1023(H)(2).—The first sentence of paragraph (2) of section 1023(h) (relating to adjustments to basis for December 31, 1976, fair market value) is amended by striking out "If—" and inserting in lieu thereof "Except as provided in subsection (i), if—".

(4) AMENDMENT OF SECTION 1023(I).—Subsection (i) of section 1023 (relating to regulations) is amended by redesignating subsection (i) as (j), and by inserting after subsection (h) the following new subsection:

"(i) There shall be no increase under the provisions of this section in the basis of

an interest in an independent local newspaper business (as defined by section 529) to the extent that payment of the tax imposed by section 2001 attributable to such interest is paid by a trust qualified under section 529.".

(5) AMENDMENTS TO SUBTITLE B.—

(A) Section 2002 (relating to liability for payment of estate taxes) is amended by striking out "executor." and inserting in lieu thereof "executor except to the extent paid by an independent local newspaper advance estate tax payment trust as provided by section 529.".

(B) Section 2013 is amended by adding at the head thereof the following new subsection:

"(h) TAX IMPOSED UNDER SECTION 2046 ON CERTAIN INDEPENDENT LOCAL NEWSPAPER ADVANCE TAX PAYMENT TRUSTS.—For purposes of this section, if section 2046 applies to exclude any property from the gross estate of the transferor and an additional tax is imposed with respect to such property under section 259(g)—

"(1) the additional tax imposed by section 529(g) shall be treated as a Federal estate tax payable with respect to the estate of the transferor; and

"(2) the value of such property and the amount of the taxable estate of the transferor shall be determined as if section 2046 did not apply with respect to such property.".

(C) Part III of subchapter A of chapter 11 of subtitle B (relating to gross estate) is amended by adding at the end thereof the following new section:

"SEC. 2046. EXCLUSION OF NEWSPAPER TRUST.

"Notwithstanding any other provision of law, the value of the gross estate shall not include the value of any interest of the decedent at the time of his death in, or any tax payments made by, an independent local newspaper advance estate tax payment trust to the extent provided by section 529.".

(6) CLERICAL AMENDMENT TO SUBTITLE B.—The table of sections for part III of subchapter A of chapter 11 of subtitle B is amended by adding at the end thereof the following new item:

"Sec. 2046. Exclusion of newspaper trust.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after January 1, 1979.

SEC. 3. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE INCLUDES INTEREST IN INDEPENDENT LOCAL NEWSPAPER.

(a) IN GENERAL.—Subchapter B of chapter 62 (relating to extension of time for payment of estate tax) is amended by adding after section 6166A the following new section:

"SEC. 6166B. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE INCLUDES INTEREST IN INDEPENDENT LOCAL NEWSPAPER.

"(a) EXTENSION PERMITTED.—If an interest in an independent local newspaper business is included in the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States, the executor may elect to pay, in 2 or more (but not exceeding 10) equal installments, part or all of the tax imposed by section 2001 attributable to the interest in 1 (but not more than 1) such independent local newspaper business. Any such election shall be made not later than the time prescribed by section 6075(a) for filing the return of such tax (including extensions thereof), and shall be made in such manner as the Secretary shall by regulations prescribe. If an election under this section is made, the provisions of this subtitle shall apply as though the Secretary were extending the time for payment of the tax.

"(b) LIMITATION.—The maximum amount of tax which may be paid in installments as provided in this section shall be—

"(1) the excess of the amount of tax imposed by section 2001 over the tax which would have been imposed if the interest in an independent local newspaper business had not been included in the gross estate of the decedent, reduced by

"(2) all payments of the tax imposed by section 2001 which are made by an independent local newspaper advance estate tax payment trust described in section 529 at or before the time prescribed by section 6075(a) for filing the return of such tax (including extensions thereof).

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) DEFINITIONS.—For purposes of this section—

"(A) INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term 'independent local newspaper business' means—

"(i) a proprietorship which publishes an independent local newspaper;

"(ii) a partnership which publishes an independent local newspaper and which has

none of its outstanding partnership interests traded in an established securities market; or

"(iii) a corporation which publishes an independent local newspaper and which has none of its outstanding capital stock traded in an established securities market.

"(B) INTEREST IN AN INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term 'interest in an independent local newspaper business' means—

"(i) the interest of the proprietor in a proprietorship described in subparagraph (1)(A)(i) to the extent the value of such interest is attributable to the independent local newspaper published by such proprietorship;

"(ii) the interest of a partner in a partnership described in subparagraph (1)(A)(ii) to the extent the value of such interest is attributable to the independent local newspaper published by such partnership; or

"(iii) the stock of a corporation described in subparagraph (1)(A)(iii) to the extent the value of such stock is attributable to the independent local newspaper published by such corporation.

"(C) INDEPENDENT LOCAL NEWSPAPER.—The term 'independent local newspaper' means a newspaper publication which is not one of a chain of newspaper publications and which has all of its publishing offices (containing its principal editorial, reportorial, circulation, and business staff) in a single city, community or metropolitan area, or, on January 1, 1979, within 1 state.

"(D) A CHAIN OF NEWSPAPER PUBLICATIONS.—The term 'a chain of newspaper publications' means two or more newspaper publications which are not published in a single city, community, or metropolitan area or within one state, and are controlled, directly or indirectly, by the same person or persons.

"(2) SPECIAL RULES.—For purposes of this subsection—

"(A) TIME FOR DETERMINATIONS.—Except as otherwise provided by paragraph (3) of subsection (g), all determinations shall be made as of the time immediately before the decedent's death.

"(B) CONTROLLED GROUP OF CORPORATIONS.—In applying subparagraphs (1)(A)(iii), (1)(C), and (1)(D) of subsection (c), if a corporation is a member of a controlled group of corporations

(as defined by section 1563 but substituting the phrase '50 percent' for the phrase '80 percent' each place appearing therein), the determination whether such corporation is publishing an independent local newspaper shall be made by treating all members of such controlled group of corporations as a single corporation.

"(C) CERTAIN INDIRECT INTERESTS.—In applying subparagraph (1)(B) of subsection (c), if an individual is the grantor of a trust which holds an interest in an independent local newspaper business and is treated as the owner of such interest by section 671(a), or is the beneficiary of a trust which holds an interest in an independent local newspaper business and a deduction was allowed with respect to such interest by section 2056(a), such individual shall be treated as owning the interest held by such trust to the extent such interest is includable in the gross estate of such individual.

"(d) DATE FOR PAYMENT OF INSTALLMENTS.—If an election is made under subsection (a), the first installment shall be paid on or before the date selected by the executor which is not more than 5 years after the date prescribed by section 6151(a) for payment of the tax, and each succeeding

installment shall be paid on or before the date which is 1 year after the date prescribed by this subsection for payment of the preceding installment.

"(e) PRORATION OF DEFICIENCY TO INSTALLMENTS.—If an election is made under subsection (a) to pay any part of the tax imposed by section 2001 in installments and a deficiency has been assessed, the deficiency shall (subject to the limitation provided by subsection (b)) be prorated to such installments. The part of the deficiency so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as, and as a part of, such installment. The part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the Secretary. This subsection shall not apply if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

"(f) INTEREST.—If the time for payment of any amount of tax has been extended under this section, interest shall be payable under section 6601 on any unpaid portion and shall be paid—

"(1) for the period prior to the first installment payment date selected by the executor, annually on each anniversary of the date prescribed by section 6151(a) for payment of the tax; and

"(2) commencing with the first installment payment date selected by the executor, annually on each anniversary of the date prescribed by section 6151(a) for payment of the tax.

Interest, on that part of a deficiency prorated under this section to any installment the date for payment of which has not arrived, for the period before the date fixed for the last installment preceding the assessment of the deficiency, shall be paid upon notice and demand from the Secretary.

"(g) ACCELERATION OF PAYMENT.—

"(1) DISPOSITION OF INTEREST.—If any part of the interest in an independent local newspaper business is sold or exchanged or otherwise disposed of (including by means of a distribution), then the extension of time for payment of tax provided in this section shall cease to apply with respect to the tax attributable to the interest sold, exchanged or otherwise disposed of and any unpaid portion of such tax shall be due and payable upon notice and demand by the Secretary. The tax attributable to such interest shall bear the same proportion to the total tax as to which an extension has been granted as the value of the interest so disposed of bears to the total value of the interest as to which such extension has been granted.

"(2) TERMINATION OF STATUS OF INDEPENDENT LOCAL NEWSPAPER.—If any part of the interest in the independent local newspaper business becomes traded in an established securities market, or if the independent local newspaper ceases to be published or is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications, the unpaid portion of the tax payable in installments shall be due and payable upon notice and demand from the Secretary.

"(3) FAILURE TO PAY INSTALLMENT.—If any installment under this section is not paid on or before the date fixed for its payment by this section (including any extension of time for the payment of such installment), the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

"(4) EXCEPTIONS.—

"(A) Subparagraph (1) does not apply to an exchange of stock pursuant to a plan of reorganization described in subparagraph (E) or (F) of section 368(a)(1), but any stock received in such an exchange shall be treated for purposes of such subparagraph as an interest qualifying under subsection (a).

"(B) Subparagraph (1) does not apply to a distribution of stock pursuant to a plan of reorganization described in subparagraph (D) of section 368(a)(1) or a distribution to which section 355 (or so much of section 356 as relates to section 355) applies by reason of section 529(g).

"(C) Subparagraph (1) does not apply to a transfer of property of the decedent by the executor to a person entitled to receive such property under the decedent's will or under the applicable law of descent and distribution.

"(h) APPLICABILITY.—This section shall be applicable to decedents who die after January 1, 1979.

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to the application of this section.

"(j) CROSS REFERENCES.—

"(1) SECURITY.—For authority of the Secretary to require security in the case of an extension under this section, see section 6165.

"(2) LIEN.—For special lien (in lieu of bond) in the case of an extension under this section, see section 6324A.

"(3) PERIOD OF LIMITATION.—For extension of the period of limitation in the case of an extension under this section, see section 6503(d).

"(4) INTEREST.—For provisions relating to interest on tax payable in installments under this section, see subsection (j) of section 6601.".

(b) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 62 is amended by adding after section 6166A the following new item:

"Sec. 6166B. Extension of time for payment of estate tax where estate includes interest in independent local newspaper.".

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 6166A(b) is amended by striking out "The maximum" and inserting in lieu thereof "No election may be made under this section if an election under section 6166 or 6166B applies with respect to the estate of such decedent, and the maximum".

(2) The following provisions are each amended by striking out "or 6166A" at each place appearing therein and inserting in lieu thereof "6166A or 6166B"—

(A) section 2204(a);

(B) section 2204(b);

(C) section 2204(c);

(D) section 6324A(a);

(E) section 6324A(c)(2);

(F) section 6324A(e)(1);

(G) section 6324A(e)(3);

(H) section 6324A(e)(4); and

(I) section 6503A(d).

(3) Section 6166(a)(4) is as amended by striking out section 6166A at each place appearing therein and inserting in lieu thereof "6166A or 6166B".

(4) The following provisions are each amended by striking out "section 6166" at each place appearing therein and inserting in lieu thereof "sections 6166 or 6166B"—

(A) section 6601(j)(1);

(B) section 6601(j)(2)(B); and

(C) section 6601(j)(3).

(5) The following provisions are each amended by striking out "or 6166A(h)" at each place appearing therein and inserting in lieu thereof "6166A(h), or 6166B(g)"—

(A) section 6324A(d)(3); and

(B) section 6324A(d)(5).

(6) The heading of section 6324A is amended by striking out "OR 6166A" and inserting in lieu thereof "6166A, OR 6166B".

(7) The heading of subsection (j) of section 6601 is amended by striking out "SECTION 6166" and inserting in lieu thereof "SECTIONS 6166 OR 6166B".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the estates of decedents dying after January 1, 1979.

II

96TH CONGRESS
1ST SESSION

S. 999

To amend the Internal Revenue Code of 1954 with respect to interest payments on nonpayments of tax.

IN THE SENATE OF THE UNITED STATES

APRIL 24 (legislative day, APRIL 9), 1979

Mr. BENTSEN and Mr. COCHRAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 with respect to interest payments on nonpayments of tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (a) of section 6601 of the Internal Revenue Code of 1954 (relating to interest on underpayment, nonpayment, or extension of time for payment of tax) is amended to read as follows:

"(a) GENERAL RULE.—If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or

before the last date prescribed for payment, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, interest on such amount at an annual rate established under section 6621 shall be paid for the period from such last date to the date paid.".

SEC. 2. EFFECTIVE DATE.

The amendments made by this Act apply with respect to taxable years beginning after December 31, 1977.

II

96TH CONGRESS
1ST SESSION

S. 1488

To amend the Internal Revenue Code of 1954 to provide for the partial exclusion of interest from gross income.

IN THE SENATE OF THE UNITED STATES

JULY 12 (legislative day, JUNE 21), 1979

Mr. NELSON introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for the partial exclusion of interest from gross income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 116 of the Internal Revenue Code of 1954 (relating to partial exclusion of dividends received by individuals) is amended—

(1) by inserting "AND INTEREST" after "DIVIDENDS" in the heading of such section; and

(2) by striking out subsection (a) and inserting in lieu thereof the following:

"(a) EXCLUSION FROM GROSS INCOME.—

"(1) IN GENERAL.—Gross income does not include amounts received during the taxable year by an individual as—

"(A) dividends from domestic corporations, and

"(B) interest or dividends on savings deposits or withdrawable savings accounts from a bank (as defined in section 581) or a savings institution described in section 591.

For purposes of this paragraph, interest or dividends described in subparagraph (B) which are credited to the account of an individual shall be treated as received on the day on which they are so credited.

"(2) LIMITATIONS.—

"(A) DIVIDENDS.—For purposes of paragraph (1)(A), dividends shall be taken into account only to the extent that the dividends do not exceed $100.

"(B) INTEREST.—For purposes of paragraph (1)(B), interest or dividends described in such paragraph shall be taken into account—

"(i) only to the extent the interest and dividends received by the taxpayer during the taxable year exceed such interest or divi-

dends received by the taxpayer during the preceding taxable year, and

"(ii) then, only to the extent that the excess described in clause (i) does not exceed $100.".

(b)(1) Section 116(b) of such Code is amended by striking out "Subsection (a)" and inserting in lieu thereof "Subsection (a)(1)".

(2) Section 116(c) of such Code is amended—

(A) by striking out paragraph (1), and

(B) by inserting "and interest" after "dividends" each place it appears in paragraph (3).

(3) Section 116(d)(1) of such Code is amended by inserting "and interest" after "dividends".

(4) The table of sections for part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by inserting "and interest" after "dividends" in the item relating to section 116.

(c) EFFECTIVE DATE.—The amendments made by this Act shall apply to taxable years beginning after December 31, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1542

To amend the Internal Revenue Code of 1954 to provide for a $100 exclusion of interest from gross income and to increase the amount of the dividend exclusion and provide an additional interest exclusion if the dividends and interest are reinvested.

IN THE SENATE OF THE UNITED STATES

JULY 19 (legislative day, JUNE 21), 1979

Mr. PERCY introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for a $100 exclusion of interest from gross income and to increase the amount of the dividend exclusion and provide an additional interest exclusion if the dividends and interest are reinvested.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 116 of the Internal Revenue Code of 1954 (relating to partial exclusion of dividends received by individuals) is amended—

(1) by inserting "AND INTEREST" after "DIVIDENDS" in the heading of such section;

(2) by striking out subsection (a) and inserting in lieu thereof the following:

"(a) EXCLUSION FROM GROSS INCOME.—Gross income does not include amounts received during the taxable year by an individual as—

"(1) dividends from domestic corporations—

"(A) to the extent that the dividends do not exceed $100, and

"(B) to the extent that the dividends exceed $100 but do not exceed $500, if such dividends constitute qualified dividends; and

"(2) dividends or interest on a time or demand deposit with a bank (as defined in section 581), a savings institution described in section 591, or a credit union insured under Federal or State law—

"(A) to the extent that the amount of interest or dividends does not exceed $100, and

"(B) to the extent that the amount of interest exceeds $100 but does not exceed $500, if such dividends or interest constitute qualified dividends or interest.

For purposes of this subsection, dividends or interest described in paragraph (2) which are credited to the account of

an individual shall be treated as received on the day on which so credited."; and

(3) by adding at the end thereof the following new subsection:

"(e) QUALIFIED DIVIDENDS OR INTEREST.—

"(1) IN GENERAL.—For purposes of subsection (a)(1)(B) or (2)(B), the term 'qualified dividends or interest' means that portion of the excess of dividends or interest described in such subsection which the taxpayer, promptly upon receipt of the dividend or interest—

"(A) uses to purchase stock in a domestic corporation the dividends of which are excludible under subsection (a), or

"(B) uses to make a time or demand deposit the interest or dividends on which are excludible under subsection (a).

"(2) NET INVESTMENT LIMITATION.—No amount of dividends or interest received during any taxable year shall be treated as qualified dividends or interest if as of the last day of such taxable year the investment base of the taxpayer is less than the sum of—

"(A) the investment base of the taxpayer as of the first day of the taxable year, plus

"(B) the amount of dividends or interest excludible from gross income for such taxable year

as qualified dividends or interest (determined without regard to this pararaph).".

"(3) INVESTMENT BASE.—For purposes of this subsection, the term 'investment base' means an amount equal to the sum of—

"(A) the amount of the adjusted basis (within the meaning of section 1011) of all stock in domestic corporations held by the taxpayer, and

"(B) the amount of money in all time or demand deposits of the taxpayer with institutions described in subsection (a)(2).".

(b)(1) Section 116(b) of such Code is amended by striking out "Subsection (a)" and inserting in lieu thereof "Subsection (a)(1)".

(2) Section 116(c) of such Code is amended—

(A) by striking out paragraph (1), and

(B) by inserting "and interest" after "dividends" each place it appears in paragraph (3).

(3) Section 116(d)(1) of such Code is amended by inserting "and interest" after "dividends".

(4) The table of sections for part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by inserting "and interest" after "dividends" in the item relating to section 116.

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1543

Relating to tax treatment of qualified dividend reinvestment plans.

IN THE SENATE OF THE UNITED STATES

JULY 19 (legislative day, JUNE 21), 1979

Mr. NELSON (for himself and Mr. BENTSEN), introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

Relating to tax treatment of qualified dividend reinvestment plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 305 (relating to distributions of stock and stock rights) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) QUALIFIED DIVIDEND REINVESTMENT PLANS.—

"(1) IN GENERAL.—Subject to the limitation under paragraph (2) if a shareholder makes an election under paragraph (7), a distribution of stock under a

qualified dividend reinvestment plan shall be considered to be a distribution of stock of a corporation made by such corporation to its shareholders with respect to its stock under subsection (a), and subsection (b) shall not apply.

"(2) LIMITATION.—The amount of any distribution excluded from gross income by any taxpayer under subsection (a) by reason of paragraph (1) shall not exceed $1,500 per year ($3,000 in the case of a joint return under section 6013).

"(3) BASIS AND HOLDING PERIOD.—Notwithstanding any other provision of this title, the basis of stock received as a distribution pursuant to a qualified dividend reinvestment plan by a shareholder who makes an election under paragraph (7) shall be zero and the holding period of such stock shall commence on the date of such distribution.

"(4) DISPOSITIONS.—Under regulations prescribed by the Secretary, if a shareholder sells common stock of a corporation within 1 year following the receipt of stock described in paragraph (3) of the same corporation, the stock so sold shall be deemed to be the stock so described commencing with the first shares received during said 1-year period.

"(5) DEFINITION OF QUALIFIED DIVIDEND REINVESTMENT PLAN.—The term 'qualified dividend reinvestment plan' means a plan under which the common and/or preferred shareholders of a domestic corporation (other than a regulated investment company) who elect to participate in such plan receive a distribution otherwise payable in property only in shares (including fractional shares) of authorized but unissued common stock of the corporation which common stock is pursuant to such plan (i) designated by the board of directors of the corporation as issued for purposes of this subsection and (ii) priced at not less than 95 per centum of fair market value as of the date of distribution.

"(6) PRESUMPTION.—If a corporation, or a member of its 'affiliated group' within the meaning of section 1504(a), has purchased or purchases its common stock within 1 year of making a distribution pursuant to a dividend reinvestment plan, such distribution shall be presumed not to have been made pursuant to a qualified dividend reinvestment plan. Under regulations prescribed by the Secretary the corporation may establish that it had a business purpose for purchasing such stock which is not inconsistent with the intent of this subsection, in which event the distribution will not be disqualified hereunder.

"(7) SHAREHOLDER ELECTION.—Pursuant to regulations prescribed by the Secretary, a shareholder may elect to have paragraph (1) apply to any distribution of stock described therein by making such election on the shareholder's Federal income tax return on which such distribution is reported."

SEC. 2. EFFECTIVE DATE.—This amendment shall apply with respect to distributions made on or after January 1, 1980.

II

96TH CONGRESS
1ST SESSION

S. 1628

To impose a windfall profit tax on domestic crude oil.

IN THE SENATE OF THE UNITED STATES

AUGUST 1 (legislative day, JUNE 21), 1979

Mr. HART introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To impose a windfall profit tax on domestic crude oil.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Old Oil Adjustment Tax and New Oil Deregulation Act of 1979".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. WINDFALL PROFIT TAX.

(a) IN GENERAL.—

(1) AMENDMENT OF SUBTITLE D.—Subtitle D (relating to miscellaneous excise taxes) is amended by adding at the end thereof the following new chapter:

"CHAPTER 45—WINDFALL PROFIT TAX ON DOMESTIC CRUDE OIL

"SEC. 4986. IMPOSITION OF TAX.

"(a) IMPOSITION OF TAX.—An excise tax is hereby imposed on the windfall profit from taxable crude oil removed from the premises during each taxable period.

"(b) TAX PAID BY PRODUCER.—The tax imposed by this section shall be paid by the producer of the crude oil.

"(c) EXEMPTION FOR SMALL PRODUCERS.—

"(1) IN GENERAL.—The tax imposed by subsection (a) for any taxable period shall not apply to any person whose qualified production during such period does not exceed the product of—

"(A) 3,000 barrels, multiplied by

"(B) the number of days during such taxable period.

"(2) ALLOCATION AMONG RELATED PERSONS.—

"(A) In the case of persons who are members of the same related group during that period, the 3,000 barrel amount contained in paragraph (1) for days during such period shall be reduced for each person by allocating 3,000 barrels among all such persons in proportion to their respective qualified production during such period.

"(B) RELATED GROUP.—For purposes of subparagraph (A), the term 'related group' means—

"(i) a controlled group of corporations (as defined in section 613A(c)(8)(D)(i)),

"(ii) a group of entities among which an allocation would be made under subparagraph (B) of section 613A(c)(8), and

"(iii) members of the same family (as defined in section 613A(c)(8)(D)(iii)) and any corporation, trust or estate 50 percent or more of the beneficial interest in which is owned (directly or through the application of section 267(c)) by members of such family.

"(C) SPECIAL RULE.—If an entity is a member of more than 1 related group for any period, the determination of the entity's allocation

under subparagraph (A) shall be made by reference to the related group which results in the smallest allocation to such entity.

"(4) QUALIFIED PRODUCTION DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—A person's qualified production during any taxable period is the number of barrels of taxable crude oil—

"(i) which are removed from the premises during such taxable period, and

"(ii) with respect to which such person would be liable for the tax imposed by subsection (a) (determined without regard to this subsection).

"(B) PRODUCTION FROM TRANSFERRED PROPERTY.—

"(i) IN GENERAL.—In the case of a transfer (including the subleasing of a lease) after 1978 of an interest (including an interest in a partnership or trust) in any proven oil or gas property, the qualified production of the transferee (or sublessee) shall not include any production attributable to such interest.

"(ii) SPECIAL RULES.—For purposes of clause (i)—

"(I) The term 'proven oil or gas property' has the same meaning as when used in section 613A(c)(9)(A).

"(II) Rules similar to the rules of section 613A(c)(9)(B) shall apply.

"SEC. 4987. AMOUNT OF TAX.

"(a) IN GENERAL.—Except as provided in the provision referred to in subsection (b), the amount of the tax imposed by section 4986 with respect to any barrel of taxable crude oil shall be—

"(1) in the case of tier 1 and tier 2 oil, 100 percent of the windfall profit on such barrel, and

"(2) in the case of tier 3 oil, 60 percent of the windfall profit on such barrel.

"(b) PROVISION PROVIDING FOR 50 PERCENT RATE.—For provision providing tax rate of 50 percent in the case of Sadlerochit oil, see section 4991(b)(1)(A).

"(c) FRACTIONAL PART OF BARREL.—In the case of a fraction of a barrel, the tax imposed by section 4986 shall be the same fraction of the amount of such tax imposed on a whole barrel.

"SEC. 4988. TAXABLE CRUDE OIL; THE THREE TIERS FOR TAX PURPOSES.

"(a) TAXABLE CRUDE OIL.—For purposes of this chapter, the term 'taxable crude oil' means all domestic crude oil other than—

"(1) qualified Alaskan oil (within the meaning of section 4992(b)(6)), and

"(2) newly discovered oil and incremental tertiary oil.

"(3) stripper oil.

"(b) TIER 1 OIL.—For purposes of this chapter, the term 'tier 1 oil' means domestic crude oil which—

"(1) is lower tier oil, or

"(2) would be lower tier oil if the base production control level for such oil were reduced for January 1980 and each month thereafter by 1½ percent (instead of 3 percent).

For purposes of paragraph (2), the base production control level shall be determined under the June 1979 energy regulations as if the producer had elected the 1½ percent monthly reduction for 1979 and the 3 percent monthly reduction thereafter.

"(c) TIER 2 OIL.—For purposes of this chapter, the term 'tier 2 oil' means upper tier oil other than—

"(1) oil described in subsection (b)(2),

"(2) Sadlerochit oil (within the meaning of section 4991(b)(3)).

"(d) TIER 3 OIL.—For purposes of this chapter, the term 'tier 3 oil' means taxable crude oil other than tier 1 oil and tier 2 oil.

"(e) LOWER AND UPPER TIERS.—For purposes of this chapter—

"(1) LOWER TIER OIL.—The term 'lower tier oil' means domestic crude oil which is or would be subject to the lower tier ceiling price rule of the June 1979 energy regulations.

"(2) UPPER TIER OIL.—The term 'upper tier oil' means domestic crude oil which is or would be subject to the upper tier ceiling price rule of the June 1979 energy regulations.

"(3) MARGINAL PROPERTY PROVISIONS DISREGARDED.—The determination of whether crude oil is or would be lower tier oil or upper tier oil shall be made without regard to the provisions of the June 1979 energy regulations which provide for a different base production control level for marginal properties.

"SEC. 4989. WINDFALL PROFIT; REMOVAL PRICE.

"(a) GENERAL RULE.—For purposes of this chapter, the term 'windfall profit' means the excess of the removal price of the barrel of crude oil over the sum of—

"(1) the adjusted base price of such barrel, and

"(2) the amount of the severance tax adjustment with respect to such barrel provided by section 4992(d).

"(b) NET INCOME LIMITATION ON WINDFALL PROFIT.—

"(1) IN GENERAL.—The windfall profit on any barrel of crude oil shall not exceed the net income attributable to such barrel.

"(2) DETERMINATION OF NET INCOME.—For purposes of paragraph (1), the net income attributable to a barrel shall be determined by dividing—

"(A) the taxable income from the property for the taxable year attributable to taxable crude oil, by

"(B) the number of barrels of taxable crude oil produced from such property during such taxable year.

"(3) TAXABLE INCOME FROM THE PROPERTY.—For purposes of paragraph (2)—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the taxable income from the property shall be determined under section 613(a).

"(B) CERTAIN DEDUCTIONS NOT ALLOWED.—No deduction shall be allowed for—

"(i) depletion,

"(ii) section 263(c) costs, and

"(iii) the tax imposed by section 4986.

"(C) TAXABLE INCOME REDUCED BY COST DEPLETION.—Taxable income shall be reduced by the cost depletion which would have been allowable for the taxable year with respect to the property if—

"(i) all section 263(c) costs had been capitalized and taken into account in computing cost depletion, and

"(ii) cost depletion had been used with respect to such property for all periods.

"(D) SECTION 263(c) COSTS.—For purposes of this paragraph, the term 'section 263(c) costs' means intangible drilling and development costs which (by reason of an election under section 263(c)) may be deducted as expenses for purposes of this chapter (other than this paragraph). Such term shall not include costs incurred in drilling a nonproductive well.

"(4) SPECIAL RULES FOR TRANSFERS OF PROVEN OIL OR GAS PROPERTIES.—

"(A) IN GENERAL.—In the case of any proven oil or gas property transfer which, but for this subparagraph, would result in an increase in the amount determined under paragraph (3)(C) with respect to the transferee, paragraph (3)(C) shall be applied with respect to the transferee by taking into account only costs incurred during periods after such transfer.

"(B) PROVEN OIL OR GAS PROPERTY TRANSFER.—For purposes of subparagraph (A), the term 'proven oil or gas property transfer' means any transfer (including the subleasing of a lease) after 1978 of an interest (including an interest in a partnership or trust) in any proven oil or gas property (within the meaning of section 613A(c)(9)(A)).

"(5) SPECIAL RULE WHERE THERE IS PRODUCTION PAYMENT.—For purposes of paragraph (2), if any portion of the taxable crude oil removed from the property is applied in discharge of a production payment, the gross income from such portion shall be included in the gross income from the property in computing the taxable income of the producer.

"(c) REMOVAL PRICE.—For purposes of this chapter—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the term 'removal price' means the amount for which the barrel is sold.

"(2) SALES BETWEEN RELATED PERSONS.—In the case of a sale between related persons (within the meaning of section 103(b)(6)(C)), the removal price shall not be less than the constructive sales price for purposes of determining gross income from the property under section 613.

"(3) OIL REMOVED FROM PREMISES BEFORE SALE.—If crude oil is removed from the premises before it is sold, the removal price shall be the constructive sales price for purposes of determining gross income from the property under section 613.

"(4) REFINING BEGUN ON PREMISES.—If the manufacture or conversion of crude oil into refined products begins before such oil is removed from the premises—

"(A) such oil shall be treated as removed on the day such manufacture or conversion begins, and

"(B) the removal price shall be the constructive sales price for purposes of determining gross income from the property under section 613.

"(5) MEANING OF TERMS.—As used in this subsection, the terms 'premises' and 'refined product' have the same meaning as when used for purposes of determining gross income from the property under section 613.

"SEC. 4990. ADJUSTED BASE PRICE.

"(a) ADJUSTED BASE PRICE DEFINED.—For purposes of this chapter, the term 'adjusted base price' means the base price for the barrel of crude oil plus an amount equal to—

"(1) such base price, multiplied by

"(2) the inflation adjustment for the calendar quarter in which the crude oil is removed (or deemed removed) from the premises.

The amount determined under the preceding sentence shall be rounded to the nearest cent.

"(b) INFLATION ADJUSTMENT.—

"(1) IN GENERAL.—For purposes of subsection (a) the inflation adjustment for any calendar quarter is the percentage by which—

"(A) the implicit price deflator for the gross national product for the second preceding calendar quarter, exceeds

"(B) such deflator for the calendar quarter ending December 31, 1978 (June 30, 1979, in the case of tier 3 oil).

"(2) FIRST REVISION OF PRICE DEFLATOR USED.—For purposes of paragraph (1), the price deflator used shall be the first revision thereof.

"(c) BASE PRICE FOR TIER 1 OIL.—For purposes of this chapter, the base price for tier 1 oil is the lower tier ceiling price (as of May 1979) for such oil under March 1979 energy regulations.

"(d) BASE PRICE FOR TIER 2 OIL.—For purposes of this chapter—

"(1) IN GENERAL.—Except as provided in paragraph (2), the base price for tier 2 oil is the upper tier ceiling price (as of May 1979) for such oil under March 1979 energy regulations.

"(2) MONTHLY INCREMENTS STARTING NOVEMBER 1, 1986.—Beginning with November 1986, the base price for tier 2 oil of any grade and location shall include such monthly increments as may be provided pursuant to regulations prescribed by the Secretary (and modified by him from time to time) for the purpose of eliminating (as ratably as may be practicable) over the 50 month period ending December 31, 1990, the gap between the tier 2 base price for such oil and the tier 3 base price for such oil.

"(e) BASE PRICE FOR TIER 3 OIL.—For purposes of this chapter, the base price for tier 3 oil is the price provided

pursuant to regulations prescribed by the Secretary for the purpose of estimating (as nearly as may be practicable) the price at which uncontrolled crude oil of the same grade and location would have sold in December 1979 if the average landed price during such month for imported crude oil were $16 a barrel.

"SEC. 4991. NEWLY DISCOVERED OIL; TERTIARY RECOVERY PROJECTS; CERTAIN ALASKAN OIL.

"(a) NEWLY DISCOVERED OIL DEFINED.—For purposes of this chapter (including the application of the June 1979 energy regulations for purposes of this chapter)—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the term 'newly discovered oil' has the meaning given to such term by the June 1979 energy regulations.

"(2) REOPENINGS.—The term 'newly discovered oil' does not include crude oil produced from a property from which there has been any production of crude oil after 1969 and before 1979. For purposes of this paragraph, the term 'property' has the meaning given to such term by the June 1979 energy regulations.

"(3) BEHIND-THE-PIPE OIL.—The term 'newly discovered oil' does not include crude oil produced from a reservoir on a tract or parcel if—

"(A) the reservoir was penetrated after 1969 and before 1979 by a well (on such tract or parcel) from which crude oil was produced (whether or not such production was from such reservoir), and

"(B) crude oil could have been produced from such reservoir through such well before 1979.

"(4) PRODUCTION MUST HAVE BEEN IN COMMERCIAL QUANTITIES.—For purposes of paragraphs (2) and (3), only production in commercial quantities shall be taken into account.

"(b) ALASKAN OIL FROM SADLEROCHIT RESERVOIR.—For purposes of this chapter—

"(1) IN GENERAL.—In the case of Sadlerochit oil—

"(A) RATE OF TAX.—The rate of tax provided in section 4987(a)(2) shall be 50 percent instead of 60 percent.

"(B) BASE PRICE.—The base price shall be $7.50.

"(C) ADJUSTED BASE PRICE INCREASED BY TAPS ADJUSTMENT.—The adjusted base price for any calendar quarter (determined without regard to this subsection) shall be increased by the

TAPS adjustment (if any) for such quarter provided by paragraph (2).

"(D) REMOVAL PRICE DETERMINED ON MONTHLY BASIS.—The removal price of such oil removed during any calendar month shall be the average of the producer's removal prices for such month.

"(E) SEVERANCE TAX ADJUSTMENT NOT TO APPLY.—The amount of the windfall profit shall be determined without regard to section 4989(a)(2).

"(2) TAPS ADJUSTMENT.—

"(A) IN GENERAL.—The TAPS adjustment for any calendar quarter is the excess (if any) of—

"(i) $6.26 plus the product of $6.26 and the inflation adjustment, over

"(ii) the TAPS tariff for the preceding calendar quarter.

"(B) INFLATION ADJUSTMENT.—For purposes of subparagraph (A), the inflation adjustment shall be determined under section 4990(b) as if paragraph (1)(B) thereof referred to the calendar quarter ending June 30, 1978.

"(C) TAPS TARIFF.—For purposes of subparagraph (A), the TAPS tariff for the preceding

calendar quarter is the average per barrel amount paid for all transportation (ending in such quarter) of crude oil through the TAPS.

"(D) TAPS DEFINED.—For purposes of this paragraph, the term 'TAPS' means the Trans-Alaskan Pipeline System.

"(3) SADLEROCHIT OIL DEFINED.—The term 'Sadlerochit oil' means crude oil produced from the Sadlerochit Reservoir in the Prudhoe Bay oilfield.

"(c) INCREMENTAL TERTIARY OIL.—For purposes of this chapter—

"(1) INCREMENTAL TERTIARY OIL DEFINED.—

"(A) IN GENERAL.—The term 'incremental tertiary oil' means the excess of—

"(i) the amount of crude oil which is removed during any month and which is produced on or after the project beginning date and during the period for which a qualified tertiary recovery project is in effect on the property, over

"(ii) the base level for such property for such month.

"(B) BASE LEVEL.—The base level for any property for any month is the average monthly amount (determined under rules similar to rules

used in determining the base production control level under the June 1979 energy regulations) of crude oil removed from such property during the 6-month period ending March 31, 1979, reduced by the sum of—

"(i) 1 percent of such amount for each month which begins after 1978 and before the project beginning date, and

"(ii) 2½ percent for each month (after the last month described in clause (i) or, if no such month, after 1978) which is before the month for which the base level is being determined.

"(C) MINIMUM AMOUNT IN CASE OF PROJECTS CERTIFIED BY DOE.—In the case of a project described in paragraph (3)(A), the amount of the incremental tertiary oil shall not be less than the incremental production determined under the June 1979 energy regulations.

"(2) ALLOCATION RULES.—The determination of which barrels of crude oil removed during such month are incremental tertiary oil shall be made—

"(A) first by allocating the amount of incremental tertiary oil between oil which (but for this subsection) would be tier 1 oil, oil which (but for

the subsection) would be tier 2 oil, and oil which (but for this subsection) would be tier 3 oil in proportion to the respective amounts of such oil removed from the property during such month, and

"(B) then by taking into account barrels of crude oil so removed in the order of their respective removal prices beginning with the highest of such prices.

"(3) QUALIFIED TERTIARY RECOVERY PROJECT.—The term 'qualified tertiary recovery project' means—

"(A) a qualified tertiary enhanced recovery project with respect to which a certification as such is in effect under the June 1979 energy regulations, or

"(B) any project for the tertiary recovery of crude oil which meets the requirements of paragraph (4).

"(4) REQUIREMENTS.—A project meets the requirements of this paragraph if—

"(A) the project involves the application (in accordance with sound engineering principles) of one or more tertiary recovery methods which can reasonably be expected to result in a significant

increase in the amount of crude oil which will ultimately be recovered from the property,

"(B) the project would be uneconomic without the benefits of this subsection,

"(C) the project beginning date is after May 1979, and

"(D) the operator submits (at such times and in such manner as the Secretary may by regulations prescribe) to the Secretary—

"(i) a certification from a petroleum engineer that the project meets the requirements of subparagraphs (A), (B), and (C) (and continues to meet the requirements of subparagraph (A)), and

"(ii) such other information as the Secretary may by regulations require.

"(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) TERTIARY RECOVERY METHOD.—The term 'tertiary recovery method' means—

"(i) any method which is described in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations, or

"(ii) any other method to provide tertiary enhanced recovery which is approved by the Secretary.

"(B) PROJECT BEGINNING DATE.—The term 'project beginning date' means the date on which the application of the method or methods referred to in paragraph (4)(A) begin.

"(C) PROJECT ONLY AFFECTS PORTION OF PROPERTY.—If a qualified tertiary recovery project affects only a portion of a property, such portion shall be treated as a separate property.

"(D) SIGNIFICANT EXPANSION TREATED AS SEPARATE PROJECT.—A significant expansion of any project shall be treated as a separate project.

"(d) STRIPPER OIL.—For purposes of this chapter, the term 'stripper oil' has the same meaning as such term is defined in the June 1979 energy regulations.

"SEC. 4992. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) PRODUCER.—

"(1) IN GENERAL.—For purposes of this chapter, the term 'producer' means the holder of the economic interest with respect to the crude oil.

"(2) EXCEPTION IN CASE OF CERTAIN SPECIFIED AMOUNT PRODUCTION PAYMENTS.—If a portion of the crude oil removed from a property is applied

during the taxable year in partial or complete discharge of a production payment which—

"(A) is not limited by time or to a specified number of units, but

"(B) will be fully discharged only when a specified dollar amount (plus interest or other charges, if any) has been received by the holder of the production payment,

then the holder of the economic interest from which the production payment was created (rather than the holder of the production payment) shall be treated as the producer of such portion.

"(b) OTHER DEFINITIONS.—For purposes of this chapter—

"(1) CRUDE OIL.—The term 'crude oil' has the meaning given to such term by the June 1979 energy regulations.

"(2) BARREL.—The term 'barrel' means 42 United States gallons.

"(3) DOMESTIC.—The term 'domestic', when used with respect to crude oil, means crude oil produced from an oil well located in the United States or in a possession of the United States.

"(4) UNITED STATES.—The term 'United States' has the meaning given to such term by paragraph (1) of section 638 (relating to Continental Shelf areas).

"(5) POSSESSION OF THE UNITED STATES.—The term 'possession of the United States' has the meaning given to such term by paragraph (2) of section 638.

"(6) QUALIFIED ALASKAN OIL.—The term 'qualified Alaskan oil' means any crude oil produced from a well north of the Arctic Circle other than Sadlerochit oil.

"(7) TAXABLE PERIOD.—The term 'taxable period' means each calendar quarter beginning after December 31, 1979.

"(8) ENERGY REGULATIONS.—

"(A) IN GENERAL.—The term 'energy regulations' means regulations prescribed under section 4(a) of the Emergency Petroleum Allocation Act of 1973, as amended.

"(B) MARCH 1979 ENERGY REGULATIONS.—The March 1979 energy regulations shall be the terms of energy regulations as such terms existed on March 1, 1979.

"(C) JUNE 1979 ENERGY REGULATIONS.—The June 1979 energy regulations—

"(i) shall be the terms of energy regulations as such terms existed on June 1, 1979, and

"(ii) shall be treated as including final action taken pursuant thereto before June 1, 1979, and as including action taken before, on, or after such date with respect to incremental production from qualified tertiary enhanced recovery projects.

"(D) CONTINUED APPLICATION OF REGULATIONS AFTER DECONTROL.—Energy regulations shall be treated as continuing in effect without regard to decontrol of oil prices or any other termination of the application of such regulations.

"(c) PURCHASER COLLECTS TAX.—If the removal of any taxable crude oil is determined under section 4989(c)(1)—

"(1) the tax imposed by section 4986 with respect to such crude oil shall be collected by the purchaser of such crude oil by deducting the amount of such tax from amounts payable for such oil,

"(2) the producer shall not be required to file a return of the tax imposed by section 4986 with respect to such oil, and

"(3) the producer shall be treated as having paid the amount of tax collected by the purchaser on the due date prescribed by section 6076 for filing the return for the taxable period in which such oil was removed from the premises.

In determining the amount to be collected under paragraph (1), section 4989(b) shall not apply.

"(d) SEVERANCE TAX ADJUSTMENT.—For purposes of this chapter—

"(1) IN GENERAL.—The severance tax adjustment with respect to any barrel of crude oil shall be the amount by which—

"(A) any severance tax imposed with respect to such barrel, exceeds

"(B) the severance tax which would have been imposed if the barrel had been extracted and sold at its adjusted base price.

"(2) LIMITATION ON AMOUNT OF SEVERANCE TAX.—The amount of severance tax taken into account under paragraph (1) shall not exceed the amount which would have been imposed under the State law in effect on March 31, 1979.

"(e) SPECIAL RULES FOR POST-1978 TRANSFERS OF PROPERTY.—In the case of a transfer after 1978 of any portion of a property, for purposes of this chapter (including the

application of the June 1979 energy regulations for purposes of this chapter), after such transfer—

"(1) crude oil produced from any portion of such property shall not constitute stripper oil or newly discovered oil if such oil would not be so classified if the property had not been divided, and

"(2) the allocation of the base production control level among portions of the property shall be made under regulations prescribed by the Secretary.

"(f) EXEMPTION FOR CERTAIN INTERESTS HELD BY STATE OR LOCAL GOVERNMENTS.—

"(1) IN GENERAL.—If—

"(A) an economic interest in crude oil is held by a State or political subdivision thereof, or by an educational institution which is an agency or instrumentality of any of the foregoing, and

"(B) under the applicable State or local law, all of the net income received pursuant to such interest is dedicated to public education,

then no tax shall be imposed by section 4986 with respect to crude oil properly allocable to such interest. For purposes of this paragraph, the term 'net income' means gross income reduced by production costs, and severance taxes of general application, allocable to such interest.

"(2) AMOUNTS PLACED IN CERTAIN PERMANENT FUNDS TREATED AS DEDICATED TO PUBLIC EDUCATION.—The requirements of paragraph (1)(B) shall be treated as met with respect to any net income which, under the applicable State or local law, is placed in a permanent fund the earnings on which are dedicated to public education.

"SEC. 4993. RECORDS AND INFORMATION; REGULATIONS.

"(a) RECORDS AND INFORMATION.—Each taxpayer liable for tax under section 4986, each partnership, trust, or estate producing domestic crude oil, each purchaser of domestic crude oil, and each operator of a well from which domestic crude oil was produced, shall keep such records, make such returns, and furnish such information with respect to such oil as the Secretary may by regulations prescribe.

"(b) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of this chapter, including such changes in the application of the energy regulations for purposes of this chapter as may be necessary or appropriate to carry out such purposes.".

(2) CLERICAL AMENDMENT.—The table of chapters for subtitle D is amended by adding at the end thereof the following new item:

"CHAPTER 45. Windfall profit tax on domestic crude oil.".

(b) TECHNICAL AMENDMENTS.—

(1) The first sentence of section 164(a) (relating to deduction for taxes) is amended by inserting after paragraph (4) the following new paragraph:

"(5) The windfall profit tax imposed by section 4986.".

(2) Subsection (a) of section 613 (relating to percentage depletion) is amended by inserting before the last sentence the following new sentence: "For purposes of this subsection and section 613A(d)(1), in the case of taxable crude oil (within the meaning of section 4988(a)), gross income from the property shall be reduced by the amount of the windfall profit (within the meaning of section 4989(a) determined without regard to the severance tax adjustment) and taxable income shall be determined without regard to the tax imposed by section 4986.".

(c) TIME FOR FILING RETURN OF WINDFALL PROFIT TAX; DEPOSITARY REQUIREMENTS.—

(1) TIME FOR FILING RETURN OF WINDFALL PROFIT TAX.—

(A) Part V of subchapter A of chapter 61 (relating to time for filing returns and other documents) is amended by adding at the end thereof the following new section:

"SEC. 6076. TIME FOR FILING RETURN OF WINDFALL PROFIT TAX.

"(a) GENERAL RULE.—Each return of the tax imposed by section 4986 (relating to windfall profit tax) for any taxable period (within the meaning of section 4992(b)(7)) shall be filed not later than the last day of the second month following the close of the taxable period.

"(b) CROSS REFERENCE.—

"For depositary requirements applicable to the tax imposed by section 4986, see section 6302(d).".

(B) The table of sections for such part V is amended by adding at the end thereof the following new item:

"Sec. 6076. Time for filing return of windfall profit tax.".

(2) DEPOSITARY REQUIREMENTS.—Section 6302 (relating to mode or time of collection) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) WINDFALL PROFIT TAX.—The mode and time for collecting the tax imposed by section 4986 (relating to windfall profit tax) shall be established by the Secretary by regulations."

(3) TECHNICAL AMENDMENT.—Section 7512 (relating to separate accounting for certain collected taxes, etc.) is amended—

(A) by striking out "or by chapter 33" in subsections (a) and (b) and inserting in lieu thereof ", by chapter 33, or by section 4986", and

(B) by striking out "or chapter 33" in subsections (b) and (c) and inserting in lieu thereof ", chapter 33, or section 4986".

(d) CERTAIN INFORMATION REQUIRED TO BE FURNISHED.—

(1) GENERAL RULE.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050C. INFORMATION FURNISHED BY PURCHASER AND OPERATOR REGARDING WINDFALL PROFIT TAX ON DOMESTIC CRUDE OIL.

"(a) CERTAIN INFORMATION FURNISHED BY PURCHASER.—Under regulations prescribed by the Secretary, the purchaser of taxable crude oil (within the meaning of section 4988) shall furnish to the taxpayer liable for tax under section 4986 with respect to such oil a monthly statement showing the following:

"(1) the amount of taxable crude oil purchased from such taxpayer during such month,

"(2) the removal price of such oil,

"(3) the base price and the adjusted base price with respect to such oil,

"(4) the amount of such taxpayer's liability for tax under section 4986 with respect to such oil, and

"(5) such other information as may be required by regulations prescribed by the Secretary.

"(b) INFORMATION FURNISHED BY OPERATOR.—Under regulations prescribed by the Secretary, if the purchaser of taxable crude oil and the operator of the well from which such crude oil was produced make a joint election under this subsection, the monthly statement required to be furnished by the purchaser under subsection (a) shall be furnished by such operator.

"(c) TIME FOR FILING MONTHLY STATEMENT.—Each monthly statement required to be furnished under subsection (a) or (b) for any month shall be furnished before the first day of the second month which begins after the close of such month.

"(d) CERTIFICATION FURNISHED BY OPERATOR.—Under regulations prescribed by the Secretary, the operator of the well from which crude oil subject to the tax imposed under section 4986 was produced shall certify (at such time and in such manner as the Secretary shall by regulations prescribe) to the purchaser the base price (within the meaning of section 4990) with respect to such crude oil. For pur-

poses of section 6652(b) (relating to additions to tax for failure to file other returns) such certification shall be treated as a statement of a payment to another person.

"(e) CROSS REFERENCES.—

"(1) For additions to tax for failure to furnish information required under this section, see section 6652(b).
"(2) For penalty for willful failure to supply information required under this section, see section 7241.".

(2) TECHNICAL AND CONFORMING AMENDMENTS.—

(A) Section 6652(b) is amended by striking out "or section 6051(d)" and inserting in lieu thereof the following: "section 6050C (relating to information regarding windfall profit tax on domestic crude oil), or section 6051(d)".

(B) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050C. Information furnished by purchaser and operator regarding windfall profit tax on domestic crude oil.".

(e) CRIMINAL PENALTY FOR FAILURE TO FURNISH CERTAIN INFORMATION.—

(1) IN GENERAL.—Part II of subchapter A of chapter 75 (relating to penalties applicable to certain taxes) is amended by adding at the end thereof the following new section:

"SEC. 7241. WILLFUL FAILURE TO FURNISH CERTAIN INFORMATION REGARDING WINDFALL PROFIT TAX ON DOMESTIC CRUDE OIL.

"Any person who is required under section 6050C (or regulations thereunder) to furnish any statement, information, or certification to any other person and who willfully fails to furnish such statement, information, or certification at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 1 year, or both, together with the costs of prosecution.".

(2) CLERICAL AMENDMENT.—The table of sections for such part II is amended by adding at the end thereof the following new item:

"Sec. 7241. Willful failure to furnish certain information regarding windfall profit tax on domestic crude oil.".

(f) INFORMATION FURNISHED BY PARTNERSHIPS, TRUSTS, AND ESTATES.—

(1) INFORMATION TO BE FURNISHED TO PARTNERS AND TO BENEFICIARIES OF ESTATES AND TRUSTS.—Subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new section:

"SEC. 6050D. WINDFALL PROFIT INFORMATION TO BE FURNISHED TO PARTNERS AND TO BENEFICIARIES OF ESTATES AND TRUSTS.

"(a) REQUIREMENT.—Under regulations prescribed by the Secretary, each partnership, estate, and trust producing domestic crude oil for any taxable period shall furnish to each partner or beneficiary, as the case may be, a written statement showing the following:

"(1) the name of such partner or beneficiary,

"(2) information received by the partnership, trust, or estate pursuant to section 6050C,

"(3) such partner's or beneficiary's distributive share of the items referred to in paragraph (2), and

"(4) such other information as may be required by regulations prescribed by the Secretary.

"(b) TIME FOR FURNISHING WRITTEN STATEMENT.—Each written statement required to be furnished under this section with respect to any taxable period shall be furnished before the first day of the third month following the close of such period.".

(2) CLERICAL AMENDMENT.—The table of sections for such subpart B is amended by adding at the end thereof the following new item:

"Sec. 6050D. Windfall profit information to be furnished to partners and to beneficiaries of estates and trusts."

(g) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1980.

SEC. 3. STUDY OF EFFECTS OF DECONTROL OF OIL PRICES AND OF WINDFALL PROFIT TAX.

(a) GENERAL RULE.—The President shall, not later than January 1, 1983, submit to the Congress a report on the effect of decontrol of oil prices and the windfall profit tax on—

(1) domestic oil production,

(2) foreign oil imports,

(3) profits of the oil industry,

(4) inflation,

(5) employment,

(6) economic growth,

(7) Federal revenues, and

(8) national security.

(b) REPORT TO INCLUDE RECOMMENDATIONS.—The report required under subsection (a) shall include such legislative recommendations as the President determines to be advisable.

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II

96TH CONGRESS
1ST SESSION

S. 1703

To amend the Internal Revenue Code of 1954 to provide an exclusion for income earned abroad attributable to certain charitable services.

IN THE SENATE OF THE UNITED STATES

AUGUST 3 (legislative day, JUNE 21), 1979

Mr. CHAFEE (for himself, Mr. COCHRAN, Mr. MATSUNAGA, Mr. MOYNIHAN, Mr. JEPSEN, Mr. RIBICOFF, Mr. BOREN and Mr. LONG) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide an exclusion for income earned abroad attributable to certain charitable services.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (a) of section 911 of the Internal Revenue Code of 1954 (relating to income earned by individuals in certain camps) is amended by inserting "or who performs qualified charitable services," after "hardship area,".

(b)(1) Subparagraph (A) of subsection (c)(1) of such section 911 is amended to read as follows:

"(A) DOLLAR LIMITATIONS.—

"(i) CAMP RESIDENTS.—In the case of an individual who resides in a camp located in a hardship area, the amount excluded from the gross income of the individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of $20,000 for days during which he resides in a camp.

"(ii) EMPLOYEES OF CHARITABLE ORGANIZATIONS.—If any individual performs qualified charitable services during any taxable year, the amount of the earned income attributable to such services excluded from the gross income of the individual under subsection (a) for the taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of $20,000.

"(iii) SPECIAL RULE.—If any individual performs qualified charitable services and performs other services while residing in a camp located in a hardship area during any taxable year, the amount of the earned income attributable to such other services

excluded from the gross income of the individual under subsection (a) for the taxable year shall not (after the application of clause (i) with respect to such earned income) exceed $20,000 reduced by the amount of the earned income attributable to qualified charitable services excluded from gross income under subsection (a) for the taxable year.".

(2) Subsection (c)(1) of such section 911 is amended by adding at the end thereof the following:

"(D) QUALIFIED CHARITABLE SERVICES.—For purposes of this subsection, the term 'qualified charitable services' means services performed by an employee for an employer which meets the requirements of section 501(c)(3).".

(c)(1) The heading for such section 911 is amended by inserting "OR FROM CHARITABLE SERVICES" after "CAMPS".

(2) The item relating to section 911 in the table of sections for subpart B of part III of subchapter IV of chapter 1 of such Code is amended by inserting "or from charitable services" after "camps".

SEC. 2. The amendments made by this section shall apply to taxable years beginning after December 31, 1978.

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II

96TH CONGRESS
1ST SESSION

S. 1846

To amend the Internal Revenue Code of 1954 to provide for a $250 exclusion from gross income of interest and dividends received by an individual.

IN THE SENATE OF THE UNITED STATES

OCTOBER 1 (legislative day, JUNE 21), 1979

Mr. TALMADGE introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for a $250 exclusion from gross income of interest and dividends received by an individual.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 116 of the Internal Revenue Code of 1954 (relating to partial exclusion of dividends received by individuals) is amended—

(1) by inserting "AND INTEREST" after "DIVIDENDS" in the heading of such section; and

(2) by striking out subsection (a) and inserting in lieu thereof the following:

"(a) EXCLUSION FROM GROSS INCOME.—

"(1) IN GENERAL.—Gross income does not include the sum of the amounts received during the taxable year by an individual as—

"(A) dividends from domestic corporations, and

"(B) interest or dividends on savings deposits or withdrawable savings accounts from—

"(i) a bank (as defined in section 581),

"(ii) a mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution chartered and supervised as a savings and loan or similar institution under Federal or State law, or

"(iii) a credit union,

the deposits or accounts which are insured under Federal or State law.

"(2) DOLLAR LIMITATION.—The aggregate amount excluded under paragraph (1) for any taxable year shall not exceed $250 ($500 in the case of a joint return under section 6013).

"(3) AMOUNTS CREDITED TO ACCOUNT.—For purposes of this subsection, interest or dividends de-

scribed in paragraph (1)(B) which are credited to the account of an individual shall be treated as received on the day on which they are so credited.".

(b)(1) Section 116(b) of such Code is amended by striking out "Subsection (a)" and inserting in lieu thereof "Subsection (a)(1)".

(2) Section 116(c) of such Code is amended—

(A) by striking out paragraph (1), and

(B) by inserting "and interest" after "dividends" each place it appears in paragraph (3).

(3) Section 116(d)(1) of such Code is amended by inserting "and interest" after "dividends".

(4) The table of sections for part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by inserting "and interest" after "dividends" in the item relating to section 116.

(c)(1) Paragraph (2) of section 584(c) of such Code (relating to income of participants in fund) is amended by inserting "or interest" after "dividends" each place it appears in the heading and text thereof.

(2) Paragraph (7) of section 643(a) of such Code (relating to definition of distributable net income) is amended by inserting "or interest" after "dividends" each place it appears in the heading or text thereof.

(3) Paragraph (5) of section 702(a) of such Code (relating to income and credits of partners) is amended by inserting "or interest" after "dividends".

(d) The amendments made by this section shall apply to taxable years beginning after December 31, 1979.

Senator BYRD. The hour of 2:30 having arrived, the committee will come to order. The Subcommittee on Taxation and Debt Management will consider today several miscellaneous tax measures. The measures for consideration deal with the following issues: proposals to encourage greater individual savings by excluding a portion of interest from individual income tax—those bills are S. 246, S. 1488 S. 1542, S. 1697, and S. 1846; a proposal dealing with the election of the estate tax alternate valuation date, S. 541; a proposal dealing with the estate taxation of independent newspapers, sponsored by Senator Morgan, S. 555; a proposal dealing with exempting from penalty certain taxpayers who make late payments of taxes, S. 999; a proposal dealing with dividend reinvestment plans, S. 1543; and a proposal dealing with the tax treatment of employees of charities working abroad, S. 1703.

Witnesses have not requested to testify on two bills scheduled for hearings today, namely S. 1638, sponsored by Senator Roth, and S. 999, sponsored by Senator Bentsen. However, I believe the sponsors of these proposals do have statements that they will be making on their respective bills.

A pamphlet prepared by the Joint Committee on Taxation describing in greater detail the measures has been prepared and will be included as part of the printed record of these hearings and also the prepared statements of Senators Bentsen, Dole, Durenberger, Roth, Gravel, and Chafee.

[The information referred to follows. Oral testimony is continued on p. 129.]

INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on October 31, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a description of each bill, setting forth present law, the issues involved, an explanation of the provisions, the effective dates, and the estimated revenue effects. Also, there is included an indication of prior Congressional action with respect to the subject of the bill. The summary and description of the bills are in the numerical order of the bills listed for the hearing except that S. 246, S. 1488, and S. 1846, are presented in sequence because these bills relate to the exclusion of interest income.

The bills described in the pamphlet are:

(1) S. 246 and S. 1488 (relating to partial exclusion of interest received by individuals).

(2) S. 1846 (relating to partial exclusion of interest and dividends received by individuals).

(3) S. 541 (relating to estate tax alternate valuation).

(4) S. 555 (the Independent Local Newspaper Act of 1979).

(5) S. 999 (relating to interest on underpayments of tax).

(6) S. 1543 (relating to dividend reinvestment plans).

(7) S. 1638 (relating to amortization of business startup costs).

(8) S. 1703 (relating to the tax treatment of employees of charities working abroad).

I. SUMMARY

1. S. 246—Senator Bentsen; S. 1488—Senator Nelson

Partial Exclusion of Interest Received by Individuals

Generally, under present law, interest income is subject to Federal income taxation.

The bill, S. 246, would provide an exclusion for the first $500 ($1,000 for a husband and wife who file a joint return) of interest earned by an individual on a savings account at a bank, saving and loan association, or a credit union.

The bill, S. 1488, would provide an exclusion from gross income for the amount that eligible interest received by an individual for the taxable year exceeds the amount received for the preceding taxable year. The exclusion would be limited to $500 for each individual taxpayer with respect to deposits or accounts with banks and savings and loan associations (other than money market certificates or negotiable rate accounts).

2. S. 1846—Senator Talmadge

Partial Exclusion of Interest and Dividends Received by Individuals

Under present law, the first $100 of dividends received by an individual from domestic corporations is excludable from gross income. No exclusion is provided for interest received by an individual with respect to savings accounts.

The bill would extend the present dividend exclusion to interest received by an individual on certain savings accounts and increase the total amount excludable to $250 (or $500 in the case of a joint return).

3. S. 541—Senators Baker and Sasser

Election of Estate Tax Alternate Valuation

Under present law, an executor may elect to value assets for estate tax purposes as of the date of the decedent's death or the alternate valuation date which is generally six months after the decedent's death. Alternate valuation must be elected on an estate tax return that is timely filed.

The bill would permit an executor to elect alternate valuation on a timely filed estate tax return or, if no estate tax return is timely filed, on the first estate tax return filed.

Generally, the bill would apply with respect to estates of decedents dying after December 31, 1977. For estates of decedents dying on or before that date, the bill would apply only if an election had been attempted in the first estate tax return filed and if the executor elects the provisions of the bill within 90 days after enactment of the bill.

4. S. 555—Senators Morgan, Baker, Sasser, Percy, Inouye, Schmitt, Mathias, Riegle, McGovern, Ford, Cohen, Pell, Helms, Pressler, Durkin, Cochran, Levin, and Stewart

The Independent Local Newspaper Act of 1979

The bill would allow independent local newspapers to establish tax-exempt trust funds in order to pay the estate taxes of the owners of the paper. Contributions to the trust by the paper would generally be deductible in computing income tax, and interests in the trust would be exempt from the estate tax. In addition, the bill would provide an extended payment period for estate taxes attributable to interests in independent local newspapers.

5. S. 999—Senators Bentsen and Cochran

Interest on Underpayment of Tax

Under present law, interest is payable where the amount of any tax is not paid on or before the last day prescribed for its payment. The bill would excuse the payment of interest due with respect to an underpayment of tax if the failure to pay was due to reasonable cause and not to willful neglect.

6. S. 1543—Senators Nelson and Bentsen

Dividend Reinvestment Plans

Under present law, stock dividends received by shareholders generally are nontaxable. However, a stock dividend is treated as a taxable dividend distribution if the shareholder has the option of receiving cash or other property or, in certain cases, the distribution of stock is disproportionate among shareholders.

The bill would provide an option to exclude from gross income the value of common stock received by a shareholder under a dividend reinvestment plan. The amount excludable annually would be limited to $1,500 ($3,000 in the case of a joint return).

7. S. 1638—Senator Roth

Amortization of Business Startup Costs

Under present law, costs incurred prior to the commencement of a business normally are nondeductible expenses because they are not incurred in carrying on a trade or business. These startup or preopening costs must be capitalized and often cannot be depreciated or amortized because no ascertainable useful life can be established for these costs. However, the capitalized costs may be recovered for purposes of measuring gain or loss upon the disposition or cessation of the business.

The bill would allow an elective 60-month amortization period for certain ordinary and necessary business startup costs which are incurred incident to the investigation, formation, or creation of a trade or business entered into by the taxpayer.

8. S. 1703—Senators Chafee, Cochran, Matsunaga, Moynihan, Jepsen, Ribicoff, Boren, Long, Cranston, Mathias, Wallop, Talmadge, Hatfield, and Baucus

Tax Treatment of Employees of Charities Working Abroad

The bill would allow employees of charitable organizations working abroad to exclude up to $20,000 of foreign earned income annually on the same basis as is now afforded to employees working in camps in hardship areas.

II. DESCRIPTION OF BILLS

1. S. 246—Senator Bentsen; S. 1488—Senator Nelson

Partial Exclusion of Interest Received by Individuals

Present law

Under present law, interest earned on savings accounts is subject to Federal income taxation.

Issue

The principal issue is whether some portion of the interest received by individuals on savings accounts should be excluded from gross income.

If it is decided that a partial exclusion for interest received should be provided, other issues relate to the amount to be excludable and to the types of savings deposits or accounts the interest on which would be eligible for exclusion from gross income.

Explanation of the bills

S. 246

Under the bill, a limited amount of interest received by an individual on certain time or demand deposits would be excludable from gross income. The amount excludable would be limited to $500. In the case of a husband and wife who file a joint return, the excludable amount would be limited to $1,000.

Interest eligible for the exclusion would be amounts received on a time or demand deposit with a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union. However, interest on these deposits would be eligible for the exclusion only if the deposits and accounts of the institution are insured by either the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Administration Share Insurance Fund, or are otherwise insured in accordance with the requirement of the law of the State in which the institution is located.

S. 1488

Under this bill, interest received by an individual on certain savings deposits and withdrawable savings accounts would be excludable only to the extent the amount of qualifying interest received for the taxable year exceeded the amount received for the preceding taxable year. In addition, the amount eligible for exclusion by an individual would be limited to $500.[1] In the case of a husband and wife, each spouse would be entitled to a separate exclusion for interest received on deposits or accounts belonging to that spouse.

In general, interest eligible for the exclusion would be amounts received on a time or demand deposit with a commercial bank, mutual savings bank, savings and loan association, building and loan association, or a similar association. However, interest received on a money market certificate, or an account for which the rate of interest is negotiable, would not be eligible for the exclusion.[2]

Effective date

The provisions of S. 246 would apply to taxable years beginning after December 31, 1978. The provisions of S. 1488 would apply to taxable years beginning after December 31, 1979.

Revenue effect

The bill, S. 246, would reduce budget receipts by $4,161 million in fiscal 1980, by $3,940 in fiscal 1981, by $4,230 in fiscal 1982, by $4,203 in fiscal 1983 and by $4,474 in fiscal 1984.

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[1] As introduced, the bill would have imposed a $100 limit on the proposed interest exclusion. The bill's sponsor, Senator Nelson, has introduced an amendment to the bill which would set the dollar limit at $500. (Printed amendment no. 554, filed October 24, 1979.)

[2] This exception is contained in the amendment offered by the bill's sponsor on October 24, 1979. (Printed amendment no. 554, filed October 24, 1979.)

The bill, S. 1488, would reduce budget receipts by $107 million in fiscal 1980, by $776 million in fiscal 1981, by $833 million in fiscal 1982, by $896 million in fiscal 1983 and by $894 million in fiscal 1984. (These estimates reflect the $500 limit proposed by Senator Nelson in his amendment No. 554, of October 24, 1979.)

Prior Congressional action

In 1974, the Ways and Means Committee reported a bill (H.R. 16994) which provided an exclusion for interest on savings accounts of $500 for an individual ($1,000 in the case of a joint return). No floor action was taken. In July 1979, the Ways and Means Committee agreed to request a modified open rule on H.R. 3712 (the Mortgage Subsidy Bond Act of 1979) from the Rules Committee. The request would have allowed consideration of an amendment providing for a $100 exclusion ($200 in the case of a joint return) for interest earned on savings deposits in financial institutions providing home mortgage loans. The Rules Committee adopted a motion to table the rule on October 23, 1979.

2. S. 1846—Senator Talmadge

Partial Exclusion of Interest and Dividends Received by Individuals

Present law

Under present law, the first $100 of dividends received by an individual from domestic corporations is excludable from gross income. In the case of a husband and wife, each spouse is entitled to a separate exclusion of up to $100 for dividends received with respect to stock owned by that spouse.

No exclusion from gross income is provided under present law for interest received by an individual from banks, savings and loan associations, or credit unions.

Issues

The first issue is whether an exclusion should be provided for interest received by an individual on certain savings deposits and accounts.

The second issue is whether the existing dividends received exclusion (or an expanded exclusion also covering interest received) should be increased.

Explanation of the bill

The bill would extend the exclusion from gross income to interest received by an individual on certain savings deposits or withdrawable savings accounts. In addition, the limit on the aggregate amount of interest and dividends excludable would be increased to $250. In the case of a joint return, the limit would be $500.

Interest eligible for the exclusion would be amounts received on a savings deposit or withdrawable savings account with a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union. However, interest or dividends on such deposits would be eligible for the exclusion only if the deposits or accounts of a bank, association, or credit union, are insured under Federal or State law.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

This bill would reduce budget receipts by $430 million in fiscal 1980, by $3,112 in fiscal 1981, by $3,280 in fiscal 1982, by $3,455 in fiscal 1983, and by $3,379 in fiscal 1984.

Prior Congressional action

In 1974, the Ways and Means Committee reported a bill (H.R. 16994) which provided an exclusion for interest on savings accounts of $500 for an individual ($1.000 in the case of a joint return). No floor action was taken. In July 1979, the Ways and Means Committee agreed to request a modified open rule on H.R. 3712 (the Mortgage Subsidy Bond Act of 1979) from the Rules Committee. The request would have allowed consideration of an amendment providing for a $100 exclusion ($200 in the case of a joint return) for interest earned on savings deposits in financial institutions providing home mortgage loans. The Rules Committee adopted a motion to table the rule on October 23, 1979.

3. S. 541—Senators Baker and Sasser

Election of Estate Tax Alternate Valuation

Present law

Under present law, the executor of a decedent's estate may value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," generally six months after the date of the decedent's death (Code sec. 2032). Alternate valuation provides estate tax relief when property in a decedent's estate declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death or any period of extension granted by the Internal Revenue Service (Code sec. 2032(c)).[1]

Under Code section 6081, the Internal Revenue Service may grant an extension of time to file an estate tax return. Except in the case of taxpayers who are abroad, the Internal Revenue Service has no discretionary authority to grant an extension exceeding six months.

Issue

The issue is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed.

Explanation of the bill

The bill would permit the election of alternate valuation on a timely filed estate tax return or the first late return filed. In the case of a

[1] An executor may elect alternate valuation by checking a box on the second page of Form 706, United States Estate Tax Return. An executor's failure to check the appropriate box on a timely filed Form 706 may not prevent the use of alternate valuation where the entries on the form are otherwise consistent with an election of alternate valuation (Rev. Rul. 61-128, 1961-2 C. B. 150).

timely filed return, an executor would not be permitted to change the election after the due date for the return has passed. In the case of a late return, the election could not be changed after the first return has been filed.

Effective date

The provisions of the bill would apply to estates of decedents dying after December 31, 1977.[2]

The bill includes a transitional rule applicable to estates of decedents dying before January 1, 1978. The transitional rule would permit an effective election of alternate valuation to be made within 90 days after the enactment of the bill, if an election of alternate valuation had been indicated in the first estate tax return filed. If an election is made under the transitional rule, an assessment of a deficiency in tax may be made within 90 days of the election although such assessment is otherwise barred. The transitional rule would benefit the estate of the late Sylvia Buring of Tennessee.

Revenue effect

This bill would have a negligible effect upon budget receipts.

4. S. 555—Senators Morgan, Baker, Sasser, Percy, Inouye, Schmitt, Mathias, Riegle, McGovern, Ford, Cohen, Pell, Helms, Pressler, Durkin, Cochran, Levin, and Stewart

The Independent Local Newspaper Act of 1979

Present law

With respect to a trust established for the purpose of paying estate taxes attributable to an interest in a business (including an independent local newspaper), no provision is presently made under the Code for (1) according tax-exempt status to such a trust, (2) allowing income tax deductions for payments to the trust, or (3) excluding the corpus of the trust from estate taxes.

The Code provides extended payment provisions with respect to the estate tax attributable to interests in closely held businesses (Code secs. 6166 and 6166A).[1]

In addition, provision is made for capital gain treatment of certain

[2] The committee may wish to change the effective date to reflect the passage of time since this legislation was first introduced as S. 3381 in the 95th Congress.

[1] Section 6166 provides a 15-year period for the payment of the estate tax attributable to the decedent's interests in a closely held business (including a farm). Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses.

Section 6166A provides a 10-year extended payment of estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value. Under this 10-year extension, the value of the business must be in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

redemptions of closely held business stock where the redemption is for the purpose of paying estate taxes (Code sec. 303).[2]

Issues

The main issues are (1) whether an independent local newspaper should be permitted to establish a tax-exempt trust to pay estate taxes attributable to the value of an owner's interest in the newspaper, (2) whether the funds contributed to the trust (within prescribed limits) should be deductible by the newspaper and excludable from income by the owner for income tax purposes, (3) whether the value of the trust assets should be excludable from the owner's taxable estate, and (4) whether a 15-year period should be provided for the payment of any estate tax attributable to the value of an interest in the newspaper to the extent the tax was not paid by the trust.

Explanation of the bill

Under the bill, an independent local newspaper could establish a tax-exempt trust to receive payments to pay the estate tax liability of an owner of the newspaper. The newspaper would be allowed an income tax deduction in an amount not to exceed 50 percent of its taxable income for amounts paid to the trust. The trust assets would be required to be invested solely in obligations of the United States. The assets of the trust could be used only to pay the Federal estate taxes of the owner of the newspaper.

The trust would be limited to holding amounts necessary to pay the potential Federal estate tax liability of the newspaper owner. In determining this limitation, the potential estate tax liability of a living individual would be considered to be 70 percent, (i.e., the maximum estate tax rate) of the value of his interest in the business. Under the bill, any interest of a decedent in the trust would generally not be included in the decedent's gross estate.

If the owners of a newspaper which has established a trust for their benefit dispose of their interests in the newspaper, the amounts in the trust must be distributed and included in the owners' income and the deductions previously allowed the newspaper would be recaptured. In addition, if the newspaper is disposed of by an heir within 15 years after the death of the owner, an additional estate tax would be imposed. This tax is phased out after the tenth year following the owner's death.

An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community, or metropolitan area, or, as of January 1, 1979, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on January 1, 1979, and which are not published in a single city, community, or metropolitan area.

Under the bill, payment of any estate tax attributable to the value of an independent local newspaper not paid by a trust established under

[2] To qualify for this treatment, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must be more than 50 percent of the "adjusted gross estate." The value of the stock redeemed can be no greater than the sum of all death taxes (and interest) plus funeral and administration expenses allowable as an estate tax deduction.

the provisions of this bill could be extended for a period of up to 15 years. This provision would apply where the estate does not qualify under existing extended payment provisions of present law.

Under this extended payment provision, the executor could elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first five years, payable at the rate of 4 percent, would be payable annually. Thereafter, the principal amount of the estate tax liability could be paid in from 2 to 10 annual installments. If the business ceases to qualify as an independent local newspaper, the extension would terminate.

Effective date

The provisions of the bill would apply to estates of decedents dying after January 1, 1979.

Revenue effect

This bill would reduce budget receipts by $10 million annually.

5. S. 999—Senators Bentsen and Cochran

Interest on Underpayments of Tax

Present law

Under present law, interest is payable where any tax is not paid on or before the last day prescribed for its payment (Code sec. 6601 (a)). The interest runs on the underpayment from the original due date of the tax to the date on which payment is received. The due date of the tax is determined without regard to any extension of time to file a return or to pay a tax.

Generally, the current interest rate on underpayments of tax is 6 percent. The interest rate may be changed every 24 months, and the rate is based upon 90 percent of the adjusted prime rate of interest charged by banks during the month of September preceding the effective date of the change (Code sec. 6621(b)). As of February 1, 1980, the interest rate is scheduled to be increased to 12 percent.[1] A special 4-percent rate applies with respect to certain estate taxes attributable to a closely held business (sec. 6601(j)).

Present law generally does not authorize any waiver of interest due with respect to underpayments of tax.[2] However, penalties are not applied if the failure to pay is shown to be due to reasonable cause and not due to willful neglect (e.g., sec. 6651(a) (2) and (3)).

Issue

The issue is whether the payment of interest should be excused where an underpayment of tax or a failure to pay tax is due to reasonable cause and not to willful neglect.

Explanation of the bill

The bill would excuse the payment of interest due with respect to an underpayment, or a failure to make payment of tax, if the under-

[1] Rev. Rul. 79-366, issued on October 12, 1979.

[2] Interest may be waived when an employee of the Internal Revenue Service makes a mathematical error in the preparation of a taxpayer's return (Code sec. 6404(d)).

payment or failure to pay was due to reasonable cause and not to willful neglect.

Effective date

The bill would be effective with respect to taxable years beginning after December 31, 1977.

Revenue effect

This bill would reduce budget receipts by $40 million in fiscal year 1980, and by $25 million annually thereafter.

6. S. 1543—Senators Nelson and Bentsen

Dividend Reinvestment Plans

Present law

Under present law, stock dividends received by shareholders generally are nontaxable. However, a stock dividend is treated as a taxable dividend distribution if the shareholder has the option of receiving cash or other property or, in certain cases, if the distribution of stock is disproportionate among shareholders.

In the case of a nontaxable stock dividend, a portion of the shareholder's adjusted basis in the old stock is allocated to the new stock received (sec. 307(a)). For a taxable stock dividend, the shareholder's adjusted basis in the new stock is equal to the fair market value of the stock at the time it is distributed.

For a nontaxable stock dividend, the holding period of the stock received includes the holding period for the old stock with respect to which the distribution was made (sec. 1223(5)). The holding period for stock received in a taxable distribution begins when the stock is distributed.

For purposes of the stock dividend rules, a right to acquire stock generally is treated in the same manner as a stock dividend. However, special basis allocation rules apply to stock rights (sec. 307(b)) and, when a right is exercised, a special holding period rule applies (sec. 1223(b)).

Issue

The issue is whether an exclusion should be provided with respect to "qualified dividend reinvestment plans" under which a shareholder could elect to receive a limited amount of nontaxable common stock dividends instead of receiving cash or other property dividends.

Explanation of the bill

Under the bill, a domestic corporation (other than a regulated investment company) would be allowed to establish a "qualified dividend reinvestment plan" under which any shareholder who chooses to receive a dividend in the form of common stock rather than cash or other property may elect to exclude up to $1,500 per year ($3,000 in the case of a joint return) of these stock dividends from income.

Under the bill, qualified stock must be authorized but unissued common stock designated by the corporation to qualify for this tax exclusion. The number of shares to be issued must be determined by refer-

ence to a value not less than 95 percent of the stock's value on the distribution date. Stock will not qualify where the corporation repurchases any of its common stock within one year after the distribution date, unless a business purpose of repurchasing the stock is established.

Stock received as a qualified dividend will have a zero basis, so that when the stock is later sold, the amount of the sales proceeds will be taken into income at that time. Where the stock is sold within one year after distribution, any gain will be treated as short-term capital gain. In addition, where shares of common stock of the distributing corporation are sold by the shareholder any time within one year following receipt of the stock, the sale will be treated as a sale of the qualified dividend stock.

Effective date

The bill would apply to distributions made on or after January 1, 1980.

Revenue effect

It is estimated that this bill will reduce budget receipts by $240 million in the fiscal year 1980, $718 million in 1981, $925 in 1982, $1,044 in 1983, and $1,035 million in fiscal year 1984.

Prior Congressional action

During markup of the Tax Reduction Act of 1975, the Ways and Means Committee rejected an amendment to authorize dividend reinvestment plans.

7. S. 1638—Senator Roth

Amortization of Business Startup Costs

Present law

In general

Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not currently deductible since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenses or costs incurred in acquiring or creating an asset, *e.g.*, a business, which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

Certain business organizational expenses incurred in the formation of a corporation or partnership may be treated as deferred expenses and amortized over 60 months (secs. 248 and 709). Expenditures eligible for amortization include only those expenditures which are directly incident to the creation of the corporation or business. Preopening or startup expenses, such as employee training expenses, are ineligible for amortization under this provision.

Investigatory expenses

Business investigatory expenses may be of either a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business. All investigatory expenses are costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business.

Business investigatory expenses generally are nondeductible regardless of the status of the taxpayer by whom they may be incurred. However, taxpayers may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business.[1] Nevertheless, business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.

Startup costs

Startup or preopening expenses are those costs which are incurred subsequent to a decision to acquire or establish a particular business, and prior to its actual operation. Generally the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of business operations. These costs may include expenses relating to advertising, employee training, lining-up distributors, suppliers, or potential customers, and professional services in setting up books and records. However, startup expenses also may refer to certain items which are nondeductible and nonamortizable even if they are incurred prior or subsequent to commencement of business operations. These nondeductible and nonamortizable expenses either may be of a purely capital nautre, or may be capitalizable simply because they relate to a business with an indeterminate life.

Issue

The issue is whether "startup" expenses paid or incurred by a taxpayer prior to the active operation of a trade or business should be deductible currently or as deferred expenses over a period of not less than 60 months after the commencement of the trade or business as a going concern.

Explanation of the bill

The bill would allow taxpayers an election to amortize, over a period of not less than 60 months, ordinary and necessary startup costs incurred incident to the investigation, formation, and creation of a trade or business entered into by the taxpayers. The amortization election would apply only to ordinary and necessary startup costs which do not create an asset which has a useful life of its own and which are of a character which would allow the taxpayer to amortize them if they were expended incident to the investigation, formation, and creation of a trade or business having a determinable useful life. The election would apply only with respect to expenditures incurred with

[1] See *Harris W. Seed*, 52 T.C. 880 (1969), *acq.*, 1970-2 C.B. xxi; Rev. Rul. 77-254, 1977 2 C.B. 63.

regard to a business actually entered into by the taxpayer, and would not apply if the business had an ascertainable useful life of less than 60 months. If the business is liquidated prior to the end of the 60-month period, any "startup" expenses which had not been amortized could be deducted to the extent allowed under present law.

Effective date

The bill would apply to amounts paid or incurred after December 31, 1979.

Revenue effect

Due to the lack of adequate information on the number of potential businesses formed or investigated and on the amount of expenses incurred in the process covered by the bill, no revenue estimate is available at this time.

8. S. 1703—Senators Chafee, Cochran, Matsunaga, Moynihan, Jepsen, Ribicoff, Boren, Long, Cranston, Mathias, Wallop, Talmadge, Hatfield, and Baucus

Tax Treatment of Employees of Charities Working Abroad

Present law

In general

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. (The term "charitable" as used in this explanation includes educational, religious, scientific, literary, etc., purposes for which an exemption is allowed under section 501(c)(3).) In addition, the Act would have made certain modifications in the computation of the exclusion. The Act provided that any individual entitled to the earned income exclusion was not to be allowed a foreign tax credit with respect to foreign taxes allocable to the amounts that were excluded from gross income under the earned income exclusion. Also, the Act provided that any additional income derived by individuals beyond the income eligible for the earned income exclusion was subject to U.S. tax at the higher rate brackets which would apply if the excluded earned income were not so excluded (i.e., the exclusion was "off the bottom").

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. (The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.) However, because the provisions of the 1978 Act were effective on January 1, 1978, and the Act did not become law until November 8, 1978, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under prior law (the exclusion as amended by the Tax Reform Act of 1976) so that the 1978 Act would not have any mandatory retroactive effect. It was anticipated that this election would be of particular interest to employees of domestic charitable organizations, since under the 1976 Act they would continue to be eligible for a $20,000 exclusion, even though it would be subject to the new computation rules of the 1976 Act.

Excess living cost deduction

The new excess living cost deduction (new sec. 913) provided by the 1978 Act consists of separate elements for the general cost of living, housing, education, and home leave costs. Employees of charitable organizations are allowed these deductions on the same basis as other individuals. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14 step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach fare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

Hardship area exclusion

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. Lodging is not a "camp" unless it is substandard lodging which is (i) provided by or on behalf of the employer for the convenience of the employer because the place at which the individual renders services is in a remote area

where satisfactory housing is not available on the open market; (ii) located, as near as practicable, in the vicinity of the place at which the individual renders services; and (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees. The term "hardship area" has the same meaning for purposes of this provision as for the deduction for excess foreign living costs (sec. 913).

Charitable services

In many instances, an exclusion of earned income is of little consequence to Americans working abroad because the credit allowed for foreign income taxes imposed on the earnings may entirely or substantially offset the U.S. tax due on the income. However, certain charitable employees working abroad are exempt from foreign tax. This is the case, for example, for certain educators under a number of tax treaties between the United States and foreign countries.

Issue

The issue is whether employees of charitable organizations should be permitted to elect the same treatment under the 1978 Act as employees who reside in camps located in hardship areas, i.e., a $20,000 annual exclusion in lieu of the excess foreign living cost deductions.

Explanation of the bill

The bill would allow individuals meeting the foreign residence or presence tests who perform "qualified charitable services" to elect, in lieu of the deduction for excess foreign living costs, an exclusion of $20,000 from gross income on the same basis as employees residing in camps in hardship areas. "Qualified charitable services" are defined to mean services performed by an employee for an employer which meets the requirements of section 501(c)(3).

In the event that an individual resides in a camp in a hardship area for part of the taxable year and performs qualified charitable services for another part of the year, the $20,000 limitation applicable to the amount excludable as a camp employee would be reduced by the amount excluded as a charitable employee.

The treatment afforded by the bill is similar to the treatment afforded to charitable employees under the 1976 Act in that in each case the employee is entitled to exclude up to $20,000 of foreign earned income. It differs from the 1976 Act in that (i) it is available to employees of any organization qualifying for exemption under section 501(c)(3), whether the organization is foreign or domestic, (ii) the exclusion is "off the top," rather than "off the bottom," and (iii) the employee may elect the deduction for excess foreign living costs, if that is more favorable.

Effective date

The bill would apply to taxable years beginning after December 31, 1978.

Revenue effect

This bill would reduce budget receipts by $39 million in fiscal 1980, by $28 million in fiscal 1981, by $30 million in fiscal 1982, by $33 million in fiscal 1983, and by $36 million in fiscal 1984.

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Supplement to Description of Tax Bills Listed for a Hearing

I. SUMMARY

1. S. 1542—Senator Percy

Partial Exclusion of Interest Received by Individuals and Partial Exclusion for Reinvestment of Interest and Dividends

Under present law, the first $100 of dividends received by an individual from domestic corporations is excludable from gross income. No exclusion is provided for interest received by an individual with regard to savings accounts.

The bill would provide an exclusion for the first $100 of interest received by an individual on a savings account at a bank, saving and loan association, or credit union.

The bill would also provide (1) an exclusion of up to $400 for interest reinvested, and (2) an exclusion of up to $400 for dividends reinvested. Eligible amounts must be reinvested in qualifying savings accounts or in stock of domestic corporations. No amount of interest or dividends would be eligible for exclusion if the amount invested at the end of the taxable year by a taxpayer did not equal or exceed the amount invested at the beginning of the year plus excludable reinvestment income.

2. S. 1697—Senator Weicker

Election of Partial Exclusion of or Credit for Interest Received by Individuals

Under present law, interest earned on savings accounts is subject to Federal income taxation.

The bill would provide an election individuals (1) to claim a credit against income tax liability of up to $250 for interest received from a residential financial institution, or (2) to exclude up to $1,000 of interest received from a residential financial institution.

II. DESCRIPTION OF BILLS

1. S. 1542—Senator Percy

Partial Exclusion of Interest Received by Individuals and Partial Exclusion for Reinvestment of Interest and Dividends

Present law

Under present law, the first $100 of dividends received by an individual from domestic corporations is excludable from gross income. In the case of a husband and wife, each spouse is entitled to a separate exclusion of up to $100 for dividends received with respect to stock owned by that spouse.

No exclusion from gross income is provided under present law for interest received by an individual from banks, savings and loan associations, or credit unions.

Issues

The first issue is whether an exclusion should be provided for interest received by an individual on certain savings deposits and accounts. The second issue is whether there should be provided an exclusion from gross income for a portion of dividends or interest received by an individual which is reinvested in stock or redeposited in a savings account.

Explanation of the bill

In general

The bill would provide an exclusion from gross income for interest received by an individual. The limit on the aggregate amount of interest excludable would be $100 plus an additional amount not in excess of $400 each for certain reinvestments of dividend or interest income.

$100 interest exclusion

The bill provides that the first $100 in eligible interest received by an individual for a taxable year would be excludable from gross income. Interest eligible for the exclusion would be amounts received on a time or demand deposit with a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union. However, interest on such

deposits would be eligible for the exclusion only if the deposits or accounts of a bank, association, or credit union, are insured under Federal or State law.

Interest reinvestment exclusion

The bill also provides an exclusion from gross income for interest which is reinvested in time or demand deposits in a qualifying institution or in stock of a domestic corporation. As under the proposed $100 exclusion, a qualifying financial institution for this purpose would include a commercial or mutual savings bank, a savings and loan association, building and loan association or similar association, and a credit union insured under Federal or State law. The reinvestment exclusion applies only if the interest received is reinvested promptly upon actual or constructive receipt.

The exclusion for reinvestment would be limited to $400. In addition, this exclusion would not be allowed for any amount if the net investment limitation described below is not satisfied.

Dividend reinvestment exclusion

The bill provides an exclusion from gross income for dividend distributions from domestic corporations which are reinvested in common or preferred stock in a domestic corporation or in time or demand deposits in a qualifying financial institution. This exclusion for reinvestment would be limited to $400 and would be in addition to the $100 exclusion under present law. In addition, this exclusion would not be allowed for any amount if the net investment limitation described below is satisfied.

Net investment limitation

No amount of dividends or interest would be eligible for the reinvestment exclusions if a net investment limitation is not satisfied. For this purpose, a taxpayer's investment base at the end of the taxable year must equal or exceed the sum of the investment base at the beginning of the taxable year and the amount of dividends and interest which would be otherwise excludable from gross income under the reinvestment provisions. The investment base would mean an amount equal to the sum of (1) the taxpayer's adjusted basis in stock issued by a domestic corporation and (2) the amount of money in all time or demand deposits in a qualifying financial institution.[1]

Effective date

The amendments made by the bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

This bill would reduce budget receipts by $332 million in fiscal 1980, $2,406 million in fiscal 1981, $2,565 million in fiscal 1982, $2,731 million in fiscal 1983, and $2,673 million in fiscal 1984.

2. S. 1697—Senator Weicker

Election of Partial Exclusion of or Credit for Interest Received by Individual

Present law

Under present law, interest earned on savings accounts is subject to Federal income taxation.

Issue

The issue is whether an election should be provided to individuals to exclude from gross income the first $1,000 of interest earned on certain savings accounts or, alternatively, to claim a dollar-for-dollar credit for interest earned on savings accounts up to $250.

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[1] The committee may wish to consider a number of possible technical problems if this proposal is marked up. For the net investment limitation, the committee may wish to consider if the adjusted basis of all stocks should be taken into account without regard to manner of acquisition, e.g., purchases from related parties, margin purchases, gifts, inheritances, installment purchases, taxable stock dividends, and contributions to capital. In addition, the committee may wish to refine the concept of eligible dividends, e.g., cash or property, dividend income from a preferred stock bailout, undistributed taxable income of a subchapter S corporation, and dividend treatment arising from a one-month liquidation. The committee may also wish to consider possible exceptions for distributions received from certain corporate entities, e.g., personal holding companies, mutual funds, and subchapter S corporations.

With respect to savings investments, the committee may wish to consider refinements of the interest reinvestment exclusion so that debts incurred for funds transferred at the end of a taxable year to eligible accounts would not be reflected in the determination of the *ending investment* base.

Explanation of the bill

The bill would provide an election to individuals (1) to exclude from gross income a portion of interest earned on savings in a residential financial institution or (2) to claim a credit on a portion of such interest.

The amount of the credit would be equal to the amount of interest received by an individual on qualifying savings but the credit could not exceed $250 for a taxable year. No special rules are provided with respect to a joint return. Thus, each spouse would be eligible for a separate election. In addition, the credit could be used to offset tax liability after reduction for all other credits which are not treated as tax payments. No tax refund would be allowable for the amount by which this credit exceeds the net tax liability.

The amount of the exclusion would be equal to the amount of interest received by an individual on qualifying savings but could not exceed $1,000 for a taxable year.

Interest eligible for the credit or exclusion would be amounts received on savings in a residential financial institution. Only such amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares by commercial or mutual savings banks, savings and loan associations, buildings and loan associations, or similar associations and credit unions would be eligible for the credit or exclusion.

Effective date

The amendments made by this bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

This bill would reduce budget receipts by $1,195 million in fiscal 1980, $8,688 million in fiscal 1981, $9,341 million in fiscal 1982, $10,043 million in fiscal 1983, and $10,014 million in fiscal 1984.

REVISED REVENUE ESTIMATES FOR BILLS

These are revised fiscal year revenue estimates for bills scheduled for a hearing on October 31, 1979.

FISCAL YEARS—IN MILLIONS OF DOLLARS

	1980	1981	1982	1983	1984
S. 1488	172	1,255	1,347	1,443	1,432
S. 1846	307	2,224	2,342	2,468	2,414

STATEMENT OF SENATOR LLOYD BENTSEN

This afternoon the Tax Subcommittee of the Senate Finance Committee is holding hearings on several tax bills including two of my proposals.

My first bill, S. 246, would provide tax relief to small savers by giving individuals a tax exemption on the first $500 of interest earned from a savings account at a bank, savings and loan association or credit union. The exemption would be $1000 for a husband and wife who make a joint return. The second bill, S. 999, would excuse the payment of interest due with respect to a late payment of tax if there was reasonable cause. This bill is of particular importance to residents of Wichita Falls, Texas who were hit by devastating tornadoes just before April 16.

My savings proposal which has 19 Senate cosponsors will help those Americans who rely upon their small savings for emergency purposes. This bill will help protect the erosion of savings by inflation. The cosponsors include Senators Matsunaga, Boren, Baucus, Ford, Hollings, Stone, Morgan, Burdick, DeConcini, Zorinsky, Tower, Lugar, Pressler, Schmitt, Thurmond, Young, Armstrong, Garn and Boschwitz.

Due to inflation, individuals actually receive a "negative" rate of return on savings deposits. A tax on the interest received further penalizes the consumer who has already been hurt by inflation. The money deposited in a savings account has been taxed at the time the individual earned the income. A second tax can be harsh.

Our tax laws have penalized savings and investment and this has contributed to lagging productivity and high rates of inflation. The United States has a very poor record of savings compared to other industrialized nations. The U.S. rate of savings as a percentage of disposable national income in 1976 was only 4.8 percent com-

pared to a rate of 6.6 percent in the United Kingdom, 13.1 percent in France, 13.2 percent in Germany, 17.2 percent in Switzerland, and 25.3 percent in Japan.

The percentage of disposable income that Americans saved during the third quarter of 1979 fell to the lowest quarterly figure since 1951, according to figures released by the Commerce Department. The national savings rate during the July-September period declined sharply from 5.4% to 4.1%. The last time the savings rate was that low was the first quarter of 1951, when it fell to 3.7%.

Michael Boskin, Professor of Economics at Stanford University, who supports my savings exclusion proposal states:

"There is no greater problem facing the U.S. economy today than our extremely low rate of saving and closely related low rate of investment."

Professor Boskin goes on to state: "There is no more urgent legislation than to gradually shift to a system that would promote, rather than destroy, the incentive to save."

A recent *Wall Street Journal* article on the savings rate in West Germany points out that the funds made available by savings in that nation have helped push productivity ahead at a faster rate in Germany than in any other Western nation.

My other bill, S. 999, would provide equity to victims of natural disaster such as in Wichita Falls, Texas who were unable to complete their tax returns on time due to exceptional circumstances.

Statement of Senator Dole

Mr. Chairman, the assortment of bills listed for the hearing today addresses many problems of vital concern to various groups, from the independent newspapers struggling to survive, to charities operating abroad. I look forward to the elucidation on these bills that witnesses will hopefully provide.

Mr. Chairman, I am particularly interested in the bills that proposed a partial exclusion of interest from taxable income. These bills are aimed at giving a much needed boost to personal savings in the United States. In my judgment, personal savings in this country has dropped to a disastrously low level. In recent years, the personal savings rate in the United States had fallen far behind the saving rates of our major industrial competitors. As a percentage of individual income, United States' citizens save only about 6.5%, whereas, the savings rate in Japan is close to 25%, in West Germany 13%, and in the United Kingdom 13%. As a consequence of this low savings rate, we simply do not have the capital that industry needs to modernize, expand and compete internationally.

Thus, there is critical need for developing greater incentives for personal savings. Obviously, the corrosive effects of the Nation's uncontrolled inflation is perhaps the single greatest obstacle to increasing personal savings. It is difficult to motivate people to put their money in 5.5% savings account when inflation is raging at 13 percent. Consequently, to induce more savings we first need to bring inflation under control.

Even if a solution to the inflation problem eludes us, we should be able to spur greater savings by enacting some form of savings tax incentive, such as one of the bills considered here today.

Mr. Chairman, in addition to the savings bill specifically listed for the hearing today, I would hope that the witnesses might address the saving incentive provisions of S. 1697, the savings and investment encouragement act of 1979. This bill was introduced on July 30, 1979 with 41 cosponsors, every Republican in the Senate. The savings provisions of S. 1597 are identical to S. 1542, which was introduced by Senators Percy and Danforth. In light of the savings bills considered here today, and the others which have been introduced, it is clear that many democrats share the Republicans' strong support for enactment of some form of saving incentives.

Statement by Senator Dave Durenberger

Several months ago, when the Disability Insurance Reform Amendments appeared to be stalled in the house, I introduced legislation, S. 1643 which incorporated one section of the amendments. My bill was prompted by a concern about the disincentives in current law which inhibit the severely disabled from returning to work. Some argue that the disabled do not return to work because the disability programs provide so much in income that they have no incentive to seek gainful employment. I am not convinced that this is the case. The real problem lies in the fact that if a disabled person dares to rehabilitate themselves and seek work, that person is immediately cut-off from the benefits which they received while disabled.

The most serious drawback is the loss of Medicare benefits. The bill I introduced would correct that problem by providing for a continuation of benefits.

Experts in the field of rehabilitation know the value of employment for the disabled person. They also know the difficult problems that exist for the disabled person who seeks a job and, in so doing, jeopardizes the necessary health and financial benefits he or she receives under the various public and private programs.

Widely recognized and most important is the fact that Social Security programs, which provide monthly payments and medical protection, include highly restrictive provisions that discourage and often prevent people from attempting gainful work. Examples of these inhibitive provisions are:

The low earning level constituting substantial gainful activity;

Two consecutive years of receiving Social Security disability benefit required for medicare eligibility;

One trial work period lasting nine months, and applicable once in a person's lifetime; and

Re-entitlement to financial and medical benefits necessitates a second waiting period, similar to the initial entitlement to benefits.

We can and must do more for people who are disabled. We must change the restrictive provisions and promote improvements in the law to encourage employers to provide employment alternatives to severely disabled persons. These programs can be successful ventures for both the employer and employee, as one example demonstrates.

In January, 1978, Control Data Corporation, headquartered in Minneapolis, developed Project "HOMEWORK." HOMEWORK is a homebound employment program made possible through Control Data's computer-based education system called PLATO. Through "HOMEWORK," a select group of Control Data's permanently and totally disabled employees have re-entered the world of work.

Due to the encouraging results of the HOMEWORK experiment within Control Data, other major corporations within the United States have expressed an interest in having Control Data help them establish a HOMEWORK program for their company's disabled employees.

The most significant obstacle HOMEWORK has encountered since its inception is the disincentives currently contained in the Social Security regulations and law. Even though each HOMEWORK has been declared permanently and totally disabled by Social Security, the mere fact that each person attempts to work potentially leads to a discontinuation of all financial and medicare benefits.

Today, we are fortunate to have Gary Lohn, representing Control Data, testifying before the committee. Control Data has undertaken an important social service, and I would like to strongly associate myself with this effort.

STATEMENT OF WILLIAM V. ROTH, JR.

Mr. Chairman, I want to thank you for holding hearings on S. 1638 is to encourage persons to enter new businesses and to help them succeed.

S. 1638 corrects an inequity in the present law by permitting amortization of certain start-up costs. Start-up costs (costs incurred in preparing a business to open) that do not create an asset having a useful life of its own must be capitalized as part of the cost of the business. Usually, businesses do not have an ascertainable life, and therefore, these capitalized start-up costs cannot be recovered through depreciation. In fact, such start-up costs cannot be recovered until disposition of the business. The start-up expenses covered in S. 1638 are the ordinary and necessary expenses incident to the investigation, formation, and creation of a trade or business.

The inability to meaningfully deduct start-up costs puts new businesses in an unfair tax bind. In commercing operations, new businesses can incur exactly the same expenses as an ongoing business, yet new businesses cannot use these expenses to offset any income as would an ongoing business. For example, an ongoing business can deduct rent, supplies' costs, minor structural costs, telephone bills, insurance bills and similar business expenses under Section 162. A business preparing to open will incur the same expenses but cannot deduct them. A business preparing to open will capitalize these costs and cannot recover them until the business' last year of operation.

It is will known that many businesses fail each year. Dun and Bradstreet reported that of the businesses failing in 1977, over half, 53.1 percent, were in their first five years of operation. Many businesses never overcome the initial expenses of commencing business. The current tax laws relating to start-up costs are a deterrent to entering a business and reduce the chances of survival. The tax laws do not

encourage investigation of new enterprises nor do the tax laws adequately relieve the initial burden of starting a business. Businesses with an indeterminable life should not have to wait until liquidation or disposition to recover their ordinary and necessary start-up expenses.

S. 1638 provides a meaningful deduction for start-up costs. Under this bill, pre-opening expenses that relate to the business but do not create an asset having a useful life of its own can offset income of the business once it begins functioning as a going concern. The bill recognizes the conflict between deduction and capitalization of expenses of a self-created asset. S. 1638 provides a five year amortization period for start-up costs, not a current deduction. Although this treatment does not equalize the tax treatment between ordinary and necessary expenses for an ongoing business and ordinary and necessary expenses of a taxpayer starting a business, it does provide for recovery of start-up costs during the crucial young years of a business.

To be administrable and to prevent abuse, this provision pertains only to pre-opening expenses of the trade or business actually entered. Investigatory expenses, like other ordinary and necessary pre-opening expenses, fall within this provision only if they directly relate to the culminated business.

S. 1638 does not apply to the costs of acquiring an ongoing business because those costs are not incurred or paid before the acquired business functions as a going concern. Acquiring an existing business, however, should not be confused with a business expanding into an unrelated field. The latter case is covered by this bill.

The present treatment of costs of beginning business places new businesses in a tax bind. Given the high failure rate of new businesses, reasonable tax relief must be provided for start-up costs. In light of our need for real economic growth and increased productivity, S. 1638 is a timely and necessary bill.

I would like to include in the Record an article published in Taxes which more fully analyzes this subject matter and bill.

Tax Relief for New Businesses: Equitable Treatment of Start-Up Costs

By DAVID B. SHARP *

This article explores the tax treatment of pre-opening outlays for a new trade or business and proposes an amendment to the Internal Revenue Code to permit the meaningful deduction of such expenditures. The presently inadequate tax treatment of pre-opening costs discourages the starting of businesses as well as increases the failure rate of businesses. Inadequate tax treatment results when the pre-operating costs chargeable to capital account cannot be amortized because the business does not have an ascertainable life.[1]

I. Pre-opening Phase

The pre-opening stage of a business is divided into (A) Investigation Phase and (B) Start-Up Phase. As there is no difference in tax treatment between successful investigatory expenses and most start-up costs, timing, not tax treatment, is the basis for this division.

A. Investigation Phase.—Investigatory expenditures are the costs of examining business prospects prior to reaching a firm decision to enter a particular business. In this phase, an individual, inter alia, investigates potential markets,

* The views expressed are those of the author and do not necessarily represent the views of any other person or group.

[1] No depreciation (amortization) will be allowed unless the asset has a limited and determinable life. 4 Mertens, *Law of Federal Income Taxation*, § 23.12.

business sites, and the availability of venture capital. During this period, the prudent businessperson studies several business opportunities before making a final decision.

Investigatory expenses of a taxpayer not in a trade or business cannot be deducted under Section 162.[3] Section 162 allows as a deduction all ordinary and necessary expenses paid or incurred within the taxable year and incurred in carrying on a trade or business.[4] The courts' and the IRS's strict interpretation of the incurred-in-carrying-on-a-trade-or-business requirement prohibits deducting expenses incurred before the business commences operations.[5]

Unsuccessful investigatory expenses (investigatory expenses not pertaining to a business) cannot be capitalized as there is nothing against which the taxpayer may capitalize them. Furthermore, unsuccessful investigatory expenses of a noncorporate taxpayer are not deductible as a loss under Section 165[6] because an investigation for a business is generally not viewed as a transaction entered into for profit.[7]

Successful investigatory expenditures are capitalized as part of the cost of the business.[8] Normally, such outlays cannot be amortized because the life of a business cannot be determined.[9]

Section 212(1) allows an individual to deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.[9] Judicial precedent prohibits expenses from being deducted under Section 212(1) until the individual has a proprietary or possessory type interest in the business (income-producing property).[10] Thus, courts, by definition, have made investigatory expenses nondeductible under Section 212(1).

Existing tax treatment of investigatory expenditures incurred by persons not already in business deters one from thoroughly searching for and examining possible business sites and markets.[11] In view of the high failure rate of new companies, tax laws should promote, not impede, a deliberate selection process of potential business ventures.[12]

Moreover, in their treatment of investigatory costs, tax laws favor existing businesses.[13] Expenses of an operating enterprise interested in expansion can be deducted under Section 162, provided the expansion relates to the enterprise's economic activities.[14] In addition, a corporate taxpayer is permitted to deduct unsuccessfully investigatory expenses as a loss under Section 165.[15]

B. Start-Up Phase. The time between the firm decision to establish a business and the actual start of the business is the start-up phase. Interest, taxes, expenses for tax advice, and organizational expenditures are discussed separately because they are specifically deductible under the tax laws.

1. *Interest and Taxes.*—In *Commissioner v. Idaho Power Co.*, 418 U. S. 1 (1974), the Court held that the taxpayer was not entitled to a current depreciation deduction on transportation equipment to the extent such equipment was used in the construction of the taxpayer's own capital assets. The Supreme Court noted that Section

[3] Section references are to the Internal Revenue Code of 1954, as amended.

[4] "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." I. R. C. § 162(a).

[5] See *Frank B. Polachek*, CCH Dec. 20,453, 22 TC 858 (1954); *Morton Frank*, CCH Dec. 19,702, 20 TC 511 (1953); *George C. Westervelt*, CCH Dec. 15,850, 8 TC 1248 (1947); and Rev. Rul. 73-421, 1973-2 CB 33.

[6] "In the case of an individual, the deduction (for a loss) shall be limited to . . . , losses incurred in any transaction entered into for profit, though not connected with a trade or business. I. R. C. § 165(c)(2).

[7] Although it is difficult to precisely determine when an investigating individual enters into a transaction for profit, clearly general investigatory expenses cannot be deducted under Sec. 165. See Rev. Rul. 77-254, 1977-2 CB 63; compare *Harris W. Seed*, CCH Dec. 29,719, 52 TC 880 (1969), acq., 1970-2 CB xxi with *Joseph W. Brown*, CCH Dec. 26,260, 40 TC 861 (1953).

[8] See Rev. Rul. 74-104, 1974-1 CB 70; and Rev. Rul. 73-421, footnote 4, above. Cf. *KWTX Broadcasting Co.*, CCH Dec. 23,436, 31 TC 952 (1959); and *Radio Station WBIR*, CCH Dec. 23,416, 31 TC 803 (1959) (both involved capitalizing costs of obtaining an FCC license).

[9] See *Mid-State Products Co.*, CCH Dec. 20,157, 21 TC 696 (1954).

[9] "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income . . ." I. R. C. § 212(1).

[10] See *Weinstein v. United States*, 70-1 USTC ¶ 9190, 420 F. 2d 700 (Ct. Cls.); *Eugene Walet, Jr.*, CCH Dec. 23,838, 31 TC 461 (1958), aff'd per curiam, 60-1 USTC ¶ 9121, 272 F. 2d 694 (CA-5 1959); and *Morton Frank*, CCH Dec. 19,702, 20 TC 511 (1953).

[11] P. Galvin, "Investigation and Start-Up Costs: Tax Consequences and Considerations for New Businesses," 56 TAXES—*The Tax Magazine* 413-417 (1978).

[12] Of the businesses failing in 1977, over half, 53.1 percent, were in their first five years of operation. Dun & Bradstreet, "The Business Failure Record" (1978).

[13] This encourages an investigating taxpayer to form a corporation to search for new businesses simply to enable the shareholder(s) to recoup the expenses of unsuccessful searches. Ordinary loss deductions may be obtained through the sale of 1244 stock or the passing through of Subchapter S corporate operating losses.

[14] See Reg. § 1.162-1(a); and compare *York v. Commissioner*, 58-2 USTC ¶ 9952, 261 F. 2d 421 (CA-4) with *Mid-State Products Co.*, CCH Dec. 20,157, 21 TC 696.

[15] See Rev. Rul. 74-104, 1974-1 CB 70, and Rev. Rul. 73-586, 1973-2 CB 86.

161 [14] provides, with stated exceptions, that an expenditure incurred in acquiring (or creating) an asset must be capitalized under Section 263(a)[15] even when the expenditure might be deemed deductible under Part VI (Sections 161 to 192).[16] Therefore, a deduction expressly granted by law can be deferred if related to a self-constructed item.[17]

Although the *Idaho Power* case involved the capitalization of depreciation deductions for an existing company, notionally the decision is significant to the tax treatment of taxes and interest paid or accrued during the pre-operating stage. One could argue that if depreciation on construction equipment should be assimilated into the cost of a created asset so should interest on the loan financing the creation of an asset. Given the *Idaho Power* case, interest paid or accrued on indebtedness incurred to begin a business and taxes paid or accrued while establishing a business should not be considered automatic deductions just because interest and taxes are specifically enumerated deductions.

However, a persuasive argument can be made that interest and taxes need not be capitalized under Section 263(a) as part of the cost of the business. First, since the Court did not address the general issue of capitalization versus deductibility of construction-related expenses, the *Idaho Power* decision does not mean that all such expenses must be capitalized.

Second, interest and taxes paid or accrued to establish a business do not represent anything paid into the business.[18] Amounts paid for interest and taxes attributable to the formation of a business are too incidental to be assimilated into the cost of the business. Consequently, Sections 189 and 266 had to be enacted if interest and taxes were to be capitalized.[19] It can be inferred that without Sections 189 and 266 taxpayers would have to deduct interest and taxes. Section 266 allows a taxpayer to elect to capitalize taxes and interest rather than deduct them.[20] The enactment of Section 189,[21] which forces certain taxpayers to capitalize construction period interest and taxes, indicates that interest and taxes are not to be capitalized without a Code section so stating.

Furthermore, the regulations promulgated under Section 163 state, "except as otherwise provided in Sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income." [22] Since Section 263 is excluded, interest should not be capitalized under that section.

Irrespective of the correctness of the above argument, it is doubtful that the IRS would actively pursue this issue because interest paid on an indebtedness incurred to establish a business is analogous to interest paid on a home mortgage. Forcing the capitalization of interest under Section 263(a) in the former example and not in the latter would be inconsistent. Requiring the capitalization of home-mortgage interest under Section 263(a) would achieve consistency, but it would never be tolerated by Congress.

2. *Expenses for Tax Advice.*—Section 211 is the counterpart of Section 161 for Part VII (Sections 211 to 220) of the Code.[23] Therefore, Section 263 has priority over any Part VII deduction.

A person seeking a suitable business entity incurs attorney or accountant fees. Under Section 212(3),[24] an individual's fee for consultation concerning the tax consequences of the business's

[14] "In computing taxable income under Section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX . . . ." I. R. C. § 161.

[15] "No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." I. R. C. § 263(a)(1).

[16] *Commissioner v. Idaho Power Co.*, 74-2 USTC ¶ 9521, 418 U. S. 1, 17.

[17] See Id.; but see *All-Steel Equipment Inc.*, CCH Dec. 30,353, 54 TC 1749 (1970), rev'd on other grounds, 72-2 USTC ¶ 9660, 467 F. 2d 1184 (CA-7).

[18] Cf. *Westerfield v. Rafferty*, 1 USTC ¶ 109, 4 F. 2d 590 (DC N. Y. 1925) (court held that taxes and interest attributable to real property could not be capitalized).

[19] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, at 25 (1976) (amounts paid for interest and taxes attributable to the construction of real property were, prior to the enactment of Sec. 189, allowable as current deductions).

[20] "No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as . . . are chargeable to capital account . . . if the taxpayer elects . . . to treat such taxes or charges as so chargeable." I. R. C. § 266.

[21] "(I)n the case of an individual, an electing small business corporation . . . or personal holding company . . . no deduction shall be allowed for real property construction period interest and taxes." I. R. C. § 189(a).

[22] Reg. § 1.163-1(a).

[23] "In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX . . . ." I. R. C. § 211.

[24] "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(3) In connection with the determination, collection or refund of any tax." I. R. C. § 212(3).

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formation is deductible.[87] In light of the *Idaho Power* decision, it is arguable that this fee, like interest and taxes, should be assimilated into the cost of the business. However, the cost of tax advice need not be capitalized because it is so incidental to the creation of the business.

3. *Organizational Expenditures.*—Corporate organizational expenditures are the cost incident to the creation of the corporation, chargeable to the capital account, and amortizable over the life of the corporation if that life is determinable.[88] If the corporation so elects, Section 248 allows it to amortize organizational costs over a five-year period. Since investigatory and start-up expenditures are costs incidental to the creation of the corporation and meet the other two definitional requirements, it might be argued that Section 248 covers those costs. However, the regulations limit the scope of Section 248 to those expenses incurred in forming the corporate shell.[89]

Section 709 allows for the amortization of partnership organizational costs.[90] These costs include legal fees for drafting the partnership agreement and necessary accounting fees.

There is no similar provision for a noncorporate and nonpartnership business entity. Such a business entity would have nominal organizational costs, such as accounting fees and perhaps fees for local license and title.

Organizational expenditures, like successful investigatory and start-up costs, are not deductible for two reasons. First, organizational expenses cannot be deducted because they are pre-operating expenses[91] Second, they are considered part of the cost of creating an asset, the business, which assuredly has a useful life of at least several years.[92] Therefore, organizational expenditures should be capitalized, and without a Code section providing for an amortization period, they normally could not be amortized.

4. *Remaining Start-Up Costs.*—Remaining start-up costs include management fees, rents, surveys, appraisals, insurance, utilities, advertising, and other routine expenditures that do not create an asset other than the business.

Only expenses incurred in carrying on a trade or business are deductible under Section 162.[93] To ensure that an expense was incurred in carrying on a business, courts must determine when the business started. Most courts accept the starting date to be when the business begins functioning as a going concern and performs those activities for which it was organized.[94] However, one court also required the taxpayer to have the motive and intention of realizing a profit,[95] and at least one court considered the act of incorporation to be the start of business.[96] Except in the latter case, start-up costs by definition cannot be deducted under Section 162 as they are incurred before the business functions as a going concern.[97]

The little authority there is on this issue indicates that start-up expenses cannot be deducted under Section 212(1) because an individual does not have a sufficient interest in the business until it is established.[98] Inasmuch as the courts' existing-interest test, which determines if a deduction is allowed under Section 212(1), is similar to the condition that the business functions as a going concern before a deduction is allowed under Section 162,[99] start-up costs do not fall within the scope of Section 212(1).

Even if an individual is considered to have a proprietary or possessory type interest in the business during the start-up phase, start-up expenses are still nondeductible. The denial of deductibility to start-up (and successful investigatory) expenses is consistent with the general tax principle of capitalizing an expenditure paid or incurred to acquire or create an asset that has an economically useful life beyond the tax-

[87] Cf. *Kaufmann v. United States*, 64-1 USTC ¶ 9235, 227 F. Supp. 807 (DC Mo. 1963) (advice for tax consequences of a reorganization held to be deductible under Sec. 212(3)).

[88] "The organizational expenditures of a corporation may, at the election of the corporation . . . be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation . . . ." I. R. C. § 248.

[89] See Reg. § 1.248-1(b)(2).

[90] Amounts paid or incurred to organize a partnership may, at the election of the partnership . . . be treated as deferred expenses. . . ." I. R. C. § 709(b).

[91] See *Commercial Investment Trust Corp.*, CCH Dec. 8069, 28 B. T. A. 143 (1933), aff'd per curiam, 74 F. 2d 1015 (CA-2 1935).

[92] See *Jackson E. Cagle, Jr.*, CCH Dec. 32,828, 63 TC 86 (1974); and *W. P. Brown and Sons Lumber Co.*, 26 B. T. A. 1192 (1932), app. dismissed, 68 F. 2d 1022 (CA-6 1934); and Rev. Rul. 75-214, 1975-1 CB 185 (the first and third holdings involved partnership organizational expenses and led to the enactment of Sec. 709).

[93] See *Morton Frank*, footnote 4, above.

[94] See *Richmond Television Corp. v. United States*, 65-1 USTC ¶ 9395, 345 F. 2d 901 (CA-4).

[95] See *Edwin Miner*, CCH Dec. 25,665(M), 21 TCM 1173 (1962).

[96] See *Southern Express Co.*, 19 B. T. A. 490 (1930).

[97] But see J. Sylva, "Tax Planning: Raising the Case Again for Deductibility of Promotional Expenses," 57 TAXES—*The Tax Magazine* 456 (1979).

[98] See Rev. Rul. 73-421, footnote 4; see also *Weinstein v. United States*, footnote 10, above.

[99] See A. Fleischer, Jr., "Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment," 14 *Tax Law Review* 581 (1959).

able year.[40] Although in creating an asset it is not always clear which expenses require capitalization,[41] start-up (and successful investigatory) outlays should be assimilated into the cost of the business.[42] However, they cannot be recovered through amortization if the business has an indeterminable life,[43] which is almost always the case. This results in a business's inability to recoup such costs until its last year of operation or its disposition.[44]

II. Amendment to the Internal Revenue Code

The present tax treatment of many pre-operating outlays is unfair. Too often an expense incurred in preparing a business to open cannot be recovered until the business is disposed of, even though an existing business can currently deduct the same expense.

The prohibition of offsetting a business's income against pre-opening expenditures denies needed and deserved tax relief. To alleviate the tax bind of new businesses, the Code should be amended to include a section providing for recovery of start-up expenditures during the critical young years of a business. The purpose of the section would be to encourage taxpayers to enter new businesses and to help them succeed. A bill containing such an amendment would read as follows:

> *Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That (a) part VI of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:
>
> SEC. 193. START-UP EXPENDITURES.
>
> (a) Election to Amortize.—Start-up expenditures of a trade or business may, at the election of the taxpayer in the trade or business (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer in the trade or business (beginning with the month the trade or business starts functioning as a going concern) or if the trade or business is liquidated before the end of the 60 month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.
>
> (b) Start-Up Expenditures Defined.—The term "start-up expenditures" means any expenditure which is—
>
> (1) paid or incurred prior to the first month in which the trade or business starts functioning as a going concern;
>
> (2) an ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business;
>
> (3) chargeable to capital account; and
>
> (4) of a character which, if expended incident to the investigation, formation, and creation of a trade or business having a determinable life would be amortizable over such life.

Under this amendment, pre-opening expenses that relate to the business but do not create an asset having a useful life of its own can offset income of the business once it begins functioning as a going concern. The judicial phrase "functioning as a going concern" is incorporated into the amendment to prevent any overlap with Section 162. Ordinary and necessary expenses incurred before the business functions as a going concern fall within the proposed section. Section 162 applies to expenses incurred after the business begins functioning as a going concern.

To be administrable and to prevent abuse, this provision pertains only to pre-opening expenses of the trade or business actually entered. Investigatory expenses, like other ordinary and necessary pre-opening expenses, fall within this provision only if they directly relate to the culminated business. Admittedly, this limitation does not promote a thorough examination of possible business opportunities, but that is not the purpose of the bill.

It has been suggested that unsuccessful investigatory costs should be deductible.[45] This would result in beneficial tax treatment for such costs but would not improve the presently inad-

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[40] See Reg. §§ 1.263(a)-2(a) and 1.212-1(n).

[41] Compare *Louisville & Nashville R. R. Co.*, CCH Dec. 34,014, 66 TC 962 (1976), appeal docketed, No. 78-1303 (CA-6 June 2, 1978), with *Fort Howard Paper Co.*, CCH Dec. 28,712, 49 TC 275 (1967).

[42] See *Richmond Television*, footnote 34, above, and Rev. Rul. 73-421, footnote 4, above.

[43] See footnotes 1 and 6, above.

[44] Start-up costs and successful investigatory expenses will either increase gain upon sale of business, or upon liquidation costs could be recovered under Sec. 165.

[45] A. Fleischer, Jr., footnote 39, above, at 599.

equate treatment of successful investigatory expenses.[46] The proper vehicle for providing tax relief for unsuccessful investigatory expenses is through an expansion of Section 165, not this provision.

The amendment does not apply to the costs of acquiring an ongoing business because those costs are not incurred or paid before the acquired business functions as a going concern.[47] One might argue that the costs of acquiring a business should be included because there is no policy reason to encourage persons to start a new business rather than to enter an existing business (whether or not successful). On the other hand, our antitrust laws restricting horizontal and vertical integration reflect the fear of oligopoly and increased concentration of business, suggesting that an increase in new businesses, rather than a consolidation of existing enterprises, is a commendable goal. In any event, including such costs would create political difficulties. It is doubtful that any attempt to ease the cost burden of business acquisitions, especially through stock takeovers, would be welcomed in today's political arena.[48] Acquiring an existing business should not be confused with a business expanding into an unrelated field.[49] In the latter case, this proposal would apply.

Since this provision does not apply to the costs of acquiring a business, it does not replace Sections 248 and 709. These sections, which provide deductions for certain start-up expenses (organizational expenditures), are necessary to allow the amortization of organizational costs of a newly formed entity following the acquisition of an ongoing business. Because of the overlap between this provision and Sections 248 and 709, they should provide similar tax treatment. Overlaps in the tax laws allowing an expense to fall within different sections providing for identical treatment may be unusual but are not unknown.[50]

The deductibility of interest, taxes, Section 212(3) expenses, and similar expenses is not affected by the bill because such expenses are not chargeable to capital account.

The proposed section is elective. If a business has an ascertainable life shorter than 60 months, the business would not elect to come within this section.

A particularly attractive feature about this amendment is that it does not employ a radical approach to stimulate new economic activities and to remedy the presently inadequate tax treatment of start-up costs. In effect, all it does is assign a useful life of no shorter than five years to new business. There are existing Code sections, such as Sections 248 and 709, which effectually do the same.

III. Conclusion

Existing tax laws do little to alleviate the cost burden of entering a new business and reduce the chances of survival. Inequity in the present law denies adequate tax relief for ordinary and necessary expenses incurred in preparing a business to open while allowing an existing business to deduct similar expenses. A business with an indeterminable life should not have to wait until liquidation or disposition to recover its start-up costs.

Legislation is needed to provide sufficient tax relief for expenses incurred in commencing a business. In light of the clamor in Congress for assistance to small businesses, real economic growth, and for supply-side tax cuts emphasizing capital recovery, the time is ripe for enacting the proposed bill.

Yet, passage of this bill is not assured. The amendment may not generate active support from organizations seeking to exert pressure on the congressional tax committees. Liberal lobbying groups are not likely to support this legislation because it would result in a static revenue loss, thereby potentially decreasing amounts of funds available to social programs.[51] Some lobbying groups on the other side of the ideological fence will not push for this legislation because they represent existing businesses who will realize no gain from it.

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[46] It is not likely to receive tax relief for unsuccessful investigatory expenses, only extremely unlikely. See, e. g., *Harris W. Seed* and Rev. Rul. 77-254, footnote 6 above.

[47] Such costs need tax relief as it has been long established that reorganizational expenses are not currently deductible as business expenses under Sec. 162. R. Walthall, "Deductibility of Legal and Accounting Fees, Bribes and Illegal Payments," *342 T. M. 27*.

[48] The recent activity in the Senate Subcommittee on Antitrust, Monopoly and Business Rights indicates the current congressional sentiment against making mergers cheaper or easier. (e. g., S. 600, prohibiting mergers on the basis of size, and S. 1246, prohibiting an oil company's acquisitions in non-related fields).

[49] See footnote 14, above.

[50] See, e. g., §§ 162 and 212.

[51] The static revenue loss for this provision would be relatively small, given the high mortality rate of new businesses, which causes a revenue loss. The amendment would not result in a dynamic revenue loss since it increases the likelihood of new businesses succeeding, which would have a positive effect on tax revenues.

The Administration may initially oppose the bill. It is likely to prefer that the goals of this bill be achieved through a spending program rather than through a tax expenditure provision. However, to promote new businesses, this bill is preferable to loans and grants and their entailing paperwork.

Although the proposed section does not equalize the tax treatment between ordinary and necessary expenses of an ongoing business and ordinary and necessary expenses of a taxpayer starting a business, it does provide for recovery of start-up expenditures during the crucial young years of a business. Allowing the amortization of start-up costs will encourage new businesses and help them succeed. Permitting the meaningful deduction of pre-opening outlays will stimulate new economic activities, resulting in real economic growth. Considering the law of deductibility versus capitalization of the costs of a self-constructed item, the amendment is a reasonable and fair answer to a problem of long standing. ●

STATEMENT OF SENATOR MIKE GRAVEL

Mr. Chairman, I am pleased to state that I am a sponsor of S. 555, The Independent Local Newspaper Act. While I generally refrain from sponsoring legislation to be considered by the Finance Committee, on which I serve, I have made an exception in this case because of what I perceive to be a unique problem requiring prompt legislative relief.

During the past 30 years, our nation's newspapers have undergone a major transformation insofar as ownership and local control are concerned. In 1950, less than 30 percent of our daily newspapers were owned by chains. Today, over two-thirds of the dailies are controlled by chains, and these include most of the larger papers, since the chains account for over 72 percent of daily circulation and more than 76 percent of Sunday circulation.

In the past year, the chains have been buying formerly independent daily newspapers at a rate of one a week. I am advised that each week, three or four weekly newspapers are absorbed into newspaper chains.

Mr. Chairman, I am disturbed by this trend and what it forbodes for this nation. While many chain-owned newspapers do an excellent job for their communities, particularly in national and international news, they lose their local roots in these communities. More important, the diminution in independent newspapers voices diminishes as well the size and scope of the marketplace of ideas which we expect from our newspapers. Freedom of the press should not be circumscribed, but we must insure that our newspapers are not all abosrbed into an ever-smaller number of chains and media conglomerates. That is the situation we face today.

What are the underlying causes that have led to the growth of chains at the expense of locally-owned newspapers? One major cause is the effect of the estate tax laws on the highly inflated prices being paid for independent newspapers. So far as can be determined, no other area of endeavor is attracting such high-earnings ratios as are being paid for newspapers. The chains and media conglomerates are paying 40, 50, 60 times earnings to buy these properties. As the number of available independents decreases, the ratios being paid increase accordingly.

Mr. Chairman, we cannot control the prices paid for these newspapers, but we can and should look to the dislocations caused by such prices on the effects of the Federal estate tax law. Estate taxes are levied on the values of the properties, and these values are determined by what a buyer will pay for that property. In the case of independent newspapers, the Internal Revenue Service sets the value on what a chain will pay for a newspaper, which is well in excess of its value based upon earnings, plant, or the like.

The Independent Local Newspaper Act provides a pragmatic remedy for this problem. Rather than altering the valuation criteria, or providing exemptions from taxation, S. 555 offers a pre-payment plan for estate taxes. It would allow owners of independent newspapers during their lifetimes to pre-pay into the Treasury amounts sufficient to cover their estate tax obligations so that their heirs will not be forced to sell these newspapers.

Mr. Chairman, this is a means of meeting the problems I just described at little if any real cost to the Treasury. To be sure, it is special interest legislation—but legislation which is in the interest of the public, by preserving a diverse and independent press. I join with my colleagues who have cosponsored S. 555 in urging this Committee to take early and affirmative action on this legislation.

STATEMENT BY SENATOR JOHN H. CHAFEE

Mr. Chairman, I want to thank you for including S. 1703 on the Subcommittee's agenda this afternoon.

Our bill now has 13 Senate cosponsors, and just yesterday, Mr. Conable introduced its companion on the House side, H.R. 5730. The kind of support we have received is, itself, recognition of the urgency with which we must act to relieve the drastic new tax burdens facing Americans who perform charitable services overseas.

While the verdict has not yet been returned on the overall effectiveness of the Foreign Earned Income Act of 1978, it is abundantly clear that the employees of non-profit organizations will be severely penalized under its provisions.

In some cases, as will be demonstrated by the Subcommittee's witnesses, the tax increase for these individuals will amount to several hundred percent. In virtually all cases, it is evident that to retain Americans in their overseas positions will require charitable organizations to cutback personnel or, alternatively, increase salaries to compensate for the increased taxes.

The ultimate result will be a substantial reduction in the services provided by these ambassadors of charity and goodwill from our country. They have no customers to whom they can pass along their increased costs. The new demands of the Foreign Earned Income Act must be absorbed directly as increased program costs. The tradeoff will be food, medical care and education to the world's needy for a few more tax dollars to the U.S. Treasury.

These tax increases result directly from provisions of the Foreign Earned Income Act of 1978. Prior to last year, Congress allowed Americans living and working abroad to exclude a certain amount of income from U.S. taxes each year. For employees of charitable organizations, the exclusion was $20,000. For corporate employees, it was $15,000. The Foreign Earned Income Act of 1978 repealed these exclusions for both groups, replacing them with a series of tax deductions based on extraordinary housing expenses, education costs for the children, home leave expenses, costs of living in various parts of the world, and so on. Only for Americans working in remote construction camps was the $20,00 foreign income exclusion retained. This was done for two reasons: one, to encourage Americans to take jobs under hardship conditions; and, two, because the cost of living deductions would offer little tax relief to such individuals.

If the Congress could see its way clear to provide for the special circumstances of Americans working for profit in remote camps, then we should also be able to recognize the special needs of our overseas charities. S. 1703 simply proposes that Americans employed abroad by 501(c)3 organizations be allowed the option of using the $20,000 earned income exclusion now available to camp workers. This is the same tax treatment allowed charitable workers prior to 1978.

I must say that the administration's objection to our proposal seems ironic in face of the President's recent call to our charities for stepped up aid to the thousands of refugees daily fleeing their homes in Southeast Asia. It has always been a matter of National policy that we encourage private relief efforts overseas to the maximum possible extent. Official U.S. foreign aid has its obvious limits regardless of its humanitarian goals, as was clearly demonstrated this week by Cambodia's refusal to accept U.S. food relief.

Let us not undercut established National policy in order to collect an additional few million tax dollars.

We have with us this afternoon several individuals who can speak much better than I can to the serious problems they now face as a result of implementation of the 1978 tax changes. They are:

Mr. Louis Samia of CARE;

Bishop Broderick of the Catholic Relief Services;

Dr. J. Winston Crawley from the Foreign Mission Board of the Southern Baptist Convention;

Dr. Vernon Larson, President of U.S. University Directors of International Agricultural Programs;

Dr. A. Colin McClung, Executive Officer of the International Agricultural Development Service.

Gentlemen, welcome and thank you for making the trip to Washington for this brief hearing.

Senator BYRD. The Chair will now recognize the Senator from Wisconsin, Mr. Nelson.

Senator NELSON. Mr. Chairman, I will be very brief as I have to leave for the airport shortly. I would like to be able to stay here and listen to the testimony of my colleague Senator Eagleton, however, I am sure he will give me a copy.

Mr. Chairman, there are two matters pending that I would like to make very brief comments on. The first is S. 1543. This proposal is identical with S. 3430, a bill I introduced in the 95th Congress; and to H.R. 654, a bill introduced in the House by Congressman Pickle.

Under this proposal, a qualified reinvestment plan would be defined as one which provides for reinvestment of a cash dividend in the original-issue stock of a company.

The proposal would allow single taxpayers to reinvest a maximum of $1,500 a year; a married taxpayer filing a joint return would be limited to $3,000.

A shareholder purchasing stock with reinvested dividends would be required to hold the stock for at least 1 year. Otherwise, any gain on the sale would be taxed as ordinary income.

There are other witnesses testifying on this bill, Mr. Chairman, so I would simply ask that the balance of my statement be printed in the record.

Senator BYRD. Without objection, so ordered.

[The prepared statement of Senator Nelson follows:]

OPENING STATEMENT OF SENATOR GAYLORD NELSON

Mr. Chairman, this morning the Subcommittee on Taxation and Debt Management will hear testimony on S. 1543, a bill I introduced earlier this year which would permit a federal tax deferral on dividends that are reinvested in original issue stocks offered by any company with a qualified dividend reinvestment plan. The measure is cosponsored by Senators Bentsen, Schmitt, Tower and Hollings.

This proposal is identical to S. 3430, a bill I introduced during the 95th Congress and to H.R. 654, a bill introduced in the House by Congressman Pickle.

Under this proposal, a qualified reinvestment plan would be defined as one which provides for reinvestment of a cash dividend in the original-issue stock of a company.

The proposal would allow single taxpayers to reinvest a maximum of $1,500 a year; a married taxpayer filing a joint return would be limited to $3,000.

A shareholder purchasing stock with reinvested dividends would be required to hold the stock for at least one year. Otherwise, any gain on the sale would be taxed as ordinary income.

If a corporation purchases its own stock within one year of making a distribution pursuant to a dividend reinvestment plan, the distribution shall be presumed not to have been made pursuant to a qualified dividend reinvestment plan.

Although stock purchased with reinvested dividends would basically be regarded as the equivalent of a conventional stock dividend, the cost basis of the stock would be zero and the holding period of the stock would commence on the date of purchase.

In recent years, businesses have had great difficulty raising equity capital at a reasonable cost. Interest rates on borrowed funds are prohibitive (the prime rate is currently 15 percent) and our current depreciation system is so complex that the average business cannot generate enough cash internally. This is particularly true of utility companies which must continually offer new common stock to finance their capital requirements.

Under existing law, federal income tax is imposed currently on the value of stock received by a stockholder who opts to participate in a dividend reinvestment plan and to take stock, instead of cash. This is a disincentive to those stockholders who may be pressed to use the cash dividends to pay the current tax. Deferral of the current tax would greatly encourage increased participation. Besides benefitting investors, the proposal would encourage the growth of companies and make more jobs available.

On the investor level, the proposal will primarily benefit middle income taxpayers. Studies by the New York Stock Exchange indicate that 71 percent of all stockholders have incomes between $12,000 and $50,000; 50 percent of all shareholders have stock portfolios valued at less than $10,000 and 55 percent of all dividends received are by individuals in income levels of less than $50,000.

This proposal would provide substantial, direct and immediate help in the formation of new capital. It would represent a step in the direction of reducing the double tax on dividends by eliminating the tax imposed at the stockholder level when the dividends are reinvested in the corporation.

Finally, this proposal would encourage savings by supplementing retirement income. In this respect, it is analogous to Keogh and IRA programs which have been fostered by favorable tax treatment.

Senator NELSON. The other bill I am interested in is S. 1488, the Individual Savings Act of 1979 which I introduced earlier this year. This proposal seeks to help solve the inflationary cycle by increasing the consumer's incentive to save by reducing the disincentive which has been created by the present tax system.

Under the bill, any interest earned from a savings account in excess of the interest earned during the preceding taxable year would be tax free, up to a maximum of $500. Individuals filing a joint return would be allowed a $1,000 exclusion. For example, if an individual deposited $2,000 in a 5-percent passbook savings account in 1979, he would earn $100 in interest. If he deposited an additional $2,000 in 1980, he would earn $200 in interest. This additional $100 of interest would be tax free, and that would be the case each year.

As I said, Mr. Chairman, there are witnesses here who will testify on this proposal, and I would ask that the balance of my statement be printed in the record.

Senator BYRD. Without objection, so ordered.

[The prepared statement of Senator Nelson follows:]

TESTIMONY OF SENATOR GAYLORD NELSON

Thank you Mr. Chairman for inviting me to testify today on an issue which is at the heart of the current economic malaise—insufficient savings.

The American consumer has at least three good reasons not to save. First, soaring prices make it virtually impossible for the saver to maintain the purchasing power of his dollar, even with interest rates at record levels.

Second, our tax system creates an additional disincentive to save by further reducing the purchasing power of the savings dollar.

And finally, rampant inflation increases the benefit of buying now instead of saving. Immediate purchases are substantially less expensive then they would be if the purchases were delayed.

S. 1488, the Individual Savings Act of 1979, which we introduced earlier this year, seeks to help solve the inflationary cycle by increasing the consumers incentive to save through reducing the disincentive to save created by the tax system.

Under the bill, any interest earned from a savings account in excess of the interest earned during the preceding taxable year would be tax free, up to a maximum of $500. Individuals filing a joint return would be allowed a $1,000 exclusion. For example, if an individual could only afford to save $2,000 every year, he would receive a benefit under the bill. If he put $2,000 in a 5% passbook savings account in 1979 and earned $100 in interest and put an additional $2,000 in the account in 1980 and now earned $200 in interest on the total of $4,000 in the savings account, the additional $100 of interest would be tax free. Interest received from money market certificates and from negotiables would not be eligible for the exclusion.

Previous legislative attempts in earlier Congresses to stimulate savings have generally been met with two criticisms. First, that they do little to encourage increased savings and merely provide a windfall tax break for already existing savings. And second, that they cost the government too much in lost revenue.

The Individual Savings Act is designed to help overcome those two criticisms of earlier legislation. By giving a tax-break on only incremental increases in interest received from additional savings, it (1) provides an incentive for a person to increase their savings from one year and no windfall for existing savings; and (2) minimize any revenue loss to the government.

For example, if an individual were allowed to exempt from taxation the first $100 of interest received, there would be no incentive to increase savings from one year to the next. And, according to revenue loss estimates prepared by the Joint Economic Committee on Taxation, that flat exemption would cost the government $1.085 billion in lost revenue in calendar 1980.

The Individual Savings Act, providing a maximum $500 exclusion, would potentially provide the individual taxpayer with 5 times the benefit of the $100 flat exclusion; and, would encourage individuals to increase their savings from year to year at a cost to the government of $1.15 billion. That is 5 times the benefit at a comparable cost.

America is the only major industrialized nation which fails to encourage savings. Consequently, according to U.S. Department of Commerce statistics, our rate of savings as a percent of disposable income has dropped from a healthy 7.4% in 1970, to a meager 4.9% in 1978, to a dismal 4.0% in the third quarter of 1979. According to the National Savings and Loan Foundation, the British save 13% of their dispos-

able income, the West Germans save 15% and the Japanese 25%. Each of these countries encourages saving through tax incentives. To put these figures in perspective, if Americans saved the same percentage of their disposable income as the Japanese, we would have saved nearly $300 billion more than the $76 billion saved in the U.S. last year. This would have provided a tremendous boost to investment in new plant and equipment, business expansion and new home construction.

If this nation is to meet its long-term capital formation requirements, we must stimulate a high rate of individual savings. Our failure to save is creating two major problems. It's starving our capital markets and helping to create excessive spending which is fueling a high rate of inflation. Without savings, there can be no money loaned for new home construction or for capital investment. Without investment, productivity declines, inflation increases, and no new jobs are created.

It has become a vicious circle. Inflation encourages people to buy now pushing prices higher and higher. Taxation discourages people from saving now by taxing the interest they receive. The consumer is left with no choice but to buy, buy, buy, thus draining the economy of needed savings dollars and starving our capital markets. If current savings and buying trends are to be reversed, substantial savings incentives must be created.

Mr. Chairman, tremendous benefits will accure to the economy and to the taxpayers if we can enact a bill to protect and encourage savings. Such a bill would help stabilize consumer prices, would help reduce interest rates and stimulate the housing industry; would provide needed dollars for capital investment and help increase sagging productivity growth; and, would help protect the savings of our elderly and retired who now see their savings dwindled by the ravages of inflation. I would like to commend you for your efforts to increase savings and for holding this hearing today. Thank you.

Senator NELSON. Thank you very much.

Senator BYRD. I thank the Senator from Wisconsin.

Before calling on the first witness, the Chair recognizes the Senator from Texas, Mr. Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman. And let me first thank you for holding these hearings. I appreciate very much your doing it.

I am here particularly because of my concern and interest in my bill S. 246 which now has some 19 Senate cosponsors, and that is a bill that would exempt the first $500 of interest earned on a savings account, or $1,000 for a joint return. Due to inflation, individuals today often receive a negative return on savings accounts. Our tax laws have really punished savings in this country.

The rate of savings in the first quarter of this year were 4.6 percent. That is dead last of all the nations in the world, the lowest rate of savings. The rate of savings in Japan at the same time were 22 percent, and the rate of savings of the Germans on the order of 13 percent.

If we are going to get this country moving again, if we are going to increase productivity, we have to have capital formation, and that means we have to encourage the rate of saving in this country. We can do that if we put the incentives in the system and if we bring fairness to the tax system so people have a reason for saving and don't end up finding themselves in effect doubly taxed on this kind of savings.

So, Mr. Chairman, I am delighted to see this many witnesses here who have some of the same thoughts in mind. I have never seen this kind of generalized support from the various groups that we see. We are seeing a myriad of financial institutions represented, and at the same time, consumer organizations, all with the same objective in mind.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Bentsen.

Senator Talmadge, do you want to make a statement?

Senator TALMADGE. Mr. Chairman, in the interests of time, I will submit for the record my statement. I want to commend you for holding the hearings on this very important matter. Our productivity rate is the lowest of any industrialized nation in the world. Our savings rate is the lowest of any industrialized nation in the world. I think it is of paramount importance that we do whatever we can to stimulate our savings rate, stimulate our productivity. I think the bills that you are holding hearings on today are a step in the right direction.

I compliment you, I compliment my colleagues that have offered similar bills to my own.

I ask unanimous consent that this statement be entered in the record.

Senator BYRD. Without objection, so ordered, and also Senator Bentsen's.

[The prepared statement of Senator Talmadge follows:]

STATEMENT OF SENATOR HERMAN E. TALMADGE

Mr. Chairman, I am very pleased that this Subcommittee is holding hearings on my proposal, S. 1846, and those of Senator Bentsen and Senator Nelson to encourage increased savings through tax incentives. It is imperative that such legislation be adopted during the current Congress. I hope the full Committee will be able to turn its attention to such legislation in the near future.

The United States lags behind every other major industrial nation in the world in economic growth. We save at a lower rate. We invest at a lower rate. American productivity has been at a virtual standstill.

Not only are we not keeping up with the rest of the world in economic growth, we are falling farther and farther behind. Every day we are bombarded by economic indicators which show that the United States is no longer preeminent in technology and productivity.

The U.S. economy is losing its vigor. It is not an exaggeration to say that we could become a second or third-rate economic power by the year 2000—and many noted economists are warinig just that.

We must set new national goals. We must switch national priorities away from spending to saving.

Virtually every major foreign industrialized nation has institutionalized productivity—especially Japan and West Germany, They have established strong, working parnerships between government, business, and labor to increase national output, for the benefit of their own people and to make their products more competitive in the world market.

The facts speak for themselves. In the past 10 years, Japan increased its productivity 107 percent; France 72 percent; West Germany, 70 percent; Italy, 62 percent; and United States 30 percent.

The only bright part of the entire picture is in agriculture. U.S. agricultural productivity is increasing about 6.4 percent a year. It is the only segment of the American economy that is making any gains.

It is no secret that both personal savings and corporate retained earnings have declined as a percentage of the gross national product during the 1970's. We have a serious capital investment problem. In fact, we have the lowest level of capital investment of all of the newer industrialized nations. Japan invests over 35 percent of its gross national product in capital; West Germany, over 25 percent; the United States only 17.4 percent.

The reduction in capital investment is directly related to America's poor savings record. The Japanese save almost 25 percent of their income. The West Germans save 15 percent. Even the British save 13 percent, while Americans save only 6½.

Our reduced savings rate has resulted from the fact that "real" after-tax return on savings has plummeted into the negative number. During the period 1977-1979, the after-tax return has been minus 5 percent, while the return on corporate bonds has been approximately minus 2.8 percent. This disincentive to save cuts down on the availability of investment for capital stock which reduces the capital labor ratio and consequently results in a reduction of productivity growth.

To put it simply, our current tax laws penalize savings and investments. The United States is one of only a few industrialized nations that does not currently encourage long-term savings. West Germany and Great Britain provide for a total exclusion of interest earnings from taxation. Other nations such as France provide government bonuses of up to 5 percent on interest-earning savings accounts.

The time is long overdue for us to address this important issue and move toward putting the United States back into it rightful position of preeminence in the world economy. We must begin by adopting legislation to encourage Americans to save through tax incentives and, Mr. Chairman, I pledge my strong support and efforts to see that such a measure is adopted.

Senator BENTSEN. For the record, I would like to introduce the statement of Senator Percy and Senator Danforth for the record.

Senator BYRD. Without objection, they will be inserted in the record.

[The prepared statement of Senator Percy and Senator Danforth follows:]

STATEMENT BY SENATORS CHARLES H. PERCY AND JOHN C. DANFORTH

Mr. Chairman, the savings rate in the United States is the lowest of the major industrialized nations. Because personal savings and investment are major sources of business investment capital, this low rate of savings is a crucial economic problem.

Without this investment capital there can be no economic growth and no productivity gains. The result is continued high inflation. Congressional attention to this problem is long overdue. This hearing on several proposals to encourage personal savings and investment, including the Small Savers Incentive Act of 1979, S. 1542, will focus attention on the importance of boosting the savings rate in this country and stimulating capital accumulation. You are to be commended for your interest and leadership in this area.

The Small Savers Incentive Act which we introduced on July 19 of this year will serve two purposes. It will make savings and investment more profitable for Americans and will increase, through its reinvestment requirement, the amount of capital available for investment and economic growth.

The Small Savers Incentive Act is Title I of the three-bill package all 41 Republicans in the Senate introduced on July 30, the Savings and Investment Encouragement Act of 1979 (S. 1597). This package includes savings and investment incentives for both individuals and businesses which we believe are vital components in a sound economic program for the future. The Small Savers Incentive Act represents the portion of the package which will encourage individuals to save for the future.

First, the Small Savers Incentive Act will provide a $100 tax exclusion for interest earned from savings accounts and certificates like the existing exclusion for dividends from domestic corporations. Second, the bill will provide additional exclusions for both dividends and interest up to $400 to the extent that this income is reinvested.

To be reinvested, interest income may remain in the same savings account or it may be used to purchase a savings certificate or stock in a domestic corporation. Likewise, dividends may be reinvested in the same corporation's stock, the stock of other domestic corporations or deposited with an eligible savings institution. The bill will give the individual the flexibility to choose his investments.

To insure reinvestment and an increase in a taxpayer's total savings and investment, the bill provides that the additional exclusions may not be elected by a taxpayer unless his total savings and investment increase for the taxable year. The bill accomplishes this goal by defining a taxpayer's "investment base" as the sum equal to the amount of the adjusted basis of all stock in domestic corporations plus the amount of money in all deposits in eligible savings institutions. Therefore, if the investment base on December 31 is the same or less than the investment base on January 1 of the same taxable year, no exclusion will be allowed for reinvested dividends and interest income. The investment base must increase by an amount either equal to or more than the dividends and interest reinvested before a taxpayer is eligible for the same exclusions. This requirement does not affect the current $100 exclusion for dividends or the $100 exclusion for interest income created by this bill.

The revenue effect of this bill depends upon what percentage of interest and dividends is reinvested. According to an estimate prepared by the staff of the Joint Committee on Taxation, the percentage of interest and dividends which will be reinvested will fall between 33 and 60 percent. The following chart shows the

revenue loss from 1980 to 1984 for both the interest and dividend provisions of S. 1542 under these assumptions.

[In millions of dollars]

	1980	1981	1982	1983	1984
1. 33 percent reinvestment assumption:					
Calendar	2,261	2,390	2,527	2,671	2,823
Fiscal	339	2,459	2,492	3,111	2,733
2. 60 percent reinvestment assumption:					
Calendar	3,189	3,376	3,577	3,788	4,012
Fiscal	478	3,470	3,352	3,924	3,871

We are also submitting for the hearing record a table showing the estimated revenue loss of the bill if all excluded amounts were reinvested (see attached).

Also for the record, we would like to submit several letters we have received from various segments of the financial industry which endorse the Small Savers Incentive Act.

Mr. Chairman, in its report earlier this year the Joint Economic Committee recommended improvements in our nation's policy to provide incentives for capital formation and saving. The report stated:

"A very high rate of capital formation is needed if we are to succeed in reversing the disastrous course of productivity growth in the American economy. A high rate of productivity growth also is essential to the success of our long-run goal of significantly slowing inflation."

We firmly believe one way to spur capital formation is to encourage personal savings and investment. The United States has a dismal record of savings as compared to the other industrialized nations. According to the Organization for Economic Cooperation and Development 1979 Economic Survey, in 1977 the United States was last among the industrialized nations in the rate of household savings. Japan led the way with 21.2 percent, West Germany 12.6 percent, France 16.7 percent, the United Kingdom 13.7 percent and the United States 5.3 percent.

The same survey also evaluated international savings rates as a percentage of gross national product. This rate is determined by deducting national consumption from GNP and stating it as a percentage of GNP. In 1977, Japan saved 32.2 percent of its GNP, West Germany 24.2 percent, France 23.4 percent, the United Kingdom 20.3 percent and the United States 17.7 percent. While these statistics show the United States in a more favorable light, the fact is that we still finish last.

The low savings rate is a major factor in the shortage of capital available for business investment in new plant and equipment. Here again, statistics show that the United States falls behind other major industrialized nations. From 1966 to 1976, the United States invested 13.5 percent of its GNP in plant and equipment. During the same period, Japan invested 26.4 percent, West Germany 17.4 percent, France 16.7 percent and the United Kingdom 14.9 percent.

It is time that we in Congress take steps to reverse these alarming statistics and we believe the Small Savers Incentive Act should be an integral part of that policy.

1978 INCOME LEVEL

Expanded, Inc.	Tax decrease			Tax increase			Net tax change	Percent of total distribution
	Returns	Amount	Average (actual)	Returns	Amount	Average (actual)		
Below $5,000	1,366,000	−$35,000,000	−$26				−$35,000,000	0.7
$5,000 to $10,000	6,540,000	−395,000,000	−60				−395,000,000	7.9
$10,000 to $15,000	6,625,000	−556,000,000	−84				−556,000,000	11.0
$15,000 to $20,000	6,875,000	−616,000,000	−90				−616,000,000	12.2
$20,000 to $30,000	9,256,000	−1,145,000,000	−124				−1,145,000,000	22.8

1978 INCOME LEVEL—Continued

Expanded, Inc.	Tax decrease			Tax increase			Net tax change	Percent of total distribution
	Returns	Amount	Average (actual)	Returns	Amount	Average (actual)		
$30,000 to $50,000	5,051,000	−1,247,000,000	−247			$1,168	−1,247,000,000	24.8
$50,000 to $100,000	1,348,000	−733, 000,000	−544				−733,000,000	14.6
$100,000 to $200,000	291,000	−228, 000,000	−784				−228,000,000	4.5
$200,000 and above	76,000,000	−75,000,000	−981			5,368	−75,000,000	1.5
Total	37,429,000	−5,030,000,000	−134			2,245	−5,030,000,000	100.0

1979 Present law, 1979 proposed law

Number of returns switching to standard	112
Amount	−1
Number of returns switching to itemized	25
Amount	−5

CREDIT UNION NATIONAL ASSOCIATION, INC.,
Washington, D.C., October 3, 1979.

Hon. CHARLES H. PERCY,
U.S. Senate, Washington, D.C.

DEAR SENATOR PERCY: The Credit Union National Association (CUNA) adopted a resolution at its February quarterly meetings endorsing legislation that would allow deductions for all, or a portion of interest earned on savings deposits. The bill which you have sponsored, S. 1542, would exempt a significant part of an individual's interest income. This would do much to encourage savings and investment, both of which have suffered noticeably in the United States in recent years.

Credit unions, in the normal course of their activities, act to balance the borrowing and saving functions of their members. We therefore support measures that would reverse the more recent inclination to spend rather than save. Most other western industrialized nations provide some impetus to individuals or families to accumulate wealth in the form of savings. In the United States this practice is clearly penalized. Lack of incentives combined with the effects of inflation provide severe disincentive to save.

Efforts such as yours will have the support of the Credit Union National Association which includes the 51 credit union leagues representing each state and the District of Columbia. Through the leagues, CUNA represents nearly 22,000 federally and state chartered credit unions which serve over 40 million people.

Even without incentives Americans still have the propensity to save. This propensity wanes, however, when an objective appraisal is made by savers which convince them that more is lost than gained by saving. The set of conditions that now cause Americans to lose faith in this previously sound financial practice must not be permitted to continue and we applaud your leadership in this area.

Sincerely,

J. ALVIN GEORGE, *Chairman.*

ASSOCIATION FOR MODERN BANKING IN ILLINOIS,
Springfield, Ill., August 22, 1979.

Hon. CHARLES H. PERCY,
U.S. Senator,
Dirksen Office Building, Washington, D.C.

DEAR SENATOR PERCY: Thank you very much for your letter to Loren M. Smith, Chairman of the Board of AMBI, relative to the Small Savers Incentive Act of 1979.

Thank you very much for having introduced this worthwhile legislation and we certainly are prepared to support your efforts in any way necessary.

We agree that this legislation provides the incentives necessary to stimulate savings and investment in the United States.

As the legislation begins to move if there are any areas in which we can be helpful to you please don't hesitate to let me know.

Best regards.

Cordially,

JAMES B. WATT, *President.*

ILLINOIS ASSOCIATION OF REALTORS,
Springfield, Ill., September 13, 1979.

Hon. CHARLES H. PERCY,
U.S. Senator,
Dirksen Office Building, Washington, D.C.

DEAR CHUCK: On August 29, 1979 I sent you correspondence stating the National Association of Realtors® policy concerning the Small Savers Incentive Act of 1979. I also stated that the Illinois Association of Realtors® would be reviewing the legislation further.

On September 5, 1979 the Assessment and Taxation Legislative Subcommittee reviewed S. 1542. It was their recommendation to support the concept as applied in the Small Savers Incentive Act of 1979.

We very much appreciate the opportunity to review the legislation. If I.A.R. can be of further assistance, please do not hesitate to contact our Staff.

Sincerely,

ROBERT E. COOK, CAE,
Executive Vice President.

THE NEW YORK STOCK EXCHANGE,
New York, N.Y., August 15, 1979.

Hon. CHARLES H. PERCY,
U.S. Senate, Committee on Governmental Affairs, Washington, D.C.

DEAR CHUCK: Thank you for your letter regarding the Small Savers Incentive Act of 1979 which you have drafted. As you know, we have been concerned over the implications of the decline in the number of shareholders, especially among the younger age groups, and the low rate of savings and investment in this country.

The proposed legislation would provide a direct stimulus to saving and partially ease the double-taxation of dividends. By whetting individuals' interest in equity ownership, the legislation can help promote a better understanding and appreciation of our private enterprise system. This is vital in getting our economy back on a relatively fast growth, low-inflation track. The Small Savers Incentive Act, in combination with the 10-5-3 depreciation plan, promises to enhance the rate of capital formation, so necessary toward achievement of our economic goals.

I was particularly pleased with the emphasis on productivity. The productivity problem has been both a focus of the Exchange's efforts and a personal concern. Less inflation, adequate real growth and a strong dollar internationally, require single-minded policies to stimulate productivity growth.

Again, I am glad that the Exchange was able to contribute to your effort to spur capital formation. Please call me or my staff if we can assist you in any way.

With best personal regards,

WILLIAM M. EATTEN.

Senator BYRD. At this point the Chair had planned to recognize the distinguished Senator from Missouri, Mr. Eagleton, but the Chair understands that the representative from the State of Hawaii, Mr. Heftel, has another pressing commitment and Senator Eagleton has agreed to yield to the Congressman from Hawaii.

You may proceed, sir.

STATEMENT OF HON. CECIL HEFTEL, A REPRESENTATIVE IN CONGRESS FROM THE FIRST CONGRESSIONAL DISTRICT OF THE STATE OF HAWAII

Mr. HEFTEL. Thank you very much, Mr. Chairman and committee members. I am really here on behalf of my colleague on the Ways and Means Committee, Jake Pickle, who introduced comparable legislation in the prior session of the Congress, and it is a great pleasure on my part to speak on behalf of Jake and myself supporting S. 1543, which on the House side is known as H.R. 654.

I will read the statement in total, skipping one page of it, rather than extemporizing because it is in fact my colleague, Jake Pickle's statement.

Senator BYRD. The entire statement can be printed as if delivered.

Mr. HEFTEL. Thank you very much.

Briefly, the bill is called the Dividend Reinvestment bill. It would allow a stockholder to defer tax payments on any dividends that the stockholder exchanges for new issue stock in the corporation. There are several guidelines to this.

The stock issued has to be new issue stock. The stockholder has to have an option—he can take cash or the new issue stock. The corporation's plan has to be qualified, and on the record with the IRS.

From a tax standpoint, the obvious advantage to the stockholder is that a cash dividend is taxed at regular tax rates whereas the sale of stock is treated as a capital gain. The legislation is designed to prevent abuse of this tax principle. If a person gets, for example, 10 shares of stock instead of cash, and he adds that to his existing 100 shares, that person cannot immediately convert some stock into the cash at the capital gain rate. The reason is that the bill sets up a last-in, first-out rule. Also, if a stockholder sells any stock within 1 year of getting his stock dividend, the IRS will consider that stock to be the most recently acquired. Thus, a tax would be paid at the regular rate, not the capital gain rate for the sale within 1 year.

The bill also arbitrarily sets the value of the stock to be zero. Thus, when it is sold, either at the capital gain rate or the regular tax rate, the total price is taxable since the value has gone from zero to whatever is the price of the stock at that time.

Finally, the bill puts a $1,500 cap on the amount of value a taxpayer can claim for this tax deferral in any year.

It is true that many companies are beginning to have these original issue stock dividend plans. This is particularly the case for utility companies. In fact, these firms have pioneered this approach to raising money.

These companies have sufficient capital, but they also have the largest outlays of any type of business in America. New power plants are coming in on line at about $1 billion today. Assuming continued inflation problems, plants on the drawing boards today that will exist in 6 or 7 years will have a projected cost of $2 billion. There is no end to the demand for these incredible amounts of money.

These firms realize that issuing bonds, and borrowing money from banks has its limits. So they have turned to this method of finance.

Unlike other capital formation proposals, such as the investment tax credit and accelerated depreciation, divident reinvestment will provide capital only to firms that need it. These other approaches, which have good logic behind them, and which I do not oppose per se, will give more cash to all businesses that make a profit. For example, a cash rich oil company will get more cash from the tax credits and depreciation legislation. In all likelihood, the corporation with cash would not start up a dividend reinvestment program.

Also important is that this legislation is a simple, first step toward the elimination of the double taxation of dividends. Up to this point, we have been unable to solve the double taxation of dividends because of complexity and cost to the Treasury. With this bill, the taxpayer could end the taxation of dividends up to $1,500 per year. This is a logical first step toward ending the problem of taxing the same money twice without complexity and without large costs to the Treasury.

Senate 1543 is not an expensive bill. Its first year cost is around $240 million on a fiscal year basis. It is my understanding that the cost for the full calendar year would be $640 million. In normal circumstances both the House Ways and Means Committee and the Senate Finance Committee could put this legislation into action and report a $240 million revenue drop in fiscal year 1981.

Please note that I am using the figures from the Joint Committee on Taxation. As is their policy, they do not compute any feedback from increased economic activity. I would feel that with this money going back into a firm to expand and build, the new construction and business activity would be substantial. This would thus mean more tax revenues. Once this ball got rolling, a highly respected economic firm, Robert Nathan Associates, stated that the revenue drop would be offset by revenue gained the second year of operation of the dividend reinvestment legislation.

In sum, I would ask that the committee give favorable consideration to S. 1543. The bill would be a good, rifle shot capital formation proposal, a first step to ending double taxation of dividends, and would not cost large sums to the Treasury.

In Jake's words, I cannot think of a better deal.

And I do want to thank the Senator from Missouri for his kindness in permitting me to address you first.

Senator BYRD. Thank you, Congressman. You certainly know how to end right at the sound of the gong. Tell Jake we missed him, but you made a fine presentation for him and we are glad to have you.

Mr. HEFTEL. My thanks to you very much.

[The prepared statement of Mr. Heftel follows:]

TESTIMONY OF CONGRESSMAN CECIL HEFTEL

Mr. Chairman, it is a pleasure to speak in behalf of S. 1543, which is known on the House side as H.R. 654.

Briefly, the bill is called the Dividend Reinvestment bill. It would allow a stockholder to defer tax payments on any dividends that the stockholder exchanges for new issue stock in the corporation. There are several guidelines to this:

The stock issued has to be new issue stock.

The stockholder has to have an option—he can take cash or the new issue stock.

The corporation's plan has to be qualified, and on the record with the IRS.

From a tax standpoint, the obvious advantage to the stockholder is that a cash dividend is taxed at regular tax rates, whereas the sale of stock is treated as a capital gain. The legislation is designed to prevent abuse of this tax principle. If a person gets, for example, 10 shares of stock instead of cash, and he adds that to his existing 100 shares, that person cannot immediately convert some stock into cash at the capital gain rate. The reason is that the bill sets up a last-in, first-out rule. Also, if a stockholder sells any stock within one year of getting his stock dividend, the IRS will consider that stock to be the most recently acquired. Thus, a tax would be paid at the regular rate, not the capital gain rate for the sale within one year.

The bill also arbitrarily sets the value of the stock to be $0. Thus, when it is sold, either at the capital gain rate or the regular tax rate, the total price is taxable since the value has gone from $0 to whatever the price of the stock is.

Finally, the bill puts a $1,500 cap on the amount of value a taxpayer can claim for this tax deferral in any year.

Those of us who are supporting this bill have been more than willing to accept changes that would prevent any gain to the individual that is not in line with our purpose. When Congressman Jake Pickle introduced this bill in the last Congress, many of these safeguards were not in the bill. However, they have been adopted as problems were pointed out, and if in the days ahead we see other problems, the same attitude on our part will continue.

The purpose of the bill lies mainly in a desire to create capital for the economy. This in turn will insure jobs for our future and increased productivity. The bill creates capital by creating money through the traditional and sound method of selling shares of a company to make equity. Currently, most businesses can expand through two methods—borrowing from a traditional lending institution, or issuing debt paper. With a shortage of capital and with interest rates so high, the business that can expand with its own cash flow, or retained earnings, is in very good shape.

But unfortunately, not all business have the kind of cash to do this.

This vicious cycle of borrow, borrow, borrow can be broken by the firm that can raise money through its equity. Right now, the incentive of the stockholder to have a bigger piece of the action instead of cash is not great enough to see this phenomenon do the job that it can.

It is true that many more companies are beginning to have these original issue stock dividend plans. This is particularly the case for utility companies. In fact these firms have pioneered this approach to raising money.

These companies have sufficient capital, but they also have the largest outlays of any type business in America. New power plants are coming on line at $1 billion today. Assuming continued inflation problems, plants on the drawing boards today tht will exist in six or seven years will have a projected cost of $2 billion. There is no end to the demand for these incredible amounts of money.

These firms realize that issuing bonds, and borrowing money from banks has its limits. So they have turned to this method of finance.

Unlike other capital formation proposals, such as the investment tax credit and accelerated depreciation, dividend reinvestment will provide capital only to firms that need it. These other approaches, which have good logic behind them and which I do not oppose per se, will give more cash to all businesses that make a profit. For example, a cash rich oil company will get more cash from the tax credits and depreciation legislation. In all likelihood, the corporation with cash would not start up a dividend reinvestment program.

Also important is that this legislation is a simple, first step towards the elimination of the double taxation of dividends. Up to this point, we have been unable to solve the double taxation of dividends because of complexity and cost of the Treasury. With this bill, the taxpayer could end the taxation of dividends up to $1,500 per year. This is a logical first step towards ending this problem of taxing the same money twice without complexity and without large costs to the Treasury.

S. 1543 is not an expensive bill. Its first year cost is around $240 million on a fiscal year basis. It is my understanding that the cost for the full calendar year would be $640 million. In normal circumstances both the House Ways and Means Committee and the Senate Finance Committee could put this legislation into action and report a $240 million revenue drop in Fiscal year 1981.

Please note that I am using figures from the Joint Committee on Taxation. As is their policy, they do not compute any feedback from increased economic activity. I would feel that with this money going back to a firm to expand and build, the new

construction and business activity would be substantial. This would thus mean more tax revenues. Once this ball got rolling, a highly respected economic firm, Robert Nathan Associates, stated that the revenue drop would be offset by revenue gain the second year of operation of the dividend reinvestment legislation.

In sum, I would ask that the Committee give favorable consideration of S. 1543. The bill would be a good, rifle shot capital formation proposal, a first step to ending double taxation of dividends, and would not cost large sums to the Treasury. I cannot think of a better deal.

Senator BYRD. Senator Eagleton, the committee is very glad to have you today.

STATEMENT OF HON. THOMAS F. EAGLETON, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator EAGLETON. Thank you, Mr. Chairman. I want to thank you and the other members of the committee for the opportunity to testify before your subcommittee on such very short notice. I contacted the staff only yesterday, and they were very accommodating in permitting me to appear on today's agenda.

The Senate is currently in the midst of a debate on H.R. 4986, the so-called Consumer Checking Account Equity Act. As that bill presently stands, it would have a far-reaching impact on the banking industry, the housing industry and the consumer. One of my biggest concerns about the bill is the provision to reduce the denomination of certificates of deposit from $10,000 to $1,000 in an effort to provide relief to the small saver. I am sympathetic with the purpose of this legislation, but nevertheless must oppose the provision because of the certain harmful impact it would have on our savings and loan associations, the housing industry, and ultimately the consumer. I believe there are far more positive ways to help the small saver without causing the mortgage market to become even more constricted than it already is.

For that reason, I introduced yesterday, S. 1956, a bill to provide relief for small savers. While I am aware that this subcommittee is considering today three other bills which provide tax relief for savers, I believe my bill has several distinct advantage or two over these other bills. S. 1956 is truly a small saver bill. It would allow a tax exclusion on interest income earned only from passbook savings accounts at commercial banks, mutual savings banks, savings and loan's and credit unions. Individuals would be allowed a deduction of up to $500 and $1,000 for married couples who file a joint return. As a double test to insure that only the truly small saver will benefit from this exclusion, the bill provides that only those taxpayers who earned an aggregate of $500 or less in interest and dividends, and $1,000 or less for joint returns from all reportable sources can qualify for the tax exemption. I propose this second test to preclude the case of an individual who may be earning a sizable return on high yielding investments and then decides to place some money in a passbook account to receive the tax benefit. The small saver does not have such an option. His only alternative is his passbook savings accounts. It is this individual I think we want to help.

While I commend the intentions of my colleagues whose bills provide tax relief for savers, I nevertheless believe that S. 1956 is an improvement over the others because of its reduced revenue costs and the fact that it is so explicitly targeted to the small saver.

According to very rough estimates—and I emphasize these are rough estimates from the Treasury Department—the revenue loss costs of the bills are as follows:

S. 246 would cost approximately $4.6 billion in 1984.

S. 1846 would cost about $2.6 billion in 1984.

S. 1488 would cap, after about 5 years, at $1.3 billion.

According to the Treasury Department, my bill, S. 1956 would cost approximately $850 million in 1980 and only $1 billion in 1984. As one can see, this would be the least costly in terms of revenue lost by the Treasury Department.

Once again, let me say my bill would be targeted to the small saver and therefore would be less costly. It would specifically help people that I call the Aunt Hazels of the world who have placed all or nearly all of their savings in a bank or a savings and loan or a credit union. I urge my colleagues to look at this Aunt Hazel bill. I think it is an effective means to assist the beleaguered small saver.

I thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Eagleton.

Senator Bentsen.

Senator BENTSEN. Well, I would only comment that I share very much the Senator's concern about what they are talking about, the reduction of the certificate from $10,000 to $1,000. I think that something along the lines that either he has proposed or I have proposed is a much more positive approach to it.

Frankly, I would be offering a substitute on the floor this afternoon if I didn't know it wasn't subject to a point of order.

But I think the day has come, as evidenced by the kind of support we are seeing here, and that we are going to get positive action in the next tax bill, which I don't think is far off, along these lines, and I commend the Senator.

Senator EAGLETON. I thank my colleague.

Senator BYRD. Senator Talmadge.

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

I compliment you, Senator Eagleton, on a very fine statement. I also associate myself with the distinguished Senator from Texas on your comment on money market certificates because I fear, too, that a reduction will have a very adverse effect on savings and loan's and the housing situation.

Senator EAGLETON. I thank my colleague and I thank you.

Senator BYRD. Thank you very much, Senator Eagleton.

[The prepared statement of Senator Eagleton follows:]

STATEMENT OF SENATOR THOMAS F. EAGLETON

Mr. Chairman, I would like to thank you for this opportunity to testify before your Subcommittee on such short notice. I am also appreciative of the accommodations your staff made on my behalf.

The Senate is currently in the midst of debate on H.R. 4986, the Consumer Checking Account Equity Act. As this bill presently stands, it would have a far-reaching impact on the banking industry, the housing industry and the consumer. One of my biggest concerns about this bill is the provision to reduce the denomination of certificates of deposit from $10,000 to $1,000 in an effort to provide relief for the small saver. I am sympathetic with the purpose of this legislation, but nevertheless must oppose the provision because of the certain harmful impact it would have on our savings and loan associations, the housing industry, and ultimately the consumer. I believe there are far more positive ways to help the small saver without causing the mortgage market to become even more constricted than it already is.

For that reason, I recently introduced S. 1956, a bill to provide relief for small savers. While I am aware that this subcommittee is considering today three (3) other bills which provide tax relief for savers, I believe my bill has several distinct advantages over these other bills. S. 1956 is truly a small saver bill. It would allow a tax exclusion on interest income earned only from passbook savings accounts at commercial banks, mutual savings banks, S&Ls and credit unions. Individuals would be allowed a deduction up to $500 and $1,000 for married couples who file a joint tax return. As a double test to insure that only the truly small saver will benefit from this exclusion, the bill provides that only those taxpayers who earned an aggregate of $500 or less in interest and dividents ($1,000 or less for joint returns) from all reportable sources can qualify for the tax exemption. I propose this second test to preclude the case of an individual who may be earning a sizable return on high yielding investments and then decides to place some money in a passbook account to receive the tax benefit. The small saver does not have such an option—his only alternative is his passbook savings account. It is this individual we want to help.

While I commend the intentions of my colleagues whose bills provide tax relief for savers, I nevertheless believe that S. 1956 is an improvement over the others because of its reduced revenue costs and the fact that it is so explicitly targeted to the small saver.

According to some very rough estimates from the Treasury Department, revenue costs for the other bills would be as follows:

(1) S. 246 which permits an outright exclusion in interest for any and all individuals ($1,000 for joint returns) will cost approximately $4.6 billion in 1984.

(2) S. 1846 which is similar to S. 246 but permits a $250 exclusion ($500 for joint returns) on interest and dividends will cost $2.0 billion in 1980 and $2.6 in 1984.

(3) S. 1488 which allows an exclusion of up to $500 on interest and dividends earned ($1,000 for joint returns) only to the extent that the interest and dividends received during the taxable year exceed the interest and dividends during the preceding taxable year would cost roughly $900 million the first year and would cap after 5 years at about $1.3 billion.

According to the Treasury Department, S. 1956 would cost approximately $850 million in 1980—and only $1 billion in 1984. As you can tell, this would be the least costly bill in terms of revenue lost by the Treasury Department.

Once again, let me say that my bill would be targeted to the small saver and therefore would be less costly. It would specifically help the people I call the "Aunt Hazels" of the world who have placed all or nearly all of their savings in a bank, S&L or credit union. I urge my colleagues to take a look at my "Aunt Hazel bill." I think it is an effective means to assist the beleagured small saver.

Senator BYRD. The next witness will be Mr. Harvey Galper, Associate Director, Office of Tax Analysis, Department of the Treasury. Mr. Galper will address S. 246, S. 1488, S. 1543 and S. 1846.

At the same time, Mr. David Rosenbloom, International Tax Counsel, Department of the Treasury, might come forward—Mr. Rosenbloom will address S. 1703; and Mr. Harry L. Gutman, Deputy Tax Legislative Counsel, Department of the Treasury, will address S. 541, S. 555, S. 999, and S. 1638.

Mr. Galper.

STATEMENT OF HARVEY GALPER, ASSOCIATE DIRECTOR, OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY

Mr. GALPER. Thank you, Mr. Chairman, and members of the subcommittee. I welcome the opportunity to present the Treasury's views on four bills now before you: S. 246, S. 1846, S. 1488, and S. 1543. There are two other bills, as you indicated, S. 1542 and S. 1697, also relating to the same subject, but unfortunately we did not receive notification that these would be on the schedule in time for us to prepare a full analysis for you. My comments on the other

four bills, however, in large measure would apply to those two latter bills as well.

The first and simplest of these pieces of legislation is S. 246, which would exempt up to $500 of interest on savings accounts, $1,000 for joint returns.

The second bill, S. 1846, would enlarge the existing exemption for dividends received. S. 1488 would exempt up to $500 of interest on savings accounts or $1,000 on a joint return, available only to the extent that interest earned in 1 year exceeded the amount earned in the immediately preceding year.

Finally, S. 1543 would exempt up to $1,500 of dividends, $3,000 for a joint return, reinvested each year under a qualified dividend reinvestment plan.

We have given these bills careful consideration because of our interest in legislation that might promote savings or assist small savers. However, we have concluded that none of the bills would effectively further these goals, and in fact, these bills would distort the allocation of saving among financial assets. Therefore, the Treasury is opposed to all four of these bills.

Let me now focus on each proposal separately.

The Treasury opposes S. 246 for three reasons. First, it is expensive. Second, it does not stimulate savings effectively. And third, in our view, it may hinder the enactment of legislation now before the full Senate to phaseout regulation Q, which currently limits to 5½ percent the return that thrift institutions can pay to savers holding passbook accounts. The administration supports legislation to phase out regulation Q as a more effective means to aid small savers.

Let me discuss each of these three points. In terms of foreign revenue, S. 246 would range from about $3.4 billion in its first full year to in excess of $4.5 billion after it has been in effect for 4 or 5 years.

S. 246 also does not stimulate savings effectively because, for the most part, it does not operate on the margin of decisionmaking. Almost three-quarters of the revenue loss, or over $3.3 billion a year at 1984 levels, would go to the largest savers and would do absolutely nothing to encourage saving for those savers who currently have in excess of $500 of interest in their savings account. Some marginal incentive would be provided to increase savings for small savers, but even if this group were to increase their savings significantly, they represent such a small portion of total savings that aggregate savings is likely to be affected very little.

While S. 246 would provide some relief for small savers, the simplest and most effective way to provide assistance is to phase out regulation Q, which is what forces small savers to receive an unfairly low rate of return in the first place.

Essentially what we are saying here is that when you are dealing with small savers who are subject to low marginal tax rates, tax exemption does not represent much of an increase in their rate of return, compared to the market rates that they might receive if regulation Q were phased out.

For example, assuming—and this is just an assumption—that a 9 percent rate were available on passbook accounts, if regulation Q were phased out, then we would find that a taxpayer in the 14

percent bracket would receive after tax a 41 percent higher rate of return from phasing out regulation Q than from making the current 5½ percent passbook rate tax exempt. Similarly, a 20 percent bracket taxpayer would receive over a 30 percent higher rate of return.

Therefore, in our view, if we wish to help the small saver, it makes more sense to get rid of those restrictions which are currently preventing market rates of return from being provided to the small saver. The administration therefore supports S. 1347 which would phase out regulation Q over a 10 year period.

Let me turn briefly to S. 1846, which would exempt a combined total of up to $250 of interest and dividends from tax for a single return, $500 for a joint return. Again we are confronted with a substantial revenue loss, ranging from $2 billion in 1980 to $2.6 billion in 1984, and I reiterate this revenue loss point because we are indeed dealing with a tight budget, and we just don't have the room in the budget at this time for major tax initiatives.

In addition, there would be a similar waste of revenue in the sense that most of the money would not be available for taxpayers who would receive a higher incentive to save as a result. Over 60 percent of the revenue loss is wasted on taxpayers who are over the $250 limit.

And again, we would support removing regulation Q as a much more effective way of assisting the small saver.

S. 1488, however, is a somewhat different matter. It represents an intriguing attempt to overcome some of the weaknesses of the earlier bills by trying to reduce the size of the revenue loss which would not provide a direct incentive to save. This is done by an incremental approach of providing the subsidy, or the tax exemption, only for saving or for interest income in excess of a prior year's interest income. However, this approach, while interesting, is not fully successful either. First, one must be careful not to overstate the magnitude of the incentive effects provided by an incremental approach. It is only a 1 year incentive for saving, not a permanent incentive. As a result, the incremental approach provides a much smaller incentive to save than does a permanent incentive on a higher level of passbook saving maintained in a savings account.

We have an example in the testimony which illustrates why this is true.

Furthermore, the incremental approach encourages various types of transactions which certainly do not seem to make sense from an overall policy point of view. In other words, a taxpayer may reduce savings for a year, or even better, transfer his funds into other assets for a year in order to establish a lower savings account interest base for the following year. In this fashion, his holdings of eligible assets may go up and down to take maximum advantage of the tax benefit.

It does not appear desirable policy to encourage such transactions in order to qualify for tax benefits.

Furthermore, an incremental approach is bound to have some arbitrary impacts on taxpayers in particular situations. For example, it would discriminate against older persons who are at a stage in life when they ordinarily draw down their savings, and would

favor younger persons who are at a stage of life when they ordinarily would add to their savings. In either case, there may not be an appropriate incentive provided for the saver in that particular category.

As a result, the Treasury is also opposed to S. 1488.

Let me turn now to S. 1543, which differs from the other three bills by providing a relatively narrow incentive for reinvesting dividends rather than broader incentives for all dividends or all interest on savings accounts. This is a departure from the previous three bills in that it is most definitely not a program for small savers. The effect of S. 1543 is to give shareholders an option to convert cash dividends into earnings retained on their behalf by a corporation. In other words, it is a device to effectively convert dividend income into capital gains. The benefits, therefore, would not be to small savers but to those who gain most from relatively advantageous taxation of capital gains, and for those who do not need the immediate cash from current dividends.

Furthermore, S. 1543 could encourage tax motivated churning of assets in the sense that an individual who really needed to liquidate assets would merely hold on to the asset or the stock that was created by the reinvestment of the dividends, and sell off another part of his portfolio if current income were needed. It would encourage tax motivated borrowing to the extent that it is easier and less risky to borrow against stock in a secure, high yield company than stock in a company which is a growth company.

The basic question raised by this legislation is: Should shareholders pay any tax on current earnings of the corporation? Such taxes are now paid on current dividend distributions of the corporation. To the extent that S. 1543, resembles past proposals to relieve the double tax of dividends, it does so in a rather peculiar way. Rather than providing that dividends are taxed once at the marginal rate appropriate to each shareholder, it taxes them, in effect, at corporate rates by allowing the individual not to pay taxes on his individual dividends at his own individual income tax rates. For these reasons, the Treasury also opposes S. 1543.

However, we recognize that the tax system, especially in an inflationary period, does discourage savings ind investment and that it remains an important economic objective to stimulate greater capital formation. Budgetary considerations, however, simply do not permit new tax initiatives at this time. When appropriate, we would expect to evaluate a whole range of alternative approaches for promoting savings and investment. These would include not only possible savings incentives that would not have the deficiencies of the proposals before you today, but would also extend to measures to accelerate depreciation allowances, and to provide, perhaps, for a general restructuring of tax burdens. Choices among these approaches would then be based on the considerations of equity and relative effectiveness in promoting savings and investment.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

Senator Bentsen?

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

Mr. Galper, reading your testimony, at one point you say, referring to S. 246, it would do absolutely nothing to encourage savings. Well, now, I think that is just so flatly wrong on its face—and I am talking about the bottom of page 2—it is the same sort of thing we heard on capital gains. Capital gains was not going to do anything for venture capital, and we turned around and passed it in this Congress, and we had to drag the administration into it, kicking and screaming. But the figures show that venture capital in this country went up almost 10 times, by professional venture capital managers, following that. The new issue market increased substantially.

Now, I just want to tell you that this is going to pass in one form or another because the people in this country are ready to see that kind of psychology turned around.

If you have got passbook savings today that are bringing you 5½ percent interest and your taxes on it gets down below 4 percent, you have got inflation at 13 percent, and you have got yourself a negative 9 percent, I think it is time we learned something from what some of the other countries are doing.

I cited you a bunch of figures on what other countries are doing on savings, 22 percent, by the British depending on the period of time, 25 percent by the Japanese, the Germans at 13 percent, but some of the reasons that we see that is that they have put incentives in the system for that.

Let me give you some examples. Now, in Britain, their national savings certificates up to the equivalent of $2,237, are tax free. British savings bonds, save as you earn, national savings bank accounts, totally tax free. In Germany, deposits at savings and loan institutions are deductible based on family size, veteran status, and other factors. In Japan, interest income from deposits up to $15,000, totally exempt, ever since World War II. The policy in this country has been to try to take care of the economy by stimulating consumption and we have become almost a nation of demand junkies.

Now, the Joint Economic Committee, in its annual report this year, is talking about turning that around, getting over to the supply side, doing some things about capital formation. Now, this is a positive approach that we are trying to make, and I really think Treasury ought to get aboard and try to assist because I frankly think we are going to prevail, and there is enough credit to go around, and we will let some of it spill over to you. [Laughter.]

Senator BENTSEN. You know, if you take this lesson to heart, that is.

Mr. GALPER. Let me respond on a couple of points. One is that I didn't say, at least I hope I didn't say that the whole proposal would do nothing to encourage savings.

Senator BENTSEN. Well, you were kind enough not to denounce the whole proposal.

Mr. GALPER. To the extent that the benefits go to people already having interest income in excess of the limit, there is no incentive to encourage saving. That is a different point.

Senator BENTSEN. Well, I think that is an incentive for them to leave that money in there.

Mr. GALPER. It is already in there.

Senator BENTSEN. Because otherwise they are going to pull out unless they can see some additional considerations in this period of inflation.

Mr. GALPER. We are certainly in agreement with you on the desire to increase capital formation, and it is for that reason that we have to be very careful in trying to determine measures which will really achieve that goal because we can spend a lot of money to very little effect.

Senator BENTSEN. I would think every one of your arguments could be used with the same degree of justification to what Japan is doing, Germany is doing, Britain is doing, but they decided to do them anyway, even in spite of your reasoning on this, and the savings are substantially higher than ours.

Mr. GALPER. Well, I did not testify in front of them, but I think if we want to look at their experiences, we also should evaluate whether they are successful and not just whether they have them. And on the margin, we should ask if the money or the revenue that would be lost in this way, would it indeed succeed in stimulating additional savings.

Senator BENTSEN. Well, let me say I sat down and had breakfast with the French Economics Minister who assured me they were amazingly successful, that they were just delighted and gratified.

Senator BYRD. Senator Dole.

Senator DOLE. Well, I would just say—and I have read, tried to catch up on the statements on S. 246—there is another proposal to provide a tax incentive for savings, S. 1597, which I think underscores what Senator Bentsen has indicated. There is a lot of support for the concept. In fact, S. 1597, the Savings and Investment Encouragement Act of 1979, is one of the few bills that I can remember on which all the Republican Senators are in agreement. We have introduced S. 1597, which excludes from income both qualified interest and qualified dividend income, to encourage both savings and investment. An additional exclusion is provided for interest and dividends that are reinvested.

I don't know whether your objection, Mr. Galper, would apply to the dividend exclusion or not. Would you support that?

Mr. GALPER. Well, there are a couple of points to be made there. One is that the same budget point that I have been making applies in any case. However, putting that aside for a moment, I think one would say that the broader the incentive is applied, that is, across various types of capital income, the less there is likely to be switching from one asset to another asset, just to take advantage of the tax benefit that would only apply in one case and not in another case. So to that extent I would say if revenue considerations were not a constraint, then a broader approach may make more sense than a narrower one.

Senator DOLE. Well, I am not suggesting Senator Bentsen's proposal does not make sense. I am just suggesting that there is a lot of support for incentives for both savings and investment, and while I can understand the Treasury's concern with the revenue impact, I believe there might be some way to avoid the initial revenue loss through a phase-in. There may be some way the exclusion can be put in place without the initial heavy revenue losses, which could cause problems with the budget.

Mr. GALPER. Well, it is something to consider.

Senator DOLE. Well, I think as Senator Bentsen has indicated, it probably will happen one of these days in the Congress. There is widespread support for this kind of incentive. We hope it is justified as economic policy, not just politically desirable, to try to exclude interest and dividend income. But it is important to look at political prospects, and I think I can speak for the 41 Republicans who are sponsoring S. 1597. No one has asked to be taken off the bill as a cosponsor since its introduction on July 30.

So there is a lot of interest in it.

Thank you.

Senator BYRD. Thank you.

Mr. Rosenbloom.

[The prepared statement of H. David Rosenbloom follows:]

STATEMENT OF H. DAVID ROSENBLOOM, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. ROSENBLOOM. Thank you.

Mr. Chairman, members of the subcommittee, I am happy to have this opportunity to appear today to present the views of the Treasury Department on S. 1703. That bill would grant employees of organizations which are exempt from Federal taxation under Section 501(c)(3) of the Code the $20,000 exclusion of foreign earned income that was generally available to U.S. citizens employed abroad prior to the Tax Reform Act of 1976.

If it pleases the chairman, I would propose to simply submit my written statement for the record, and simply to summarize our views.

Senator BYRD. Yes, your statement will be published in full in the record.

Mr. ROSENBLOOM. The aim of this bill, broadly stated, is to enable exempt organizations to pursue their worthy purposes abroad, and the theory of it generally speaking is that if such organizations can pay tax-exempt wages to their employees abroad, they can pursue more activities in pursuance of those purposes. Of course, we have no quarrel with the proposition that the purposes of these organizations are eminently worthy. That is why they are exempt from Federal taxation in the first place. Nor do we have any quarrel with the proposition that if they could pay tax-exempt wages to their employees abroad, they could engage in more activities in pursuance of their exempt purposes.

Our difficulty with the argument, and the reason that we are compelled to oppose the bill, is that it applies with equal force to a wide variety of other activities and other organizations, including, most relevantly for present purposes, charities pursuing exempt activities in the United States. This bill would, in effect, provide a subsidy linked directly to the pursuit of charitable activities abroad. We believe that Congress has gone through fairly recently a long debate on the appropriate taxation of Americans abroad, and has, generally speaking, come up with a reasonable solution which provides deductions to compensate for the excess costs encountered by Americans overseas. We cannot see anything in the recent congressional consideration of this matter that would justify taking one group of Americans abroad and providing them a subsi-

dy which is not available to their counterparts in the United States.

And for that reason, we oppose S. 1703, Mr. Chairman.

Senator BYRD. Let me ask you this. Take an employee of the World Bank here in Washington. What taxes does he pay?

Mr. ROSENBLOOM. Well, you are talking about in the United States, living in the United States?

Senator BYRD. Living in the United States, yes.

Mr. ROSENBLOOM. Well, there are separate provisions governing the taxation of employees of international organizations in which the United States is a member, section 893.

Senator BYRD. I understand that, but tell me what taxes it is? Does he pay the same taxes as you and I pay?

Mr. ROSENBLOOM. Well, is he a U.S. citizen or not, sir?

Senator BYRD. Yes.

Mr. ROSENBLOOM. Well, then, he would pay U.S. taxes, yes, sir.

Senator BYRD. And if he is not a U.S. citizen?

Mr. ROSENBLOOM. If he is not a U.S. citizen, he is exempt pursuant to section 893 of the Code, which covers international organization employees in the United States.

But the people we are talking about here are employees of private charities, not international organizations.

Senator BYRD. Yes, I understand, but the employees of—is it not correct that the employees of an international organization, U.S. employees of an international organization, is it not correct that those salaries are adjusted to make them comparable to the foreign employees who do not pay taxes?

Mr. ROSENBLOOM. Yes, I think that is correct, and indeed, that leads to my point. We would, of course, have no objection to consideration of an alternative approach to the goals of this bill through comparable direct grants, appropriations for direct grants, much as you suggest with respect to employees of international organizations. Then it would be a direct expenditure. It could be reviewed by the appropriate committees of Congress, and it would be more efficiently administered.

So I think in your suggestion of comparing these people to employees of international organizations, that is pretty much what we are suggesting.

Senator BYRD. Well, that really wasn't my suggestion. I was merely trying to understand how that is handled. My understanding is that the employees of the international organizations have their salaries adjusted upward to take care of the taxes that they have to pay, which in effect means that they don't pay taxes.

Mr. ROSENBLOOM. Well, it is not quite accurate to say they don't pay taxes. They pay taxes, but there are——

Senator BYRD. They pay taxes, but they have had their salary adjusted to take care of the taxes that they pay.

Mr. ROSENBLOOM. Yes, but those salaries are adjusted with funds which are appropriated by the Congress to be paid to the international organizations to take care of the U.S. share of participation in the international organizations. So the money is paid by the employees as taxes, and periodically there are appropriations to cover the added costs of employing U.S. citizens.

Senator BYRD. Senator Bentsen.

Senator BENTSEN. I have none, thank you.
Senator BYRD. Senator Dole.
Thank you, sir.
Mr. Gutman.

STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. GUTMAN. Thank you, Mr. Chairman, members of the subcommittee.

With your permission, Mr. Chairman, I would like to submit my written statement for inclusion in the record.

Senator BYRD. Yes, it will be included in the record.

Mr. GUTMAN. Thank you.

I would like to deal briefly with the major aspects of the four remaining bills: S. 1638, S. 541, S. 999, and S. 555.

First Mr. Chairman, I would like to talk about S. 1638, a bill that would permit the amortization of certain preoperating expenses by a corporation or business.

With one minor modification which I have noted in my statement Treasury supports this legislation. It would reduce, in our view, the disparity in tax treatment between ordinary and necessary preopening expenses and similar expenses which are incurred by an operating business. In addition, and perhaps more importantly, it would, we hope, reduce the number of controversies which presently exist between taxpayers and the Internal Revenue Service where a taxpayer who is already engaged in some form of business activity incurs expenses to open what might be viewed by the Internal Revenue Service, as a new business. Therefore we support it.

The second bill I would like to address is S. 541, which would permit executors to make an alternate valuation date election on a late filed estate tax return. We have no objection to this substantive change to the election procedure in section 2032. However, Mr. Chairman, we do oppose the bill as it is drafted because of its effective date and transition provisions. The bill is effective in general for estates of decedents dying after December 31, 1977. We don't believe this retroactive effective date is necessary. Rather, we would recommend that the provision be generally applicable for estates of decedents dying after date of enactment.

Senator BYRD. Excuse me just a minute. This is S. 541?

Mr. GUTMAN. This is S. 541, yes, sir. The other reason that we object to the bill has to do with the transition relief embodied in the bill. Under the transition rule in the bill, executors of estates of decedents who die before the general effective date, whatever that is, would be allowed within 90 days of enactment of the bill to perfect what was previously a defective alternate valuation date election. But they would be granted this privilege only if such an election had been indicated on the first estate tax return that had been filed by the executor.

In our view, Mr. Chairman, this form of transition relief is unfair and rewards the wrong people. It will reward those who attempted to elect alternate valuation in circumstances where clearly, under the statute, no alternate valuation date election would have been allowed because the return was filed late. On the

other hand, the transition relief does not help any person who filed a late return and, cognizant of the fact that an alternate valuation election was prohibited under the circumstances, did not bother to try to elect alternate valuation even though such an election would have benefitted the estate.

The uneven application of this transition rule cannot be rectified short of granting to all executors who filed late returns some limited time period within which to reelect alternate valuation. However, we believe that a transition rule that would operate fairly and encompass all of the affected individuals would be difficult if not impossible to administer fairly, both from the point of view of the Internal Revenue Service, and in terms of the problems of identification and notice to affected executors and heirs. Thus, unless the effective date is modified and the transition relief eliminated, we cannot support the bill.

Senator BYRD. Now, how do you suggest modifying it?

Mr. GUTMAN. Well, I think the only way it can be modified, Mr. Chairman, to make it work fairly in terms of transition relief, is to allow the opportunity for all executors who filed late returns to go back and say, if the alternate valuation date would have helped us, now we should be permitted to elect it. The problem with doing that, however, is that assets may have been sold in the interim or assets may have been distributed to various beneficiaries. The alternate valuation date election has an income tax consequence because the basis of the property in the hands of an heir is under the applicable law its date of death value or its alternate valuation date value. If you change from one to the other, you affect the basis of property. If this property has been sold in the interim, any person who has received that property and sold it has to file an amended income tax return. The statute of limitations may have expired. It gets very complicated, in other words.

Senator BYRD. Well, now, isn't the purpose of this bill to, where an executor, through no fault of his own, was unable to take advantage of that part of the law, that this would permit him to do so.

Mr. GUTMAN. That is certainly the effect of the substantive change.

Senator BYRD. Where there has been no willful attempt to——

Mr. GUTMAN. Certainly that is right, and the substantive change, that is the actual amendment to the statute, would permit that to happen. Indeed the particular case to which this transition relief is directed is an appealing case because of the facts under which the executor was unable to elect alternate valuation. But the problem with fashioning the relief the way it has been done is that it discriminates against people who might have been in the same situation but they read the statute and they saw they couldn't make an alternate valuation date election, so they didn't. The statute was perfectly plain; in order to make an alternate valuation date election, you had to do it on a timely filed return. To be fair about the transition relief, we believe you would have to open up the opportunity to reelect to everybody who was in that situation.

Senator BYRD. To everyone who was in the same situation.

Mr. GUTMAN. Yes.

Senator BYRD. Namely, that they——

Mr. GUTMAN. That's right, whether or not on the first return that they filed they elected alternate valuation.

Now, we don't know how to find those people, and I tried to go through with you some of the problems——

Senator BYRD. Well, you don't have an obligation to go out and find them, do you?

Mr. GUTMAN. Well, if we are going to recommend the passage of legislation, we think it ought to be reasonable to assume that there would be some opportunity for those people to take advantage of it. There are also ancillary problems that arise here, problems not only of the executor notifying the Internal Revenue Service, but the executor notifying heirs and perhaps filing a lot of amended tax returns, not just estate tax returns, but income tax returns. So it gets very complex.

Senator BYRD. Now, is it correct that under the law as it now stands—we have a vote, the last few minutes of a vote. Is it correct under the law as it now stands that the Internal Revenue Service cannot grant a waiver, even though the request is reasonable, even though——

Mr. Gutman. That is right, sir. Under the law as it presently stands, an executor must make this election on a timely filed return. If he doesn't do that, he is out of luck.

Senator BYRD. Well, is that a good law, to have it in such a fashion?

Mr. GUTMAN. We have said that we have absolutely no objection to changing that to permitting an executor to be able to elect on the first late return that is filed because it does not seem to make a lot of sense to bind him in that circumstance. The only thing that we are objecting to is the form of transition relief that is being granted here because we think that once you go back in time, it is impossible to be able to make the kinds of distinctions that are being made fairly unless you open it up to everybody. If it is opened up to everybody, we think that is going to lead to unbearable complexity.

Senator BYRD. Thank you.

The committee must take a very brief recess so Senator Dole and the Chairman can vote.

Senator DOLE. If we repeal carryover basis, maybe that would help.

Mr. GUTMAN. I am afraid it doesn't do it for this.

[A brief recess was taken.]

Senator BENTSEN [presiding]. The hearing will come back to order.

Mr. Gutman, had you finished your statement?

Mr. GUTMAN. No, I hadn't. If I could just have a couple of more minutes. I answered a few questions.

Senator BENTSEN. Fine.

We learned long ago to run these things in shifts during these votes. So that is what we are doing now.

Mr. GUTMAN. All right, fine. Well, you came back at the right time because I was about to talk about S. 999.

Senator BENTSEN. Be careful, now. All right.

Mr. GUTMAN. S. 999 would permit the Internal Revenue Service to waive the payment of interest on a late payment of tax where the late payment was not due to willful neglect.

We have to oppose this bill. We don't believe that interest is properly viewed as a penalty; rather, in its economic sense, interest is a charge for the use of money. When money isn't paid on time, the borrower continues to have the economic benefit of the use of the money which otherwise would have been available to a lender.

When tax payments aren't made on time, taxpayers have effectively borrowed money from the U.S. Government. Like any other lender, we believe the Government is entitled to be compensated for this loan. It is rare in the private business sector that interest would be waived, even in the types of compelling circumstances which gave rise to the introduction of this bill, and where a borrower is unavoidably late in making a payment. We don't believe that the Government should be treated any differently from a private lender in this situation, and thus we must oppose the bill.

Now, if I could just go on briefly to touch on S. 555, the Independent Local Newspaper Act. There is quite a bit of discussion of this bill in my testimony, and I will try to summarize in the main why it is that the Treasury strongly opposes this legislation.

In the first place, this bill, provides an extraordinary number of tax benefits to the owners of independent local newspapers in an effort to reduce the estate tax burden on those owners and to enable them to resist takeover efforts by large newspaper chains. The phenomenon which gives rise to the need for the bill is the opportunity to sell newspapers at what are alleged to be extraordinarily premium prices. We don't believe the bill solves that problem at all. We don't believe it does anything to cure the market situation which allegedly creates the need for the bill. Rather, the bill, at best, makes it less expensive to pass newspapers from generation to generation.

We have no quarrel with the proposition that a free and vigorous press ought to be protected. But if that is to be a national policy goal, we believe the problem ought to be addressed directly. If the independent local newspaper industry is threatened, special loan or subsidy programs ought to be considered. To the extent the value of these businesses is being artificially escalated by takeover bids from large newspapers, then the possible modification of the antitrust laws should be considered. Either or both of these courses, we believe, would result in a more controlled and equitable resolution of the problem than the use of tax expenditures.

Second, as I noted, the bill provides an extraordinary panoply of tax benefits in the form of departures from generally applicable tax principles. They are all laid out in my statement. I don't think it is necessary to go through them.

These tax benefits result in the Federal Government's share of a newspaper owner's estate tax liability being quite extraordinary. In fact, as some of the examples in my testimony show, it would almost be cheaper for the Government simply to exempt local newspapers from estate tax rather than get involved in a program like this.

Third, the bill provides relief to only one class of small business. We fear that it could be used as a precedent for other elements of

the small business community to come in and argue for similar relief, each one arguing its own importance. We are at least wary of the kinds of distinctions that could be made to justify this special relief for newspapers only. If the estate tax payment relief provisions of present law are inadequate, they should be comprehensively reviewed and not corrected in an ad hoc manner.

Finally, with regard to the bill itself, we don't believe that its benefits are carefully targeted to those who need the relief. If the need for the relief really exists, to target the benefits more precisely and provide adequate safeguards against abuse would require a series of extraordinarily complex amendments to a bill that is already 37 pages long and is extremely complex itself.

Thank you, Mr. Chairman.

Senator BENTSEN. The last time I looked at a tax bill submitted by the Treasury, that was just the introduction, that many pages.

But let me say that on S. 999, that was to waive delinquent interest payments, or interest payments on delinquent payments, and in that instance, of course, it was triggered by what I saw done to Wichita Falls.

Mr. GUTMAN. Right.

Senator BENTSEN. The tornadoes that tore through that city.

Mr. GUTMAN. Yes, sir.

Senator BENTSEN. People couldn't find some of their homes, much less their checkbooks.

Mr. GUTMAN. Right.

Senator BENTSEN. And it seems to me under those kinds of exceptional circumstances where you have had a natural disaster, through no fault of the individual they had not been able to pay it, where there was a reasonable cause and not due to willful neglect, that this legislation would be meritorious.

Mr. GUTMAN. I understand that, Senator. I might just point out, however, that the legislation as drafted doesn't narrowly target in on disaster areas but instead is a more broad provision which would allow the waiver of interest in any circumstance where the Service found reasonable cause.

Senator BENTSEN. Are you suggesting how I should draft it to get your approval?

Mr. GUTMAN. No, sir. I am afraid even if it were drafted the other way, we would take the same position.

Senator BENTSEN. All right.

I don't believe I will thank you for your testimony, but we are pleased to have you.

Mr. GUTMAN. Thank you.

[The prepared statements of the preceding panel follow. Oral testimony is continued on p. 175.]

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STATEMENT OF
HARVEY GALPER
ASSOCIATE DIRECTOR, OFFICE OF TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
OCTOBER 31, 1979

Mr. Chairman and members of the Subcommittee:

I welcome the opportunity to present the Treasury's views on four bills now before you: S.246, S.1846, S.1488, and S.1543. These four bills would attempt to encourage savings by making interest or dividends tax exempt under certain specified conditions. The first and simplest is S. 246. It would exempt up to $500 of interest on savings accounts ($1,000 for joint returns).

The second bill, S. 1846, would enlarge the existing exemption for dividends received. Under present law, the first $100 of dividends received by an individual each year is generally tax exempt (up to $200 on a joint return). Under S. 1846, the exemption would be increased to $250 ($500 for a joint return), and would be allowed for interest on savings accounts as well as dividends.

The third bill, S. 1488, would exempt up to $500 of interest on savings accounts ($1,000 on a joint return). However, the exemption would be available only to the extent that interest earned in one year exceeded the amount earned in the immediately preceding year.

Finally, S. 1543 would exempt up to $1,500 of dividends reinvested each year under a qualified dividend reinvestment plan. The exemption would be $3,000 for joint returns.

We have given these bills careful consideration because of our interest in legislation that might promote savings or assist small savers. However, we have concluded that none of the bills would effectively further these goals and, in fact, these bills would distort the allocation of saving among financial assets. Therefore, the Treasury is opposed to all four of these bills.

To the extent possible, any tax incentives for savers should be neutral as between different kinds of savings, should not permit tax-deductible borrowing for the purpose of securing a tax-free return, should not encourage complicated transactions to realize tax benefits, and should reward most additional saving with a higher after-tax return. In addition, any incentive program must be consistent with our fiscal objectives of moving towards budgetary balance.

We will now focus attention on each proposal separately.

S. 246

The Treasury opposes S. 246 for three reasons. It is very expensive, it does not stimulate savings effectively, and it may hinder the enactment of legislation now before the full Senate to phase out Regulation Q. Regulation Q currently limits to 5.5 percent the return that thrift institutions can pay to savers holding passbook accounts. The Administration supports legislation to phase out Regulation Q as a more effective means to aid small savers.

The revenue loss from S. 246 would be quite large. It would amount to $3.4 billion in its first year of operation and would increase to over $4.6 billion a year in 1984.

S. 246 does not stimulate savings effectively because, for the most part, it does not operate on the margin of decision-making. No incentive effect whatever is provided to savers who earn more than $500 of interest. Currently, such savers earn 92 percent of all taxable interest. While S. 246 provides no incentive effect to these large savers, they, nonetheless, are eligible for the full $500 exclusion and would receive almost three-fourths of the tax break resulting from S.246. Thus, almost three-quarters of the revenue loss (or over $3.3 billion a year at 1984 levels) would go to the largest savers and would do absolutely nothing to encourage savings.

Some marginal incentive to increase saving would be provided to the small savers with less than $500 of interest income, a group which now contributes a small share of aggregate savings. Even in the unlikely event of a substantial increase in the savings of this group, aggregate savings would be very little affected. 1/

We agree that small savers are now treated unfairly; they generally receive a very low return on savings accounts, a return that is less than the current rate of inflation. Moreover, small savers are ordinarily unable to take advantage of higher-yielding alternatives (such as money-market certificates) because of minimum deposit requirements. While S. 246 would provide some relief to small savers the simplest and most effective way to provide assistance is to phase out Regulation Q, which is what forces small savers to accept an unfairly low return.

This can be illustrated by a hypothetical example. Consider a saver in the 21 percent bracket (e.g., a family of four making $18,000 a year) who for the purpose of this example we will assume might earn 9 percent before taxes and 7.2 percent after taxes on passbook savings once Regulation Q is phased out. However, the maximum amount now allowed on passbook accounts under Regulation Q is 5.5 percent. Even if the entire 5.5 percent is tax-free, the small saver in our example is 1.7 percentage points better off if Regulation Q is phased out than if S. 246 is passed.

S.1347 which would phase out Regulation Q over 10 years, was reported out by the Banking Committee and is now before the full Senate. Because it is the most effective way to provide relief for small savers, the Administration supports S.1347.

1/ S.246 would raise the average after-tax return of savers with less than $500 of interest income by no more than one-third. Even under the assumption of an extremely high savings response to this increase in after-tax return (assume an interest elasticity of 0.4) such small savers would increase their holdings of interest-earning assets by no more than 12 to 13 percent. This, in turn, would represent an increase of only 1 percent in holdings of all interest-earning assets or less than one-quarter of one percent in holdings of all assets yielding capital income. Thus, the increase in aggregate savings would be imperceptible.

Finally, S. 246 encourages savers to switch from one kind of savings to another, e.g., from stocks and bonds to savings accounts. Activity of this kind merely rearranges savings, and does nothing to increase savings. 2/

S. 1846

S. 1846 would exempt a combined total of up to $250 of interest and dividends. (Up to $500 of interest and dividends would be exempt on joint returns.) Thus, compared to present law, S. 1846 expands the exemption to cover interest on savings accounts as well as dividends and increases the total exemption from $100 to $250.

S. 1846 has many of the same weaknesses as S. 246. Over 60 percent of the revenue loss is wasted on taxpayers who are over the $250 limit and who therefore are not given any incentive to save. Only about 7.5 percent of interest and dividends is affected at the margin.

Because S. 1846 sets a lower limit than S. 246 ($250 rather than $500), it results in a smaller revenue loss. The revenue loss from S. 1846 -- which would grow from $2.0 billion in 1980 and $2.6 billion in 1984 -- would be about three-fifths of the revenue loss from S. 246. Also, S. 1846 treats dividends and savings account interest equally, thereby reducing the incentive to switch from one form of savings to another. Switches between non-eligible assets--such as corporate and government securities--to savings accounts would still be likely, however.

2/ S. 246 also suffers from the defect that it may encourage taxpayers to borrow from one bank in order to make tax-exempt deposits at another bank. For example, a taxpayer in the 50 percent bracket (e.g., a family of four making $80,000 a year) might borrow $10,000 at 15 percent from one bank and use the money for a 9 percent certificate of deposit at another bank. Interest paid on the money borrowed would be deductible, but interest earned on the certificate of deposit would be tax exempt. Therefore, the taxpayer would make an after-tax profit of $150 a year, without doing any real saving at all. A remedy would be to allow the exemption only for interest income in excess of interest expense. For example, if a taxpayer received interest of $500 and paid interest of $300, only the net amount of $200 would be exempt from tax.

In conclusion, the Treasury is opposed to S. 1846 because it would result in a substantial revenue loss, would do little to promote savings, and would provide less relief for small savers than phasing out Regulation Q--the same reasons we are opposed to S. 246.

S. 1488

S. 1488 exempts up to $500 of interest on savings accounts each year (up to $1,000 on a joint return). However, a taxpayer is eligible for the exemption only if he earns more interest this year than he did last year. For example, if a taxpayer earned $200 of interest last year and earns $500 this year, only the increase of $300 is exempt.

The revenue loss from S.1488 would be $1.1 billion in 1980 rising to $1.5 billion in 1984.

S.1488 is an intriguing attempt to overcome a major weakness in S.246. As noted earlier, S.246 has no incentive effect on large savers, but nonetheless gives them more than $3 billion a year. The incremental approach of S.1488, combined with quite high dollar limits on these increments, means that some incentive effect is likely to be provided to all but the very largest savers. However, one must be careful not to overstate the magnitude of the incentive effects provided by an incremental approach. While both S.1488 and S.246 exempt interest income from taxation, S.1488 has a much smaller effect on any particular saving decision than S.246.

To see why this is so, consider a taxpayer in the 21 percent bracket (e.g., a family of four with an income of $18,000 a year) trying to decide whether to add $100 to a pass book savings account. If the passbook interest rate is 5.5 percent, S.246 would permanently increase the after-tax interest return from $4.35 a year to $5.50 a year. On the other hand, S.1488 would increase the after-tax interest return by the same amount, but for only a single year. In other words, if the taxpayer in our example is truly a marginal saver (i.e., the increase in after-tax return is necessary to induce him to maintain a $100 higher balance in his passbook savings account) then he will withdraw the $100 after the temporary effect of S.1488 has worn off at the end of the year. While S. 1488 does reduce the waste of non-incremental approaches, this example illustrates that much of the cost savings under the incremental approach is achieved by providing a smaller incentive to save.

Under an incremental approach, a taxpayer may also reduce savings for a year (or even better transfer his funds into other assets for a year) to establish a lower savings account interest base for the following year. In this fashion, his holdings of eligible assets may go up and down to take maximum advantage of the tax benefit. While his average asset holdings over every two-year period may indeed rise--at least perhaps his holdings of savings accounts--, it does not appear desirable policy to encourage such transactions in order to qualify for tax benefits.

Furthermore, an incremental approach is bound to have some arbitrary impacts on taxpayers in particular situations since there is no operational way to determine exactly the normal or baseline savings level for each taxpayer. Taxpayers who would have added to savings in the absence of the tax incentive are rewarded even if they do not change their behavior; whereas those who are forced to draw down savings are completely denied the opportunity to respond to the incentive.

Thus, while a non-incremental approach would affect all persons equally regardless of what is happening to their savings from year to year, the incremental approach of S.1488 would not: It would discriminate against older persons who are at a stage in life when they ordinarily draw down their savings, and would favor younger persons who are at a stage of life when they ordinarily would add to savings. Other arbitrary events triggering eligibility may be changes in interest rates or increases or decreases in interest income because a taxpayer sells or buys a house in a particular year. Also, since no netting of interest expense against interest income is provided in S.1488, it is possible to make money by borrowing for the purpose of generating tax-exempt interest income.

We recognize that S.1488 attempts to achieve greater efficiency as a savings incentive but it can only do so at the expense of injecting arbitrary elements into the tax code. Accordingly, Treasury is opposed to S. 1488.

S.1543

S. 1543 differs from the other three bills by providing a relatively narrow incentive for reinvesting dividends, rather than broader incentives for all dividends or all interest on savings accounts. Under the bill, up to $1,500 ($3,000 on a joint return) of dividends would be tax exempt if reinvested in a qualified dividend reinvestment plan. Under such a qualified plan, a corporation would issue new

shares of common stock to shareholders who elect to participate. The new stock would be issued at fair market value or at a discount not to exceed 5 percent. Shareholders who elect not to participate would continue to pay tax on cash dividends received.

Special tax rules would apply to stock purchased under a qualified dividend reinvestment plan. If such stock is sold within a year after issue, the entire amount received would be treated as ordinary income. If the stock is held for more than a year, this amount would be taxed as a long-term capital gain.

The effect of S. 1543 is to give shareholders an option to convert cash dividends into earnings retained on their behalf. These optional retained earnings would generally be taxed in a manner similar to actual retained earnings; they would not be included in the shareholders' income but would be taxed as capital gains if the shareholder sells his stock.

Under current law, investors can seek the optimal mix of cash flow and retained earnings from stocks by choosing the type of stock that suits their needs. Investors in high tax brackets who seek to defer tax on retained earnings can buy stocks with low dividend/earnings ratios; investors in low tax brackets who are interested in cash flow can buy stocks with high dividend/earnings ratios.

This bill enables shareholders to realize the tax benefits of retained earnings without purchasing growth stocks. Consequently, the effect of this bill would be highly regressive. The major beneficiaries would be high-bracket investors who could obtain the benefits of deferral without assuming the risks generally associated with growth stocks. Low-bracket investors and retired people would not benefit because they would generally choose to receive cash dividends.

In addition, tax-motivated borrowing would be encouraged to the extent it is easier and less risky to borrow against stock in a secure, high yield company. For example, a wealthy investor who borrows on margin to purchase shares of a public utility would be able to receive tax-free accumulation while deducting interest paid on the margin account.

S. 1543 resembles past proposals to relieve double taxation of dividends only to the extent it provides a tax break for shareholders. However, its other effects are exactly the opposite of double tax relief as ordinarily

understood. Rather than encouraging a more flexible capital market, as do other proposals for double tax relief, it encourages retention of earnings within each corporation. Rather than providing that dividends are taxed once at the marginal rate appropriate to each shareholder, it taxes them at corporate rates.

The expected revenue loss from S. 1543 will be $640 million in calendar year 1980 and slightly over $1 billion in calendar year 1984.

For the foregoing reasons, the Treasury opposes S. 1543.

Our testimony has stressed the weaknesses of four bills now before the Committee that attempt to encourage savings. However, we recognize that the tax system, especially in an inflationary period, does discourage savings and investment and that it remains an important economic objective to stimulate greater capital formation. Budgetary considerations simply do not permit new tax initiatives at this time. But when appropriate, we would expect to evaluate a whole range of alternative approaches for promoting savings and investment. These would include not only possible savings incentives that would not have the deficiencies of the proposals before you today, but would also extend to measures to accelerate depreciation allowances and to provide for a general restructuring of tax burdens. Choices among these approaches would then be based on considerations of equity and relative effectiveness in promoting savings and investment.

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STATEMENT OF
H. DAVID ROSENBLOOM
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
OCTOBER 31, 1979

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear today to present the views of the Treasury Department on S. 1703. S. 1703 would grant to employees of organizations exempt from Federal taxation under section 501(c)(3) the $20,000 exclusion of foreign earned income that was generally available to United States citizens employed abroad prior to the Tax Reform Act of 1976.

During consideration of the Foreign Earned Income Act of 1978, both Congress and the Administration took the position that the United States tax treatment of United States citizens employed abroad in the private sector should take into account the excess costs of living abroad. As a result, United States taxpayers living abroad are entitled under section 913 of the Code to a deduction for certain excess housing, education, home-leave travel, and general living costs. In addition, it was generally believed that some tax preference for overseas employment could be justified in cases in which the employee abroad had to accept hardship conditions. Accordingly, United States taxpayers living in hardship areas are entitled under section 913 to a $5,000 deduction in addition to the deduction for excess foreign living costs.

The $20,000 exclusion of foreign earned income allowed to taxpayers generally under prior law was retained in section 911 only for employees living in substandard lodging in certain camps located in hardship areas. Section 911 was tightly drawn to compensate certain taxpayers who effectively must incur a cost in the form of a substantially lower standard of living than they would normally have in the United States; section 913 generally compensates those who incur the added costs necessary to maintain a reasonable living standard. Section 911 was also intended by some persons to give an incentive to multinational companies, particularly in the labor-intensive construction industry, to hire American citizens instead of citizens of other countries. Congress anticipated that this incentive would produce benefits for the United States economy through the purchase by Americans employed abroad of American machinery, equipment, and technical services.

Regardless of the merits of section 911, the reasons for its enactment in its present form do not justify extending the exclusion on a general basis to employees of exempt organizations. To the extent that the employees of exempt organizations experience adverse living conditions in camp facilities, they may qualify for section 911 on the same basis as employees in other industries. Employees of exempt organizations who do not qualify for section 911 may be compensated for hardship conditions by the $5,000 deduction provided in section 913.

Although S. 1703 has been described as a measure that would compensate employees of charities experiencing hardship conditions while they carry out activities favored by the United States, there is no requirement under the bill that hardship conditions be experienced. Nor is the bill limited to employees of organizations engaged in relief activities or, for that matter, to employees of United States organizations.

Even if the bill were narrowly framed, it would provide benefits to activities carried on outside the United States that are not available with respect to similar activities in the United States. There may be specific situations of the type covered that merit Federal assistance. Organizations providing aid to the poor and to agriculture, which are of the greatest concern to the sponsors of the bill, may be examples. If an incentive to certain groups or activities is desired, we recommend that direct grants be provided. It does not appear logical or efficient to employ the tax system for this purpose. With direct grants, the activities to be benefited could be defined more precisely, the cost would be subject to periodic review, and the program would be administered by persons expert in the area.

For the foregoing reasons, we oppose S. 1703.

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STATEMENT OF
HARRY L. GUTMAN
DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
OCTOBER 31, 1979

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear today to present the views of the Treasury Department on four bills: S. 541, S. 555, S. 999, and S. 1638. A summary of the Department's position on each bill is attached as Appendix A.

S. 541 - ELECTION OF ESTATE TAX ALTERNATE VALUATION

The value of assets included in a decedent's estate is determined, in general, either at the time of the decedent's death or six months after the decedent's death. The latter date is called the alternate valuation date. Under present law an alternate valuation date election must be made on a timely filed estate tax return. S. 541 would permit an executor to elect alternate valuation on the first late return filed.

As the proponents of S. 541 have stated, the estate tax consequences of an alternate valuation election will not change if an election is permitted on a late return. It is also true, however, that an alternate valuation date election

will usually have income tax consequences under either step-up in basis at death (i.e., an heir's basis is, in general, equal to the estate tax value of the property received) or carryover basis (i.e., an heir's basis is, in general, equal to the decedent's basis in the property after a number of statutory adjustments). In these cases, an extension of the election date to include late returns may, despite late filing and payment penalties, encourage deferred elections in an attempt to minimize the aggregate estate and income tax consequences to the recipients of inherited property. We would become concerned if such a trend developed. On balance though, we do not oppose the substantive change made by S. 541.

However, we do oppose S. 541 as drafted because of the bill's effective date and transition relief provisions. The bill is effective, in general, for estates of decedents dying after December 31, 1977. We do not believe this retroactive effective date is necessary. Rather, we recommend the provision be effective for estates of decedents dying after the date of enactment.

In addition, we are opposed to the special transition rule pursuant to which executors of estates of decedents dying before the general effective date could, within 90 days of enactment, perfect a defective alternate valuation date election so long as such an election had been indicated on the first estate tax return filed by the executor. Our primary difficulty with this form of transition relief is that, to the extent it is administrable, it will apply unevenly. It will reward those who attempted to elect alternate valuation in circumstances where a valid election was clearly prohibited. However, it will not afford relief to those who filed late returns and, cognizant of the fact that an alternate valuation election was prohibited under the circumstances, did not attempt an election even though it would have benefited the estate. The uneven application of the transition rule cannot be rectified short of granting all executors who filed late returns a limited time period within which to reelect the alternate valuation date. However, a transition rule fashioned so broadly would result in significant administrative difficulties and problems of identification of and notice to affected executors and heirs. Therefore we strongly recommend the transition relief be deleted from the bill.

S. 555 - THE INDEPENDENT LOCAL NEWSPAPER ACT OF 1979

The objective of S. 555 is to preserve local ownership of newspapers in the face of increasingly aggressive acquisition offers by large newspaper chains or conglomerates. If the owner of a local newspaper declines to sell and dies owning the newspaper, the estate tax value of the business is determined in part by reference to recent

sales of comparable newspapers, which, it is alleged, are occurring at unrealistic, inflated prices. It is further alleged that a newspaper valued in this manner cannot generate funds sufficient to pay estate taxes. As a result, local newspaper owners, at death or prior thereto, are encouraged to sell out to the large chains.

The bill attempts to solve this problem by providing an extraordinary number of special exemptions from generally applicable tax provisions to permit the tax-free accumulation of funds to pay the estate tax attributable to the value of the newspaper and to allow any unfunded estate tax to be paid over fifteen years. Thirty-seven pages of statutory language are required to codify these provisions.

We have no quarrel with the proposition that a free and vigorous press should be protected. But if this is to be a national policy goal, we believe the problem should be addressed directly. If the independent local newspaper industry is threatened, special loan or subsidy programs should be considered. To the extent the value of these businesses is being artificially escalated by takeover bids from large newspapers, the possible modification of the anti-trust laws should be considered. Either or both of these courses would result in a more controlled and equitable resolution of the problem than the use of tax expenditures.

This point can be made clear by examining S. 555 in some detail. The bill is divided into two principal parts. The first permits the establishment of a trust by an "independent local" newspaper for the purpose of paying the estate tax attributable to any owner's interest in the business. The trust must have an independent trustee and its corpus may be invested only in United States obligations. The value of the trust cannot exceed 70 percent of the value of the owner's interest in the business. The income earned by the trust corpus will be exempt from tax. Contributions to the trust are not only deductible (up to an amount equal to 50 percent of the annual taxable income of the newspaper business) by the newspaper business, but are also excluded from the taxable income of the owner. These income tax benefits are recaptured roughly if, during the owner's lifetime, the newspaper ceases to meet the statutory definition of an "independent local" newspaper. The corpus of the trust is excluded from the owner's gross estate and the estate does not realize income when its estate tax liability is discharged by the trust. The estate tax benefit is recaptured in whole or part if the business interest is sold within 15 years of the owner's death.

The second part of the bill provides an elective deferral of the estate tax attributable to the newspaper interest not otherwise paid from the assets of the estate tax payment trust. Payment may be made on essentially the same

terms as Code section 6166, with the same preferential 4 percent interest rate, but without regard to the size of the interest in relation to the owner's estate.

What generally applicable tax law principles does this bill violate? First, it permits a deduction for earnings diverted to the estate tax payment trust. Although the bill provides that such a deduction is allowable under section 162, the payment in no way can be said to meet the "ordinary and necessary" business expense criteria of that section. Nor is there any other provision in the tax law allowing a deduction for amounts to be used to pay death taxes.

Second, the bill provides that the funds transferred to the estate tax payment trust will not be included in taxable income by the owner. To the extent the newspaper business is held in corporate form, this payment would in all other cases be treated as a taxable dividend to the extent of earnings and profits.

Third, the exemption of trust earnings from income is contrary to existing law which would treat the beneficiary as the owner of the trust and taxable on its income.

Fourth, exclusion of the corpus of the trust from the owner's gross estate violates existing principles which would include in a decedent's estate any asset in which the decedent or his estate had an interest.

Finally, if it was appropriate to exclude the funding and earnings of the trust from the decedent's estate, then the exclusion from estate income of the amount paid by the trust to relieve the estate of its estate tax liability contravenes the basic income tax rule that discharge of an obligation of another results in income to the party whose obligation has been discharged.

The effect of these provisions is, in most cases, to cause the Federal government to pay a large share of the tax liability attributable to the value of an independent local newspaper. The Federal government's share will vary according to the period of time an estate tax payment trust has been in existence, the applicable corporate income tax rate, the amount of interest earned by the trust corpus, the marginal income and estate tax rates of the owner, and the form in which funds to pay the estate tax would have been accumulated absent this special relief. Nonetheless, the extraordinary scope of the benefits afforded by this bill can be illustrated by the following example.

Assume that A owns an interest in a local newspaper worth $1,000,000 at all times. Further, to highlight the problem of making lifetime arrangements to transfer this interest, assume that the $1,000,000 interest constitutes A's

sole asset and he wishes to transfer the entire interest to his heirs at death. Under present law, A would have to accumulate $516,000 in a portfolio of marketable assets in addition to his newspaper interest to pay the $516,000 estate tax on a taxable estate of $1,516,000. This is the burden A, or any testator wishing to transfer a net of $1,000,000, must bear. A might meet this burden by saving more during his lifetime, or by drawing more funds from his newspaper to accomplish his objective.

Under the provisions of S. 555, this burden is reduced by 85 percent if A's income is taxed at a 40 percent rate, or by 92 percent if his income is taxed at 60 percent. This subsidy arises from two components of the bill. First, by excluding the trust corpus from the taxable estate, A is saved $217,200, or 42 percent of the normal estate tax. Second, by permitting deposits to be deducted by the newspaper, and thereby short-circuiting both the corporate and personal income taxes, S. 555 saves A an additional $220,975 (43 percent of the normal estate tax) if he is subject to a 40 percent income tax rate or $256,810 (50 percent of the normal estate tax) if he is subject to a 60 percent income tax rate. An alternative way of expressing the effect of the bill is to note that Congress could accomplish the same result by paying $438,175 to A's estate if he agrees to leave his heirs a $1,000,000 interest in a local newspaper, should his marginal income tax rate be 40 percent, or $474,010 should he be in a 60 percent tax bracket. Moreover, due to the progressivity of estate tax rates, in the case of a $5,000,000 interest in a local newspaper and assuming a 60 percent income tax rate, S. 555 would forgive 96 percent of the relatively larger normal estate tax; it would be the equivalent of Congress appropriating $8,100,000 to be paid into a testator's estate if he agreed to bequeath a $5,000,000 interest in a local newspaper to his heirs.1/

1/ The calculations on which this illustration are based assume a 20 year period for accumulating the estate tax liquid funds; the before-personal-tax (after-corporate-tax) yield on the newspaper interest is 10 percent; the corporation is subject to a 46 percent marginal tax rate; and that the yield on trust fund assets is only 8 percent. Accumulating the same amount over a shorter perod would increase the magnitude of S. 555 benefits.

At the cost illustrated by this example, it is apparent that the benefits of this bill should at the very least be restricted to those who can demonstrate that the estate tax will, in fact, result in a forced sale of the newspaper business. Otherwise, the bill turns all independent local newspapers into income and estate tax shelters. On the other hand, proper targeting of the benefits will result in complex amendments to what is already an enormously complex bill. Even then, because the phenomenon which gives rise to the need for this bill is the opportunity to sell newspapers at allegedly premium prices, it is not demonstrable that the bill ultimately would achieve its goal. The bill would, at best, make it less expensive to pass newspapers from generation to generation. It does nothing to cure the market situation which creates the need for the relief. Thus, this bill may be questionable public policy as well as bad tax policy.

While we are sympathetic to the plight of some owners of small businesses in planning the payment of estate taxes and retaining control of the business in the heirs, we also oppose this bill on the ground that it constitutes special relief for only one group of "small businessmen."

Present law already provides relief for small business owners and their heirs. Section 303 provides that in certain cases the purchase of stock by a corporation to pay estate taxes will be treated as a redemption and thus subject to capital gains rather than ordinary income tax. Also, if a portion of the business must be sold to generate funds to pay estate taxes, any gain realized will generally be taxed at the capital gains rate. Further, the transaction can often be structured as an installment sale, in which case the payment of the income tax is deferred over the installment payment period.

In computing the estate tax, there are special relief provisions. In the 1976 Act, the amount of property which may be passed without being subject to the estate tax was increased from $60,000 to $175,000. Also, the marital deduction for transfers to surviving spouses, which before the 1976 Act was limited to one-half the estate, was changed to a limit of the greater of 50 percent of the value of the adjusted gross estate, or $250,000.

Finally, the payment of the estate tax may be deferred where a business interest constitutes a major part of the estate. Under section 6161(a), the time for payment of the estate tax may be extended for up to 10 years upon a showing of reasonable cause. Reasonable cause exists when an estate consists largely of a closely-held business and does not have sufficient funds to pay the tax on time, or must sell assets to pay the tax at a sacrifice price. Section 6166 allows a 5

year deferral and a 10 year installment payment at a 4 percent interest rate on all or a portion of the deferred estate tax if the value of the closely-held business interest exceeds 65 percent of the adjusted gross estate. Finally, section 6166A is applicable to a broader number of situations and permits the estate tax attributable to a closely-held business interest to be paid in up to 10 annual installments.

The adoption of S. 555 would provide a wedge to be used again and again by other segments of society, each arguing its own importance. We do not believe in this piecemeal approach to legislation. There are existing provisions intended to minimize the problems inherent in the payment of taxes. If they are inadequate they should be reviewed in a comprehensive and not an ad hoc manner.

S. 999 - WAIVER OF INTEREST ON UNDERPAYMENT OF TAX

Under present law, a taxpayer is charged interest on any amount of tax that is not paid on time. S. 999 would impose interest unless the taxpayer's failure to pay tax on a timely basis is due to reasonable cause and not due to willful neglect. The Treasury opposes S. 999.

The payment of interest is an economic concept; it is not a punitive one. Interest is a charge for the use of money; the borrower's intent in taking out a loan is irrelevant. When a taxpayer does not pay tax on time--for whatever reason--the taxpayer has, in effect, borrowed money from the government upon which interest is due.

The Internal Revenue Code treats the interest paid consistently with this economic approach. The taxpayer may deduct the interest on unpaid tax, and the rate of interest is adjusted periodically to follow the prevailing lending rate. Moreover, an overpayment of tax is considered a loan to the government on which the government must pay interest.

The Code does not ignore a taxpayer's intent in not paying his tax. A penalty for the late payment or nonpayment of tax will not be imposed if the taxpayer's failure to pay is due to reasonable cause and not due to willful neglect. Because the penalty is a monetary form of punishment for failure to pay tax, it is not deductible and there is no reciprocal penalty imposed upon the government. It is, then, altogether appropriate to examine a taxpayer's intent in order to determine whether the penalty should be imposed. But intent is not an appropriate consideration where the payment of interest is concerned.

Although circumstances may exist which cause a taxpayer to be unavoidably late in the payment of his taxes, such circumstances usually do not prevent the taxpayer from earning a return on the money that is retained rather than

paid in taxes. Thus, even if a taxpayer has a legitimate excuse for not paying his taxes on time, the waiver of interest in such circumstances would frequently provide a windfall gain. However sympathetic we may be to taxpayers such as the victims of natural disasters who cannot pay their tax on time, these people are still, in effect, borrowing money from the government. It is highly unusual in the business world for interest to be waived short of bankruptcy proceedings, even for natural disasters. There is no reason why the government should receive less than any other creditor in the same situation.

S. 1638 - AMORTIZATION OF START-UP COSTS

S. 1638 would permit a taxpayer to elect to amortize over a period of not less than five years certain business start-up costs that otherwise would not be deductible. The start-up costs that may be amortized under this bill are the costs paid or incurred prior to the functioning of the business as a going concern and that are incident to the investigation, formation, or creation of the business. The costs must not create an asset having a useful life of its own; they must be of a character that would be subject to amortization over the life of the business (and not the life of some other asset) if the business had a determinable useful life. Typical of these costs are the investigatory expenses directly related to the particular business, and the appraisals, advertising, insurance, utilities and other routine expenditures paid or incurred prior to the actual commencement of business.

For the following reasons, we support S. 1638.

This bill is designed to reduce the disparity in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an existing business. Under current law, most preopening expenses are neither deductible nor subject to amortization but similar expenses incurred by a going concern are usually currently deductible. It is difficult to justify such disparate treatment for similar expenses.

The problem of start-up costs arises not only for taxpayers entering their first business, but also for taxpayers with an existing business when beginning a new business that is unrelated or only tangentially related. The tax treatment of the start-up costs of a related business has generated much controversy. Under current law, these costs are currently deductible if the new operations are part of the existing "trade or business" and the costs do not create a separate asset; costs must be capitalized, however, if the new operations constitute a separate trade or business. The large number of controversies between taxpayers and the IRS on this issue reflects (1) the difficulty in many cases of

determining what constitutes a new business and when a new asset is created, and (2) the consequences of the determination. Depending on where these lines are drawn, the start-up costs are either deductible in full or must be capitalized indefinitely.

It is our hope that enactment of this bill will induce taxpayers with existing businesses to elect to amortize the start-up costs of a marginally related business thereby reducing the number of controversies in this area. In the unclear cases, of which there are many, taxpayers should elect to amortize; if they fail to elect and the IRS successfully maintains that the costs must be capitalized, the election would not be available and the costs would not be recoverable through amortization.1/ Electing to amortize these expenses over five years would appear for most taxpayers to be a more prudent decision.

In summary, we support S. 1638 because it would (1) reduce the disparity in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an operating business, and (2) tend to reduce the number of controversies between taxpayers and the IRS especially where a taxpayer begins a related business.

I will be happy to answer any questions you may have.

1/ This is based on the assumption that the bill is clarified to require that the election be made not later than the time prescribed by law for filing the return (including extensions thereof) for the year the expense was paid or incurred. A provision of this nature would be necessary, in our view, to achieve one of the major virtues of this bill.

APPENDIX A

SUMMARY OF TREASURY POSITIONS

1. S. 541 - Oppose as drafted.

2. S. 555 - Oppose.

3. S. 999 - Oppose.

4. S. 1638 - Support.

Senator BENTSEN. Next we will have a panel that will consist of Mr. Bob Duffey, the president of Texas Bankers Association; Mr. Clyde Choate, vice president, Texas Credit Union; Mr. Jerry Knippa, president, Texas Savings and Loan League; Mr. Robert Pugh, president, Texas Senior Citizens Association. If you will please come forward, gentlemen, and take the witness table; and Mr. Harvey Mitchell, president of Texas Mortgage Bankers Association.

And we will try to limit the panel to 20 minutes, because we have quite a number of witnesses that yet want to be heard.

Now, we have two groups on this panel here today, and often they are on opposite sides of the fence, but they have come here to Washington to testify together. It is unusual when you find competing financial institutions in agreement on legislation. Today we not only have these competitors working in harness, but representatives of an important consumer group, our senior citizens, and they are joining them in support of our efforts to provide an incentive for savings.

So here we have the Texas Bankers Association, Texas Credit Union League, Texas Savings and Loan League, Texas Senior Citizens Association, Texas Mortgage Bankers.

I say with a great deal of objectivity, this is a very distinguished panel.

We are delighted to have you here.

Mr. Duffey, will you proceed?

STATEMENT OF ROBERT M. DUFFEY, JR., CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, PAN AMERICAN BANK OF BROWNSVILLE, TEX., AND PRESIDENT, TEXAS BANKERS ASSOCIATION

Mr. DUFFEY. Thank you, Mr. Chairman.

I am Robert Duffey, chairman and president of the Pan American Bank of Brownsville, and president of the Texas Bankers Association, here to testify for S. 246. The bill, while benefiting the holders of time deposits across the board, should particularly be helpful to the small saver who is affected most by inflation.

The exclusion of the first $500 interest from individuals' taxable income and $1,000 for joint returns, will promote and enhance

savings, in my opinion. This dollar limitation directs emphasis to the small saver. The encouragement of personal thrift in the present atmosphere of double digit inflation should be applauded by both the public and private sectors. S. 246 will provide a base of relatively stable funds for financial institutions and add tax-free dollars to consumer incomes.

In the course of recent research relative to savings and inflation, I found the following statistics of particular interest. In the 1973-77 period, savings as a percentage of personal income in the United States were 6.7 percent while in West Germany the ratio was 15.2 percent, and as you stated before, Japan, 24.9 percent. Savings as a percentage of personal income in the United States over a period of years have been 1970-72, 7.1 percent; 1973-75, 7.5 percent; and in 1976-78, 5.3 percent, a discouraging trend. This bill, I believe, will assist in reversing the course by rewarding consumer thrift.

Savings dollars have an advantageous effect on both inflation and productivity. In the first instance, savings represent consumer dollars not in the marketplace chasing goods and services to higher and higher levels, and in the second instance, provide a relatively stable base of lendable funds for the expansion and modernization of plant and equipment. Homebuilding, now entering a period of uncertainty and inactivity, should also be enhanced as a consequence of this act.

It is interesting to note that 71 percent of the adjusted gross income reported on 1976 tax returns came from individuals in the $10,000 to $50,000 bracket. Interest income represented only 3.68 percent of adjusted gross income in this group while interest income in the group below, from $5,000 to $9,999, and the group above, $50,000 and up, represented 6.1 percent and 6.44 percent respectively. The impact of S. 246 appears properly directed to increase savings within the largest taxpayer segment, and I have attached a chart to that point, Senator.

A married couple with two dependents reporting an adjusted gross income of $10,000 would fall in the 18 percent bracket according to the 1978 tax tables. They receive a net yield of 4.31 percent on a 5¼ percent savings account. The net yield under S. 246 would be increased to the full 5¼ percent, a 21.8 percent increase in yield. A similar couple with $20,000 in adjusted gross income, the 26-percent bracket, would have their net yield increased from 3.9 percent to 5¼ percent, or 35 percent. These statistics illustrate the yield benefits of S. 246 to the small saver, and it is high time the small saver had a break.

I can attest that regular savings at Pan American Bank—and I believe this to be true of most Texas banks—are down 35 percent when money market certificates and jumbo CD's are deleted.

The Senate, through S. 246, can encourage thrift, discourage inflation and lend support to the small savers of this country, certainly objectives of the highest order.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Mr. Duffey, very much. I think the examples you have cited will be very helpful to us.

I want to state for the record that I have known Mr. Duffey for many years, and he is a very distinguished, able operator of a

financial institution and knows his savers from the largest to the smallest, and personally relates to them.

Mr. DUFFEY. Thank you, sir.

Senator BENTSEN. I would like to call on Mr. Robert Pugh, a friend of mine who is the president of the Texas Senior Citizens Association.

We are very pleased to have you here this afternoon.

STATEMENT OF ROBERT E. PUGH, PRESIDENT, TEXAS SENIOR CITIZENS ASSOCIATION

Mr. PUGH. Good evening, Mr. Senator, and those of us in Texas are proud to own you as our Senator.

Senator BENTSEN. Thank you, sir.

Mr. PUGH. With all the pride we have about anyone.

I am Bob Pugh, and at age 73, I am still gainfully employed as chief of the mental health department of Bexar County, but I am also president of the Texas Senior Citizens Association. I serve on three State committees as the only consumer advocate, and I am a consumer advocate. I think you could set my bank statement, though I am not connected with the Treasury Department. But in this day when we have long since passed the double digit inflation, perhaps it is only those of us who are older who can remember that one of our Founding Forefathers reminded us that a penny saved is a penny made. In our mad rush toward economic suicide and financial oblivion, our society seems dazed and drugged by an opiate that subtly suggests spend, and spend, with no thought that the piper is awaiting down the road for his pay. And that suggests that S. 246 by Senator Bentsen and cosponsored by 18 of his Senate colleagues is long overdue.

Our executive board, by unanimous vote, endorsed this bill and asked that I come to Washington and speak before this committee to express our feelings.

We favor this bill, first of all, because we need—I am not discussing others—we need an incentive to save. I discussed this with one of our district judges who was the best criminal district attorney we have had in Bexar County, and he was most enthusiastic about the idea, and his only comment was, well, why stop at $500 and $1,000 on a joint return? He reminded me that no one is going to save who is without some incentive. He reminded me that he began his own saving with Bexar County Employees Credit Union on a payroll deduction plan, and when this union merged with the Government Employees Credit Union, he continued to save on that basis, but he had to increase the saving because of the problem of inflation that all of us by now, I am sure, have some degree of familiarity.

He confirmed what I knew already, that this has demanded the increase of whatever savings we had. He also felt some concern with me that the money in our savings account has already been taxed by the Federal Government, and we felt that to pay taxes on the interest on any savings would be both unfair and unjust. Actually, on savings in the GECU which pays 6 percent—and this sounds good, but when inflation moves in this reduces that to about 2 to 2½ percent, and to further make this subject to income tax

would make this more unbearably a harsh load for those who are least able to bear it.

As president of a large and vocal group of senior citizens, I am deeply hopeful that our people become concerned about and interested in savings since economists tell us that a retiree who can retire now on a $10,000 a year income will need $18,000 before 1990. I think the question comes, where is that extra $8,000 going to come from? At the last report I had, Santa Claus was either dead or critically ill. And I think the only obvious answer is it must come from savings. And unless we can do something to increase the manner of savings, then these people who are going to retire now are going to face a very grim future come 1990.

And our own Government, for example, perhaps has not been very much in the market of encouraging the saving habit. For example, I have been purchasing Series E U.S. savings bonds, full well knowing that when I cash these in I have to pay taxes on the interest derived from these U.S. savings bonds. Perhaps this is but one of the many reasons why the U.S. citizens have the lowest savings rate among all the modern nations.

Senator BENTSEN. Mr. Pugh, they rang the bell on you. We have a limitation of time, and we will take your entire statement for the record. I wish we could hear more of it. It is helpful. I am delighted to have it.

Mr. PUGH. All right, sir.

Senator BENTSEN. I would like to call now on my friend Harvey Mitchell, who is the president of the Texas Mortgage Bankers Association and must be having a pretty hectic time these days.

STATEMENT OF HARVEY R. MITCHELL, PRESIDENT, TEXAS MORTGAGE BANKERS ASSOCIATION AND PRESIDENT, SOUTHERN TRUST & MORTGAGE CO., DALLAS, TEX.

Mr. MITCHELL. Very true, Senator, and thank you for letting me speak. My name is Harvey Mitchell. I am president of Southern Trust & Mortgage Co., Dallas, Tex. We are a mortgage banking firm founded in 1924. We have 16 offices in seven States. I appear today as president of the Texas Mortgage Bankers Association. Our association welcomes the opportunity to speak in favor of Senate bill 246.

The inflationary problems of the past several years have destroyed our historical savings and mortgage lending patterns. Until we go through the painful process of substantially reducing the inflation rate in this country, we will not see a strong savings base. S. 246 cannot cure our inflation problems, but perhaps this legislation would help to offset some of the effects until we can make headway on the inflation front.

It is a shame that in our country where thrift was the cornerstone of our upbringing, we now discourage savings through a combination of inflation and taxation. The most disastrous effects occur to the elderly. Most studies show that the largest proportion of savings comes from individuals over 65 years of age. Inflation these past 10 years has eaten away the purchasing power of the savings these individuals had planned for their retirement.

Based on this past record, is it any wonder that the younger people in this country are not saving? Even at the current high

rates paid on the thrifts' 6-month money market certificate, 12.65 today, most savers will not be ahead of the inflation rate. These facts suggest that the young couple who borrows to buy as much house as they can and as much furniture as they can are pretty smart investors. The interest they pay is all tax deductible. Why should they save?

Until recently, our company's experience has shown that the high interest rates have not discouraged home buyers. The inflation psychology, plus the tax deduction, make the home buyer believe he must buy now in order not to miss out on homeownership. The average price of a new home in Dallas is now about $80,000. A recent projection indicates in 5 years the average price of a home in Dallas will be $150,000. Of course, this is based on the historical inflation we have seen in housing over the past 5 years.

If the thrift institutions are to provide the enormous amounts of capital needed to finance the housing required in the near future, there must be some incentive to save. By providing an interest exclusion from taxable income, the thrifts would be better able to compete for the savings dollar. This is a better way to provide funds for housing, rather than continuing to raise interest rates on savings which, in turn, must be passed on to the home buying public.

The mortgage banking industry has historically been the bridge between capital surplus areas and capital short areas. Our industry has sold billions of dollars of loans to thrift institutions over the years. For example, in Texas in 1978, mortgage banking firms made approximately $3.5 billion of home loans. A substantial portion of this amount was sold to thrift institutions, either directly or through Ginnie Mae pass through securities. At the present time, there are virtually no direct purchases of loans by thrifts. As a result, conventional loans on homes will be nearly impossible to make in the next several months.

The Government loan programs are affected by the same problems. FHA and VA loans have traditionally been purchased by thrifts through mortgage bankers; more recently by using the Ginnie Mae passthrough securities, but in today's market, a thrift cannot afford to pay 12.65 percent for money and buy Ginnie Mae securities yielding 11.5 percent.

So as you can see, we must encourage savings in this country but this encouragement can come in a form other than just a high rate of interest. The tax exclusion gives the saver this extra encouragement. It is particularly fair to the smaller saver who does not have access to or knowledge regarding higher yielding investments which take larger amounts of money.

As mortgage bankers, we hope that Congress will explore all possible avenues to increase savings and capital formation in this country. We believe S. 246 is a part of that program.

Again, let me say I appreciate the time you have given me to speak for our association on this important subject.

Senator BENTSEN. Thank you very much, Mr. Mitchell, and we will take your entire statement for the record, but in the interests of time we will move on to Mr. Jerry Knippa, president of Texas Savings & Loan Association, following in the footsteps of his distinguished father.

STATEMENT OF JERRY L. KNIPPA, PRESIDENT, TEXAS SAVINGS & LOAN LEAGUE

Mr. KNIPPA. Thank you, Mr. Chairman. I am Jerry Knippa, president of the Texas Savings & Loan League, here to present the consolidated testimony of the more than 300 savings and loan associations in Texas.

We support the passage of S. 246 because it provides much needed help to our individual citizens, to our economy, and as a result of those two, to the savings and loan business.

Earlier testimony referred to the negative rate of return that savers receive. This return, coupled with the income tax on it, has all but destroyed the traditional savings account in this country as a vehicle for planning for individuals, as well as a source of security. We feel that S. 246 will go a long way to correct this unhappy situation.

It would also help change the deeply ingrained inflationary psychology we have of "spend now; if you don't, it will just cost you more later." The dollars which the savers withdraw may be equal in number to the dollars they deposited, but they are worth much, much less in terms of buying power, and this compels them to spend those dollars. This only serves to exacerbate an already severe inflation problem.

These economic factors have driven the rate of savings in this country to below 5 percent of disposable income, and this unhealthy trend must be reversed.

As far as the economy is concerned, the formation of capital resulting from S. 246 would greatly help combat inflation by the stimulation of significant increases in productivity. It is our judgment that the productivity in manufacturing, construction, and employment which would result from S. 246 would more than offset any short-term loss of revenues to the Treasury Department. Also, the volatility of the money markets would lessen, and the periodic disintermediation which plagues our industry, and which we are now experiencing, would diminish.

As far as the savings and loan business is concerned, the increased deposits would be channeled into homebuilding and construction, with the attendant benefits to the millions of persons who work in these and related endeavors. Also, there are innumerable home buyers who would benefit from S. 246.

In summary, Mr. Chairman, it is our belief that the passage of S. 246 is necessary to restore some much-needed strength and vitality to our economy. This bill is appealing to the individual members of our society. It is also appealing to the institutional members of our society.

We urge its passage, Mr. Chairman, and we thank you for hearing our views.

Senator BENTSEN. It is good to have you.

Mr. Clyde Choate is the vice president of the Texas Credit Union League. We are very pleased that you are able to come and we look forward to your testimony.

STATEMENT OF CLYDE CHOATE, TREASURER/MANAGER, ENSERCH FEDERAL CREDIT UNION, DALLAS, TEX., ON BEHALF OF THE TEXAS CREDIT UNION LEAGUE AND THE CREDIT UNION NATIONAL ASSOCIATION

Mr. CHOATE. Thank you, Mr. Chairman.

My name is Clyde Choate. I am manager of Enserch Federal Credit Union in Dallas, and I appear today as a respresentative of the Texas Credit Union League and the Credit Union National Association.

There are over 30 million Americans who have savings accounts in credit unions today. I would like to thank this committee and you, Senator Bentsen, for inviting us to be here today, and especially for your efforts in the area of tax incentives for savers.

A historical lack of tax incentives for savings has been aggravated tremendously by inflation and rapidly rising market rates of interest. As a credit union official, I sometimes have a problem counseling my members to save a portion of their earnings. This is a sad situation but it is due to inflation and the fact that there are not now existing Federal tax policies which encourage savings.

A tax incentive for savings should be created in order to reaffirm the faith of the individual in the concept of saving. The attention this subcommittee is focusing on this very real problem is a welcome sign to the credit unions in Texas and the Nation. We are anxious to tell our members that there is a good reason to save.

Mr. Chairman, it is my strong conviction that the average American citizen today, more than ever, needs an incentive t· save whatever he can afford without being penalized by taxation on earned interest. Most credit union shareholders have modest savings accounts. Therefore a minimum income tax payment from the small saver, such as typical in my credit union, the one I manage, is a problem and is a tax burden. In my credit union, 69 percent of the total membership of over 9,000 members have less than $500 in their savings account with us. The average of all the accounts is only $1,100.

Legislation that will provide greater incentives to save will greatly assist our credit union members as well as the average American citizen. A recent counting of the tax incentive bills this year in Congress reveals 186 sponsors and cosponsors have introduced approximately 60 pieces of legislation. This is along the lines of your remarks today to the representative from the Tax Department, Senator, that there is strong support for this legislation.

The consensus behind the legislation demonstrates considerably more unanimity than might appear from the approaches. Without commenting on the particular bills, I would like to make some observations about the tax incentive bills before this committee.

An income tax credit or reduction should be applied to both existing and new savings to encourage new deposits and to keep money in savings. And we in credit unions have a problem today about maintaining our own savings as many of the other institutions and if I may, Senator, I would call your attention today to the Washington Post, in the business and financial section today has a lead story about credit unions' savings going elsewhere.

A tax credit would be equitable and maybe a more equitable distribution. A credit or deduction should be allowed equally for all

Americans. Legislation that would provide a tax incentive for savings should help break the inflation buy-now cycle by increasing the consumer incentives to save, as my colleagues have just commented.

The Credit Union National Association and the Texas Credit Union League will be glad to work with this subcommittee in any way possible to enact this necessary and timely legislation.

Again, may I say thank you for the opportunity of being here today. I will be happy to respond if there are questions, sir.

Senator BENTSEN. Thank you very much, Mr. Choate, and we will take your entire statement for the record.

What each of you have talked about, you know, is no radical approach. I cited you the other countries that are already giving incentives for savings, Germany, Japan, France, and how they have encouraged savings and how savings have increased in those countries, and substantially higher than our own.

Let me ask about the—because I am very concerned about what is happening in housing. I had breakfast the other morning over in Treasury with Paul Volcker and Bill Miller and was expressing my concern about the commitment windows closing for housing loans.

The move by the Federal Home Loan Bank in reducing the reserves and increasing the borrowing powers of the savings and loans, has that made some headway? Is that helping?

Mr. KNIPPA. This is the reduction of the liquidity requirement from 6 percent to 5½ percent?

Senator BENTSEN. Yes.

Mr. KNIPPA. We have estimated in Texas that in terms of dollars this is $125 million. In my hometown, San Antonio, this is estimated to be $7½ million. Last month in September the savings and loans in San Antonio loaned about $30 million. So if we apply the number of dollars that will be available if all of those dollars went into home loans, we would have the equivalent of only 1 week's lending. But I think many savings and loan managers will retain that as liquidity due to economic concern, even though they no longer are required to do so.

Senator BENTSEN. Gentlemen, I have a lot of questions, and I will submit some questions to some of you in writing, and I would appreciate your answering. The limitations of time don't allow me to go further.

Thank you very much for your time.

[The prepared statements of the preceding panel follow:]

Mr. Chairman, I am Robert M. Duffey, Jr., Chairman, President and Chief Executive Officer of the Pan American Bank of Brownsville, Texas and President of the Texas Bankers Association. I am here to testify for S. 246—the Savings Account Tax Exemption bill sponsor by Senator Lloyd Bentsen of Texas. The bill, while benefiting the holders of time deposits across the board, should be particularly helpful to the small saver who is most effected by inflation.

The exclusion of the first five-hundred dollars ($500) interest from individuals taxable income and one-thousand dollars ($1,000) for joint returns will promote and enhance savings in my opinion. This dollar limitation properly directs emphasis to the small saver. The encouragement of personal thrift in the present atmosphere of double-digit inflation should be applauded by both the public and private sectors. S. 246 will provide a base of relatively stable funds for financial institutions and add tax free dollars to consumer incomes.

In the course of recent research relative to savings and inflation I found the following statistics of particular interest. In the 1973/77 period savings as a percentage of personal income in the United States were 6.7 percent while in West Ger-

many the ratio was 15.2 percent and as you stated before in Japan 24.9 percent. Savings as a percentage of personal income in the United States have been 1970/72 7.1 percent; 1973/75 7.5 percent; and 1976/78 5.3 percent—a discouraging trend. This bill will assist in reversing this course by regarding consumer thrift.

Savings dollars have an advantageous effect on both inflation and productivity—in the first instance savings represent consumer dollars not in the marketplace chasing goods and services to higher and higher levels and in the second instance provide a relatively stable base of lendable funds for the expansion and modernization of plant and equipment. Homebuilding, now entering a period of uncertainty and inactivity, should also be enhanced as a consequence of this act.

It is interesting to note that 71 percent of the adjusted gross income reported on 1976 tax returns came from individuals in the $10,000 to $50,000 bracket. Interest income represented 3.68 percent of adjusted gross income in this group while interest income in the group below—$5,000 to $9,999—and the group above—$50,000 and above—represented 6.1 and 6.44 percent respectively. The impact of S. 246 appears properly directed to increase savings within the largest taxpayer segment. And I have attached a chart to that point Senator.

A married couple with two dependents (chart B) reporting an adjusted gross income of $10,000 would fall in the 18 percent tax bracket according to 1978 tax tables. They receive a net yield of 4.31 percent on a 5¼ savings account. The net yield under S. 246 would be increased to the full 5¼ percent—a 21.8 percent increase in yield. A similar couple with $20,000 in adjusted gross income—26 percent tax bracket—would have their net yield increased from 3.9 to 5¼ or 35 percent. These statistics illustrates the yield benefits of S. 246 to the small saver and it is high time the small saver had a "break".

I can attest that regular savings at Pan American Bank—and I believe this to be true of most Texas banks—are down 35 percent when Money Market Certificates and Jumbo CD's are deleted.

The Senate, thru S. 246, can encourage thrift, discourage inflation and lend support to the small savers of this country—certainly objectives of the highest order.

A.[1]—SAVINGS STUDY—1976 INDIVIDUAL FEDERAL INCOME TAX

[Percent]

Adjusted gross income	Interest as percentage of adjusted gross income	Percentage U.S. gross taxable income reported
$5,000 to $9,999	6.1	12.2
$10,000 to $49,999	3.68	71.0
$50,000 and above	6.44	9.8

B.[1]—MARRIED COUPLE, TWO DEPENDENTS—1978 TAX TABLES

[Percent]

Adjusted gross income	Bank savings rate	Tax rate	Net yield	S. 246—increase rate of return
$10,000	5.25	18	4.31	21.8
$20,000	5.25	26	3.90	35 0

[1] Source—Statistical Abstract of the United States—1978—U.S. Department of Commerce.

TEXAS SENIOR CITIZENS ASSOCIATION

Mr. Senator, as president of the most militant politically minded Senior Citizen Group in Texas, I am intently interested in Senate Bill 246. In this day when we have long since passed double digit inflation, perhaps, it is only those of us who are older who can remember that one of our funding forefathers reminded us "That, "A Penny saved is a penny Made". In our mad rush toward economic suicide and financial oblivion, our society seems dazed and drugged by an opiate, that subtly suggest spend, and spend, with no thought that the piper is awaiting down the road for his pay, and that suggests, that S.B. 246 by Senator Bentsen, and co-sponsored by 18 of his Senate Colleagues is long over due. Our Executive Board by unanimous

vote, endorsed this bill, and asked that I come to Washington and speak before this Committee to express our feeling. We favor this bill, because:

I discussed this with one of our District Judges who was the best Criminal District Attorney we have had, in Bexar County. He was most enthusiastic about the idea, but said, why stop at $500.00 and $1,000 on a Joint return. He reminded me, that no one is going to save who is without an incentive. He began his saving with the Bexar County Employees Credit Union on a pay roll deduction plan, and when this union merged with the Government Employees Credit Union he continued and even increased his savings. The Judge confirmed, what I already knew, that it was necessary to increase savings because of the increasing inflation rate. We also felt some concern because, the money in our savings accounts, has already been taxed by the Federal Government, and we felt, that to pay tax on the interest on any savings would be both unfair and unjust. Actually on savings The Government Employees Credit Union which pays 6 percent and this sounds good, but the inflation bite reduces that to about 2 to 2½ percent, and to further make this subject to income tax would make this an unbearably harsh load, for those least able to bear this. As President of a large and vocal group of Senior Citizens I am deeply hopeful that our people become concerned about and interested in Savings, since economist tell us that a Retiree who can retire on a $10,000 a year income now, will need $18,000 before 1990. Let's face facts—where is that extra $8,000.00 a year going to come from? The only obvious answer is "Savings"—but under the present circumstances, our government is not encouraging the saving habit, for example I have been purchasing Series E, U.S. Savings Bonds, full well, knowing, that when I cash these in, I will ave to pay taxes on the interest derived from these U.S. Savings Bonds. Perhaps this is but one of the many reasons why the United States Citizens have the lowest Savings rate among all modern nations. I know even the adoption of Senate Bill 246 will not solve all the problems nor provide all the answers, but I sincerely believe it will afford some relief, and will help develop our badly needed incentive for saving. I recall the old Arab proverb, that when the Camel would get into the tent, he would first put his nose in it. So with that thought I, with others have come along ways to ask you to make a step in the right direction by voting for S.B. 246.

I speak for S.B. 246, again, for the effect that it can have on the investment angle. If you give to our people the incentive, the motivation for saving, that this will engender, as we invest in savings in Savings Banks, building and loan associations, credit unions, each of us who participate will have a part in providing the capital for home and commercial buildings, and help us have the feeling that we are helping America to get moving again. While we may not be economists, we do know the banks, the building and loan associations, and kindred institutions cannot lend money they do not have, and this is where Individual Americans all over America can come in—if something can be done to develop our incentive for saving, then we can help provide the capital, that will mean business, homes, and therefore more jobs for our people. The rank and file of Americans do not have great wealth, but they love their country and they are concerned about the future of America—they would like to know they can have a part in rebuilding America. Some of our people, for example, know that the interest on Municipal bonds is exempt from income Tax—some of them know, that the widow of a leading automobile tire manufacturer, has all her huge fortune invested in municipal bonds and the interest of them is tax free. Some of them know that since these are sold only in $100,000.00 units, that a few, if any of our people can ever purchase these—some of our people know good women like this lady can—some of us people know for example, that my own bank the Frost National Bank in San Antonio can and does purchase these—but largely we know we can't—but we do feel, that if the same government that protects the invested interest of those who purchase the $100,000.00 units of municipal bonds, should also be interested in giving this small relief to the little folks in America and let us feel we share in the great undertaking of helping provide the capital needed to get America going again, and this we can do as we invest our savings, when we know that the interest on these savings will not be subject to income tax.

STATEMENT OF HARVEY R. MITCHELL

Mr. Chairman, my name is Harvey Mitchell. I am President of Southern Trust & Mortgage Company, Dallas, Texas. We are a mortgage banking firm founded in 1924. We have sixteen offices in seven states. I appear today as President of the Texas Mortgage Bankers Association. Our association welcomes the opportunity to speak in favor of Senate Bill 246.

The inflationary problems of the past several years have destroyed our historical savings and mortgage lending patterns. Until we go through the painful process of substantially reducing the inflation rate in this country, we will not see a strong saving base. S. 246 cannot cure our inflation problem but, perhaps, this legislation would help to offset some of the effects until we can make headway on the inflation front.

It is a shame that in our country, where thrift was the cornerstone of our upbringing, we now discourage savings through a combination of inflation and taxation. The most disastrous effects occur to the elderly. Most studies show the largest proportion of savings comes from individuals over 65 years of age. Inflation these past ten years has eaten away the purchasing power of the savings these individuals had planned on for their retirement.

Based on this past record, is it any wonder that the younger people in this country are not saving? Even at the current high rates paid on the thrifts' six-month money market certificate—12.65 percent today—most savers will not be ahead of the inflation rate. These facts suggest that the young couple who borrows to buy as much house as they can and as much furniture as they can are pretty smart investors. The interest they pay is all tax deductible. Why should they save?

Until recently, our company's experience has shown that the high interest rates have not discouraged home buyers. The inflation psychology, plus the tax deduction, make the home buyer believe he must buy now in order to not miss out on home ownership. The average price of a new home in Dallas is now about $80,000. A recent projection indicates in five years the average price of a home in Dallas will be $150,000. Of course, this is based on the historical inflation we have seen in housing over the past five years.

If the thrift institutions are to provide the enormous amounts of capital needed to finance the housing required in the near future, there must be some incentive to save. By providing an interest exclusion from taxable income, the thrifts would be better able to compete for the savings dollar. This is a better way to provide funds for housing, rather than continuing to raise interest rates on savings which, in turn, must be passed on to the home buying public.

The mortgage banking industry has historically been the bridge between capital surplus areas and capital short areas. Our industry has sold billions of dollars of loans to thrift institutions over the years. For example, in Texas in 1978, mortgage banking firms made approximately $3.5 billion of home loans. A substantial portion of this amount was sold to thrift institutions, either directly or through Ginnie Mae Pass Through Securities. At the present time, there are virtually no direct purchases of loans by thrifts. As a result, conventional loans on homes will be nearly impossible to make in the next several months.

The government loan programs are affected by the same problems. FHA and VA loans have traditionally been purchased by thrifts through mortgage bankers; more recently, by using the Ginnie Mae Pass Through Securities, but in today's market a thrift cannot afford to pay 12.65 percent for money and buy Ginnie Mae Securities yielding 11.50 percent.

So, as you can see, we must encourage savings in this country, but this encouragement can come in a form other than just a high rate of interest. The tax exclusion gives the saver this extra encouragement. It is particularly fair to the smaller saver who does not have access to or knowledge regarding higher yielding investments which take larger amounts of money.

As mortgage bankers, we hope that Congress will explore all possible avenues to increase savings and capital formation in this country. We believe S. 246 is a part of that program.

Again, let me say I appreciate the time you have given me to speak for our association on this important subject.

Testimony of Jerry L. Knippa

Mr. Chairman, I am Jerry L. Knippa, President of the Texas Savings and Loan League, here to present the consolidated testimony of the more than 300 savings and loan associations in Texas.

We support S. 246 because it makes so much sense. It helps the individual citizen, it helps the economy, and, as a result, it helps the savings and loan business. One of the most effective ways to fight inflation is to increase investment, thereby increasing productivity. S. 246 does this; does it simply, and equitably. It rewards those small savers who cannot take advantage of tax-free municipals, deferred annuities, trust investments, and a myriad of tax advantages that are available to the wealthy investor.

Currently, the individual saver receives a negative return on his saving deposit. This negative return, coupled with the income tax on it, has all but eliminated the traditional savings account in this country as a source of security and a vehicle for planning for individuals. S. 246 will go a long way to correct this unhappy situation.

A $500 tax deduction on interest received from savings accounts will act as an incentive to increase savings. In the case of savings and loan associations, these increased savings will be reinvested in housing, thereby increasing the tax received from those individuals who earn their income from housing, i.e., carpenters, real estate agents, builders, etc. These segments usually pay taxes in higher brackets than small savers. Therefore, it is very possible that this tax incentive can increase, over a period of time, the revenue received from the total tax. This was the result of the Kennedy tax break in the early 1960's, when the tax incentive was concentrated on the investment side.

Another point that should be addressed is that the federal deficit is a major cause of inflation in our country, and this bill could increase the deficit. Let's be honest about this point. The federal deficit is a result of the spending policy of the government, and while increased spending by the federal government should be addressed, the deficit should not be used as an excuse to deny moderate income people an equitable way to exercise self-control and to be responsible for thier own financial matters. The present taxing policy has the effect of punishing those individuals who are being responsible and fighting inflation by saving not spending. S. 246 will help change the deeply ingrained inflationary philosophy of "spend now . . . it'll cost you more later". The two edges to this lethal economic sword are that the people have learned the folly of saving, because the dollars they withdraw, although equal in numbers to the dollars they deposited, are worth so much less in buying power. So they feel compelled to spend their dollars, which serves only for further exacerbate the inflation problem.

The existing economic factors have driven the rate of savings in this country to less than 5 percent of disposable income, and that unhealthy trend must be reversed.

In summary, we see no negative points on this piece of legislation. Most important, S. 246 begins to create some equity in the tax system by giving savers (low and moderate income citizens) some of the same advantages as investors (higher income citizens).

Second, after a period of time, it should not decrease the revenue of the government.

Lastly, the formation of capital resulting from the passage of S. 246 will help diminish inflation by providing for an increase in productivity. Also, the volatility of the money markets would lessen, and the periodic disintermediation which we are again experiencing would diminish.

In the case of the savings and loan business, these increased deposits will be channeled into the home building and construction industries, with the attendant benefits to the millions of persons working in those related endeavors, and will help relieve the pressure of high interest rates. Millions of home buyers will also benefit.

It is our belief that the passage of S. 246 is vital to restore some much needed vitality to our economy. It is a bill which makes good economic sense, and one which is appealing to both the individual citizen and the institutional members of our society.

Mr. Chairman, we urge its passage.

STATEMENT OF CLYDE CHOATE

Mr. Chairman, Committee members, my name is Clyde Choate. I am Treasurer/Management of Enserch Federal Credit Union in Dallas, Texas and I appear before you today on behalf of the Texas Credit Union League and the Credit Union National Association. The Texas League has as its members the 1,450 federal and state chartered credit unions within our borders. There are approximately three million Texans that make up the membership of these credit unions. The Texas League is one of 51 state credit union leagues, one from each state and the District of Columbia. There are between 30 and 40 million Americans who have savings accounts at credit unions across the country. I would like to thank this committee and Senator Bentsen for inviting the Texas Credit Union League to testify before you today and especially for your efforts in the area of tax incentives for savers.

As you may know credit unions are a cooperative-type financial institution which are completely owned by their members. We do not serve the general public, as other financial institutions do, but serve only members of common bond interest of institutional, occupational or community groups. Each eligible individual of these

groups is entitled to membership and equal representation to the Board of Directors of his or her respective credit union.

Credit unions are thus unique among financial institutions. Benefits accrue to the individuals in the form of earnings on savings, very reasonable loan terms, and services offered. Our institutions, in the normal course of their activities, act to balance the borrowing and saving functions of their members. The Federal Credit Union Act in fact requires by law that credit unions "encourage thrift." We therefore support measures that would reverse the more recent inclination to spend, rather than save. Yet it is becoming more and more difficult for us to fulfill our primary role as a thrift institution because in the United States the practice of saving is not only discouraged but penalized. Lack of incentives combines with the effects of inflation provide severe disincentives to save.

The realities of this situation are being recognized by a growing number of credit union members who then withdraw funds and place them in money market certificates and in more speculative areas such as commodities, real estate and other essentially nonproductive areas. Other savers who are unaware of the present financial realities of savings and those who despite this knowledge maintain an allegiance to the institutions that have served them well in the past—are unfairly robbed of the "value" of their savings.

Credit unions operate on the philosophy of securing share deposits from members and using these funds to lend to other members who have a need for small consumer-type loans. Since our credit union philosophy calls for using member funds as a basis for making member loans, the credit union movement has been dramatically affected by spiraling inflation, rising interest rates and the ever climbing cost of living.

THE INFLATION FACTOR

The historical lack of tax incentives for savings has been aggravated tremendously by inflation and rapidly rising market rates of interest. While alternative savings devices, such as savings certificates offered at near market rates have proved to be of some benefit to the saver, they are outside the traditional passbook category. Meanwhile passbook interest rates now lanquish at rates half that of the market rates and inflation rates. As a credit union official I cannot truthfully tell my members that it is in their best financial interest to save a portion of their earnings. This is a crime. It is due to inflation and the fact that we have no existing federal tax policy which encourages such saving. In order for any resolution of these problems to occur, Congress should take action on both fronts. A tax incentive for savers should be created in order to reaffirm the faith of the individual in the concept of saving. Faith in and tax incentives for savings are as necessary now in the face of a 13 percent inflation rate as they will be should there ever again be no inflation.

As inflation robs the value of the dollar, wages rise in an attempt to regain their relative purchasing power. However, the interest our members receive on savings therefore becomes subject to a higher tax liability as our credit union members are pushed into higher federal income tax brackets. As this continues a greater portion of these earnings on savings are diverted to the government. This cycle is particularly troubling to the moderate income wage earners who are often dependent in slack periods on savings for day-to-day expenses. Since approximately 80 percent of the 22,000 credit unions in this country are organized on an occupational basis and serve these wage earners, it is extremely important that we find ways to preserve the value of what these individuals can save.

The federal government has not, thus far, been able to control inflation but it can do something to end or restrict the escalating federal tax liability savers find themselves subject to. The attention this subcommittee is focusing on this very real problem is a welcome sign to credit unions in Texas, and this nation, who are anxious to tell their members that there is a good reason to save.

CREDIT UNIONS PRESSURED TWICE

Besides being a place to save, credit unions' other purpose is to be a source of consumer loans. Unlike other financial institutions we cannot redirect money from consumer loans to higher earning commercial loans. Without a steady and expanding source of funds (savings) it becomes impossible to meet the needs and desired of our members, many of whom need funds to buy the necessities of life. As savings decline we find it necessary to cut back on loans, be more selective in granting loans, require higher down payments and put into place other barriers to loan approvals. This is how we act to balance the borrowing and saving functions of our

members and comply with the anti-inflationary goals of the nation's central bank. Beyond a certain point, however, we are not fulfilling our role as "a source of loans at reasonable rates." Savings incentive measures will help credit unions to do their jobs both to "encourage thrift" and provide loans at "reasonable rates."

Mr. Chairman, it is my strong conviction that the average American citizen today, more than ever, needs an incentive to save whatever he can afford without being penalized by taxation on earned interest. Because most of credit union share holders have modest savings accounts, it becomes even more meaningful because a minimum income tax payment from the small saver, such as is typical or our credit union member, creates a financial burden of greater magnitude than to those more affluent. In my credit union, Enserch Federal, 69% of my total membership of 9,231 have less than $500.00 in their savings account. As a matter of fact, the average savings of all members is $1,101.00 per member. It is then apparent to me that most of the nation's 40 million credit union members should not be faced with a tax burden on April 15th each year for having had the foresight to accumulate a small savings account for emergencies or future needs. Legislation that will provide greater incentives to save will greatly assist our credit union members, as well as the average American citizen.

WITHOUT TAX INCENTIVES SERVICES WILL REPLACE SAVING AS THE FUNCTION OF CREDIT UNIONS

Mr. Chairman, in regard to depository institutions, I think we are at a threshold. The question we must ask ourselves is "What will our financial institutions look like tomorrow?" If the benefits of saving deteriorate to any greater degree we may see the emphasis our institutions now place on saving shift to services offered. This shift seems inevitable under present public policy. If credit unions are not successful in increasing the assets of an individual through savings, they will shift into areas where their activities will be successful. Credit union concerns may then be limited to bill-paying services, electronic funds transfers, remote automatic bank units, investment counseling, etc. This change in emphasis from saving to services will be a move away from encouraging individual thrift. Credit unions were formed to promote thrift and to do otherwise would be an abdication of the role we were created to play. Tax incentives for savers would be a shot in the arm for tradition credit union objectives.

YET PEOPLE STILL WANT TO SAVE

I would like to point out to this subcommittee that despite disincentives to save, Texas Credit Union members continue to do so. Their desire to provide for themselves and be self-sufficient is strong and I am looking forward to the day when this instinct to save and the peace of mind that accompanies having savings is encouraged by federal tax policy. For many Americans a savings account is their only buffer between them, the future and government subsidy programs (welfare). The set of conditions that now cause Americans to lose faith in savings, a previously sound financial practice, must not be permitted to continue.

LEGISLATION PENDING

A recent counting of tax incentive bills this year in Congress reveals 186 sponsors and cosponsors have introduced approximately 60 pieces of legislation. The consensus behind the legislation demonstrates considerably more unanimity than would appeal from the various approaches taken. Without commenting on any particular bill, I would make the following observations:

An income tax credit or deduction should be applied to both existing savings and new savings, to encourage new deposits and to keep money in savings accounts.

A tax credit would be more equitable than a tax deduction.

The credit or deduction should be allowed equally for all Americans.

Special purpose tax exempt savings accounts (such as individual housing accounts) should be scrapped in favor of general tax favors for all savings accounts.

With this wide consensus that exists throughout Congress on the need for tax incentives for savers, a congressional caucus might even be formed to further advance the concept that government must do something to help people themselves through savings.

CONCLUSION

Due to the present economic situation, tax incentives for savings legislation is extremely vital if credit unions are to continue their traditional role as a financial organization for moderate income individuals.

Tax incentives will invigorate the credit unions by enhancing the aspects of our activities—savings, consumer and home loans which are most important to our members.

The United States must become a nation of savers rather than spenders if the problem of inflation is ever to be licked.

With prices soaring at double-digit inflation rates, it is virtually impossible for savers to maintain the purchasing power of their savings dolars, even with interest rates at record levels.

Inflation and taxes provide a powerful disincentive to save. Since 1975 the rate of savings as a percentage of disposable income has declined from 7.7 percent to 4.18 percent in the third quarter of 1979. This drop in savings means reduced capital investment, lower productivity and higher interest rates.

Tax incentives for savings are needed more now than at any other time in our history. Consumers by now to beat inflation with a resulting further upward push on prices and a reduction of savings. Borrowers bid up interest rates as the supply of savings declines.

Legislation that would provide a tax incentive for savings would break the inflation-buy-now cycle by increasing the consumers' incentives to save. By increasing the flow of new savings and moderating the buy now philosophy, the result would be reduced inflation.

CUNA and the state credit union leagues will be glad to work with this subcommittee in any way possible to enact this necessary and timely legislation.

I thank you for this opportunity to be here today, and I would be happy to respond to any questions that you may have.

SAVINGS TAX INCENTIVES

FACT SHEET

Many bills have been introduced in the first session of the 96th Congress to counter the negative effect of inflation and taxes on savings. Inflation and taxes provide a powerful disincentive to save. Since 1975, the rate of savings as a percentage of disposable income has declined from 7.7 percent to 4.1 percent in the third quarter of 1979. This drop in savings means reduced capital investment, lower productivity and higher interest rates. The purpose of the various savings tax incentive bills is to make it pay to save again.

With prices soaring at double-digit rates, it is virtually impossible for savers to maintain the purchasing power of their savings dollars, even with interest rates at record levels. By taxing money dollars rather than increased purchasing power, the tax system further reduces the after-tax purchasing power of dollar savings. Soaring prices make immediate purchases substantially less expensive than they would be if the purchases were delayed. In combination, these factors reward spending and penalize savings.

In a period of no inflation, a consumer who saves $1,000 a year will be able to buy the same amount of good and services a year later that he could at the time of the deposit. However, if prices increase 10 percent during the year, the purchasing power of the individual's savings a year later is only $900. And the higher interest rates paid during periods of rapidly rising prices in no way fully compensate savers for this loss of purchasing power.

For example, with zero inflation, a saver might receive a 3 percent return, or $30 interest, on $1,000 held on deposit for one year. At the end of the year, the saver would have $1,030 in dollar savings and an equivalent amount of purchasing power.

During a period of 10 percent inflation, the same saver might receive 6.75 percent, or $67.50 interest, for the same one-year, $1,000 deposit. However, while the dollar savings at the end of the year would be $1,067.50, the real dollar savings would be $960.75 ($1067.50 minus $106.75 inflation factor) for a loss of $39.25 in purchasing power from the original $1,000 deposit.

Merely to break even during a period of 10 percent inflation, the saver would have to receive a return on his money of 13.3 percent.

Savings is further discouraged by the current tax system. Assuming a 22 percent federal tax rate, the same saver during a period of zero inflation would receive

$23.40 in after tax dollar income ($30 minus $6.60 taxes) on the $1,000 deposit. Thus the purchasing power of the savings at the end of one year would be $1,023.40.

However, during a period of 10 percent inflation, the $67.50 in interest income would be reduced by $14.85 in taxes for dollar savings at the end of the year of $1,052.65. In terms of real dollars, the after-tax purchasing power of the savings would be $947.38 ($1052.65 minus $105.27 inflation factor) for a loss in purchasing power of $52.62 from the original $1,000 deposit.

During a period of stable prices, a consumer might make a $1,000 purchase a year from now without suffering from a loss of purchasing power because of a price increase. Under these circumstances, the cost of buying now is $30 in foregone interest. Thus there is a clear incentive to save rather than to buy.

If prices are increasing at a 10 percent rate, however, a $1,000 purchase will cost $1,100 a year from now. The benefit of buying now is the savings of $100 a year from now. In addition, the consumer does not incur a purchasing power loss of $39.25 by placing the money in savings. Thus the total benefit of buying now is $139.25.

The savings tax bills are designed to break the inflation-buy-now cycle by increasing the consumers' incentives to save. There is nothing new in this concept; proposals to provide tax incentives for savings have been around for a long time. But for various reasons, primarily cost to the Treasury, tax incentives for savings have never become law.

In no other time, however, were tax incentives for savings more needed. Consumers "buy now" to beat inflation with a resulting further upward push on prices and reduction of savings. Borrowers bid up interest rates as the supply of savings declines. Savings tax incentives would provide new savings and moderate the "buy now" philosophy. The net result of increased savings would be reduced inflation.

Senator BENTSEN. Our next panel will be Mr. Richard Lawton, vice president, National Savings & Loan League; Mr. C. C. Hope, Jr., vice chairman of the Board, First Union National Bank of Charlotte, N.C.; Mr. Gil Thurm, vice president and legislative counsel, governmental affairs, National Association of Realtors; Mr. Lloyd Bowles, legislative chairman, U.S. Savings & Loan League; Dr. Saul Klaman, president, National Association of Mutual Savings Banks; and Mr. Michael Evans, economist.

Gentlemen, I really regret the limitations on time, but I would ask you to observe the warning light and comply with it, and we will take all of your statements for the record.

I would like to call first on Mr. Lloyd Bowles, who is the legislative chairman, U.S. League of Savings Associations. Mr. Bowles has had a long and distinguished record in savings associations, and I look on him as an authority in the business.

STATEMENT OF LLOYD S. BOWLES, LEGISLATIVE CHAIRMAN, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. BOWLES. Thank you.

Mr. Chairman, my name is Lloyd Bowles. I appear today on behalf of the U.S. League of Savings Associations.

I know your schedule is tight, and I will be brief.

The savings and loan business applauds the efforts of Senators Bentsen, Nelson, and Talmadge to correct the bias in our tax code against savings. Today's conditions are severe for our savers and also for our borrowers. A tax incentive for savings is needed right now to stop the drain of funds and permit us to perform our specialized home finance function.

But more importantly, incentives to save are needed today for the health of the American economy. A buy-now psychology guides many households. Without savings which must be paid from current income, our Nation lacks the capital that will build the

houses, the factories, the machines—which will provide the output, the jobs, and the income—for a sound economic future.

The rate of personal savings in this country, as you indicated, Mr. Chairman, has fallen to just 4.1 percent. Our present tax system contributes to this performance. Rapid inflation pushes taxpayers to higher brackets. Since virtually all savings come from after-tax dollars, fewer dollars are available for saving. Clearly a tax incentive to save is a quick, efficient, and a very effective way to reverse inflation and inadequate capital formation.

S. 246, sponsored by Senator Bentsen, is a straightforward, general and immediate response to the tax code disincentive to save. Senator Talmadge's S. 1846 corrects a longstanding inequity between the tax code treatment for corporate stock dividends and for savings account interest.

S. 1488 by Senator Nelson is an interesting and a constructive approach, too. It emphasizes an incentive to add to savings which may minimize the first-blush cost to the Treasury. It may, however, involve certain operational problems for financial institutions and the IRS. Such a limited approach does not recognize the difficulty which thrift institutions face today in holding their deposit base, or reward those thrifty Americans who have recognized the importance of savings for many years.

We would recommend that S. 1488 be considered as a way of augmenting rather than replacing a straightforward tax exclusion plan such as those envisioned in S. 246 and S. 1846.

Mr. Chairman, the U.S. League and its 4,450 members are very appreciative of having the opportunity to place our statement in the record today.

Thank you, sir.

Senator BENTSEN. We are very pleased to have it. Thank you for your contribution.

I would like to call now on Mr. Richard Lawton, vice president, National Savings & Loan League.

STATEMENT OF RICHARD S. LAWTON, VICE PRESIDENT, NATIONAL SAVINGS & LOAN LEAGUE, AND CHAIRMAN OF THE BOARD AND PRESIDENT, WASHINGTON-LEE SAVINGS & LOAN ASSOCIATION, McLEAN, VA.

Mr. LAWTON. Mr. Chairman, I am Richard Lawton. I am chairman of the board and president of Washington-Lee Savings & Loan Association, McLean, Va., and I appear here on behalf of the National Savings & Loan League.

The National League strongly supports the use of tax incentives to encourage savings. As we come to the close of the 1970's, we can look back on a decade of lagging productivity, reduced capital investment, and rising inflation. One of the causes of this economic decline has been the lack of incentive for capital formation and the significant reduction in the savings rate in the United States. If the 1980's are to show improvement, it is imperative to stop the disastrous slide in the rate of personal savings that is now occurring. For this reason, we urge the Congress to act immediately to set policies and encourage savings instead of penalizing those persons who save as we do now.

You have heard that in the third quarter of 1979 the rate of personal savings in the United States fell to a mere 4.1 percent, the lowest quarterly figure since 1951. Such a savings rate is certainly not adequate to provide capital for investment and development and the increased productivity that is needed if we are going to improve our economic picture in the future. There are several factors that account for the low rate of savings, the most important of which has been inflation. At current rising rates of inflation, people are encouraged to spend and consume, rather than to save. It is perceived as better to buy today because tomorrow the cost of the item will be much higher. In addition, interest rates on savings have not been able to keep up with inflation. Finally, inflation has pushed people into higher income tax brackets, leaving them with less disposable income in real terms, and therefore, less available funds for savings. A second factor is the taxation of interest earned on savings which further reduces the effective yield on a savings account.

We would wholeheartedly agree with you, Senator Bentsen, that the tax incentives for savings do work, as evidenced by the experience of a number of industrialized nations, particularly in Western Europe and Japan. There is no doubt in our minds that the high rate of savings in these countries has occurred in part because these nations offer some kind of tax incentive to encourage their citizens to save.

It is time to take the consumption bias out of our tax laws and break the current cycle of inflation, consumption, low productivity, low investment, more inflation by taking a strong policy to encourage higher savings rates.

Senator, I would like to take this opportunity to thank you for allowing the National League to present its views today.

We have filed a full statement.

Senator BENTSEN. Thank you very much. I appreciate your comments.

I was listening to the latter part of those comments, we said much the same thing in our annual report on the Joint Economic Committee, and if you haven't read it, I commend it to you, particularly because I helped write it. [General laughter.]

Mr. C. C. Hope, vice chairman of the board, First Union National Bank, Charlotte, N.C., and president, American Bankers Association.

STATEMENT OF C. C. HOPE, JR., VICE CHAIRMAN OF THE BOARD, FIRST UNION NATIONAL BANK, CHARLOTTE, N.C. AND PRESIDENT, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY JERRY L. JORDAN, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, PITTSBURGH NATIONAL BANK, AND MEMBER, AMERICAN BANKERS ASSOCIATION ECONOMIC ADVISORY COMMITTEE

Mr. HOPE. Thank you very much, Senator, and thank you for the privilege of being here today.

Of course, the American Bankers Association includes approximately 13,000 members of the 14,500 commercial banks in this country.

I am accompanied today, Senator, by Jerry Jordan, senior vice president and chief economist of the Pittsburgh National Bank and a member of our association's Economic Advisory Committee.

I would like to summarize our statement and then ask that the entire statement be placed in the record.

Senator BENTSEN. That will be done.

Mr. HOPE. First, I want to thank you, Senator, and applaud you for your actions and those of your colleagues who have joined in a recognition of the plight of the savers of America. The inadequate level of savings and investment in our economy today is the result of several factors. Our tax system has an inherent bias against savings and in favor of consumption. The harmful effects of this bias are aggravated by the severe inflationary conditions that have plagued our economy. Savers of more modest means suffer from governmentally imposed discriminatory deposit interest rate ceilings which significantly reduces their incentive to save. Each of these factors reduces the level of savings and investment in our economy in ways that are spelled out in our written statement.

The problem of discriminatory interest rate ceilings could be eliminated quite simply by gradually, over a period of time, phasing out deposit interest rate ceilings. To achieve such a phaseout, we urge your support of H.R. 4986 as amended by the Senate Banking Committee.

But a solution to the inflation problem is obviously more complicated. We believe that a reduction in the rate of inflation will occur only in response to properly administered monetary and fiscal policies, and we urge strong congressional support for such measures.

Our experience with mandatory wage and price controls earlier in this decade demonstrated not only that they are ineffective, but that they quickly create distortions and shortages in both product and labor markets. The current bias of our tax system against savings and in favor of consumption is a complicated problem to attack, and we believe that several of the proposals before this subcommittee will help reduce this bias.

We specifically support the basic thrust of the proposals of S. 246, S. 1488, S. 1846 as well as S. 1543 and S. 541. We believe that these bills are constructive attempts to deal with a difficult and fundamental problem. We believe, however, there are also some other promising approaches. One is a proposal which deserves particular attention, is to allow banks and other depository institutions to issue long-range, long-term, tax-deferred certificates of deposit.

Thank you very much, Senator, for permitting us to testify today.

Senator BENTSEN. Thank you, Mr. Hope, and we will take the entire statement.

Mr. Gil Thurm is vice president and legislative counsel, governmental affairs, for the National Association of Realtors.

Proceed.

STATEMENT OF GIL THURM, VICE PRESIDENT AND LEGISLATIVE COUNSEL, GOVERNMENT AFFAIRS, NATIONAL ASSOCIATION OF REALTORS, ACCOMPANIED BY JOHN AMS, DIRECTOR OF TAX PROGRAMS, GOVERNMENT AFFAIRS DIVISION, NATIONAL ASSOCIATION OF REALTORS

Mr. THURM. Thank you, Senator Bentsen. I am accompanied today by John Ams, who is our director of tax programs. We will be very brief today, Senator.

Your bill, S. 246, is strongly endorsed by the National Association of Realtors. We think it is a strong step forward toward the fight against inflation and will help very much in furthering our Nation's capital formation goals. We view your bill as one major part of a capital formation package for next year.

Just last week, for example, this same subcommittee held hearings on your other bill dealing with depreciation revision, which we also endorse as another measure to help achieve capital formation. We look forward to working with you and the committee in making some necessary changes to the bill which may have some unintended adverse effects for the real estate industry.

Nevertheless, we view those two bills as part of one big package to fight inflation.

A third aspect which you have addressed in previous years, Senator, would be to repeal the $10,000 limitation on investment interest deductions which was passed as a part of the Tax Reform Act of 1976. Those three elements should be joined in one big package next year, and again, we strongly endorse this bill, S. 246, to provide tax incentives for savers.

Thank you. The written statement of the National Association of Realtors will be inserted into the committee's permanent record.

Senator BENTSEN. Thank you very much for your comments.

You know, the other day we had a comment before the Joint Economic Committee which I chair, that this Nation was going to face a lowering of its standard of living. Well, that just doesn't have to be. I think we have the resources to turn this thing around, get it moving, but it also means we are going to have to put some incentives back in the system, and we are going to have to provide the means for capital formation and for the modernization of the productive capacity of this country. And that means that we have to have depreciation schedules that are competitive with what our competitors are doing around the world.

Again, we are not talking about some far out proposal; we are just trying to even up the odds with our competitors.

Our next witness, Dr. Saul B. Klaman, president of the National Association of Mutual Savings Banks.

I may be mispronouncing that.

Mr. KLAMAN. Klaman is fine, sir.

Senator BENTSEN. All right, proceed.

STATEMENT OF SAUL B. KLAMAN, PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Mr. KLAMAN. Mr. Chairman, I deeply appreciate this opportunity to tell you that the National Association of Mutual Savings Banks and the $165 billion industry it represents strongly supports the

tax-incentive measures which you and your colleagues have introduced. It is about time that such measures were in place to help the Nation's inflation-battered savers. Nothing has a higher priority in our industry and in our association, and we intend to work vigorously to help achieve this objective. The time has long since passed to redress the serious imbalances in our tax system which favor borrowers and hurt savers. In effect, Uncle Sam is a partner with every borrower in this country and an adversary of every saver.

Mr. Chairman, I recognize the extreme tightness of the schedule, and I am deeply appreciative of the opportunity to indicate our industry's support of your measures, and I have a statement which I hope that you will insert in the record.

Thank you very much.

Senator BENTSEN. We would be delighted to have it in its entirety in the record.

I would just like to ask one question because of the limitation of time.

I would like to ask Mr. Thurm how you think S. 246 will help housing.

Would you care to comment on that?

Mr. THURM. I would be happy to, Senator Bentsen. We think that S. 246 will provide very important help for the housing crisis that we are now facing. Right now we cannot find mortgage money in many parts of the country. Your bill will help encourage people to put their money in lending institutions which will help insure that there will be an adequate supply of money for the housing needs in this country.

Senator BENTSEN. Thank you very much.

I turn now to my colleague Senator Chafee, who has a deep interest in this legislation.

Senator CHAFEE. Mr. Chairman, I apologize for being late. As I understand it, you would exempt the first $100 of interest, would be tax free, is that it?

Senator BENTSEN. We have several versions.

Senator CHAFEE. Several approaches.

Now, what would happen, what is a savings? In other words, under these certificates that the legislation we now have before us where they would be entitled to issue CD's in the amount of $1,000, how would that be affected?

Mr. KLAMAN. These bills don't affect that, Senator Chafee, but the problem with that proposal, if I understand it, is to reduce the $10,000 certificate to $1,000, and I think everybody at this table would tell you that is just about impossible for savings institutions to tolerate, and Senator Bentsen and others have commented today, the way to give the small saver a break and to get his interest earned up is to give him a tax break and not to insist that the institutions pay what they can't earn and drive mortgage rates even higher and reduce the availability of mortgage credit.

Senator CHAFEE. I see.

So this, under 246, that would not apply to certificates of deposit, of this——

Mr. KLAMAN. Yes; it would.

Senator BENTSEN. He could put it in anything he wanted to in the way of a savings. You know, it could be a savings and loan, it could be a mutual savings bank, it could be a bank, and it is any document of savings it could apply to.

Senator CHAFEE. I see.

Well, I am not going to prolong this any longer, but if somebody had—say the bill didn't pass dealing with certificates of deposit going down, you stayed at $10,000, would your first $100 of interest on the $10,000, that would be tax exempt under this, wouldn't it?

Senator BENTSEN. Mine goes up to $500.

Mr. KLAMAN. Under this bill it would be $500.

Senator CHAFEE. All right, up to $500. That is considered a saving.

Mr. KLAMAN. Yes, sir.

Senator CHAFEE. I see, fine.

Thank you very much, Mr. Chairman.

Senator BENTSEN. And one of the problems that you run into with savings and loans, for example, when you are talking about dropping the certificate from $10,000 to $1,000 is they have long-term assets, and the savings are relatively short term, and they get whipsawed in this situation. They have made their investments based on interest rates that were substantially lower, and all of a sudden they get caught in a crunch in this type situation.

I have been there.

Well, if there are no further questions, gentlemen, we are very appreciative.

I might say, so you gentlemen can understand why we are reacting as we do to all these buzzers and those lights back there that we keep watching, we get kind of a Pavlov reaction, those of us who are members of the Senate. The light on the right is an amber light, says that we are in session. You get one light on the left, that's a vote. You get two lights, that works like a recess. Three lights is a live quorum. Four lights is the end of the session. Five lights we are halfway through the rollcall. Six lights means end of the morning business. Seven lights and it is broken. [General laughter.]

Mr. KLAMAN. Thank you, Senator.

[The prepared statements of the preceding panel follow. Oral testimony is continued on p. 244.]

STATEMENT OF LLOYD S. BOWLES
ON BEHALF OF THE U. S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

October 31, 1979

MR. CHAIRMAN:

My name is Lloyd Bowles. I am Chairman of the Board and President of Dallas Federal Savings and Loan Association of Dallas, Texas and appear today on behalf of the United States League of Savings Associations*.

I know your schedule is tight today, and I will be brief.

The savings and loan business applauds the efforts of Senators Bentsen, Nelson and Talmadge to correct the bias in our tax code against savings. As a business devoted to thrift, this should come as no surprise. Today's economic conditions are severe for our savers and for our borrowers. A tax incentive for savings is needed, and needed right now to stop the drain of funds and permit us to perform our specialized function of home finance.

But more importantly, incentives to save are needed today for the health of the American economy. The public has seen their savings eroded by inflation. A "buy-now" psychology guides many households. This leads to a vicious circle as excess demand for goods and credit pushes prices and interest rates up and up, while savings are depleted still further.

*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations representing 99-2/3% of the assets of the $510 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Joseph Benedict, President, Worcester, Mass., Ed Brooks, Vice President, Richmond, Va.; Lloyd Bowles, Legislative Chairman, Dallas, Tex.; Norman Strunk, Executive Vice President, Chicago, Ill.; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Dr., Chicago, Ill. 60601; and the Washington Office is located at 1709 New York Ave., N.W., Wash., D.C. 20006 Telephone: (202) 637-8900.

And make no mistake, without savings -- which must be paid for from current income -- our nation lacks the capital that will build the houses, the factories, the machines ... which will provide the output, the jobs, and the income ... needed for a sound economic future.

The impact of increased household savings on inflation is immediate. By foregoing consumption, increased savings will instantaneously decrease excess demand. Furthermore, as new capital stock, financed from savings, is put into place, the potential supply of goods and services will increase. And, as prices begin to moderate at home relative to prices abroad, our dollar will strengthen in international markets and the price of imported goods will subside.

The rate of savings in this country has fallen alarmingly. In the third quarter it was just 4.1% -- a 28-year low -- compared with 6.7% at the beginning of this decade. Our national savings rate is pitiful compared to other nations: the West Germans save approximately 17%, the Japanese 24%, the English 14%.

Our present tax system contributes to this embarassing performance. Rapid inflation pushes taxpayers into higher brackets. Since virtually all savings come from after-tax dollars, fewer dollars are available for savings. The escalating Social Security taxes not only bite the paycheck, but diminish one of the traditional motivations for personal savings, planning for retirement. Furthermore, government priorities and government spending are directed increasingly toward consumption-oriented income transfers rather than productive investment. In effect, potential "savings dollars" available to wage earners are used instead by

government to finance consumption by someone else, rather than to finance public capital improvements. This, too, is inflationary.

Clearly, a tax incentive to save is a quick, efficient, and effective way to reverse these damaging economic policies and developments. Other countries have long utilized such an approach. In West Germany, for example, the interest earned on long-term savings accounts (held for at least seven years) are totally exempt from income tax; four out of five German households take advantage of this opportunity. England, France, Austria, South Africa, Australia, Israel, and many South American nations currently use tax code encouragement for savings and capital formation.

The Individual Retirement Accounts and the Keogh Plans, developed with the approval of this distinguished Committee, have been an important step in the right direction. The bills under consideration today promise further progress.

S. 246, sponsored by Senator Bentsen, providing an exclusion for the first $500 of interest earned ($1,000, joint return) is a straight-forward, general and immediate response to the tax code disincentive to save. Senator Talmadge's S. 1846 corrects a long-standing inequity between the tax code treatment of family "investments" in corporate stocks and those in savings accounts by broadening the present "dividend" exclusion to $250 for both deposit interest and corporate dividends.

S. 1488, by Senator Nelson, which restricts the tax exclusion to the year-to-year increase in earnings on deposits (up to $500 for an individual, $1,000, joint return), is an interesting and constructive approach. It emphasizes an incentive to add to savings, which may minimize the first-blush cost to the

Treasury*. It may, however, involve certain operational problems for institutions and the IRS. Such a limited approach to the tax code bias against savings does not recognize the difficulty which thrift institutions face today in holding their deposit base or reward those thrifty Americans who have recognized the importance of savings for years. We would recommend that S. 1488 be considered as a way of augmenting -- rather than replacing -- a straight-forward tax exclusion plan, such as those envisioned by S. 246 and S. 1846.

In sum, each of the pending proposals would help in fighting today's rampant price and cost-of-living increases and, for the longer haul, would add to the savings and capital stock so necessary for a sustained, non-inflationary future for the American economy.

The U. S. League and its 4,450 member savings and loan associations have appreciated this opportunity to present our views. I look forward to your questions.

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*However, we would contend that very soon any revenue cost will be replaced with revenue gains as the Treasury reaps the rewards on increased output, employment, and stability inherent in sustained, non-inflationary economic growth.

Summary of the Testimony of Mr. Richard S. Lawton
On behalf of the National Savings and Loan League

1. The rate of personal savings in the United States has fallen to 4.1% - the lowest since 1951.

2. Savings rates are more than double the U. S. rate in industrialized nations which have adopted the tax incentive.

3. Our current tax laws have a consumption bias especially in periods of high inflation.

4. In the 1980s we will see housing demand for 2.2 - 2.3 new homes per year. Increased savings is essential if there is to be sufficient mortgage credit to meet this demand.

5. A tax incentive for savings will lead to greater savings - thus more capital promotion - greater productivity - real GNP growth - all of which helps to reverse the spiral of inflation.

Testimony of
Mr. Richard S. Lawton
on behalf of the
National Savings and Loan League
on S. 246, S. 1488, and S. 1542
Before the Subcommittee on
Taxation and Debt Management Generally
of the Committee on Finance
United States Senate

October 31, 1979

Mr. Chairman, Members of the Subcommittee, I am Richard S. Lawton, Chairman of the Board and President of the Washington-Lee Savings and Loan Association of McLean, Virginia. I am appearing before you today as Vice-President of the National Savings and Loan League on whose behalf I testify. We welcome the opportunity to address the very important topic of tax incentives for savings.

The National ~~Savings and Loan League~~ League strongly supports use of tax incentives to encourage savings. As we come to the close of the seventies, we can look back on a decade of lagging productivity, reduced capital investment and rising inflation. One of the causes of this economic decline has been the lack of incentives for capital formation and the significant reduction in the savings rate in the United States. If the

eighties are to show improvement, it is imperative to stop the disastrous slide in the rate of personal savings that is now occurring. For this reason, we urge the Congress to act immediately to set policies that encourage savings instead of penalizing those persons who save as we now do.

In the third quarter of 1979, the rate of personal savings in the United States fell to a mere 4.1%, the lowest quarterly figure since 1951. Such a savings rate is certainly not adequate to provide capital for investment and development and the increased productivity that is needed if we are to improve our economic picture in the future. There are several factors that account for the low rate of savings, the most important of which has been inflation. At current rising rates of inflation, people are encouraged to spend and consume, rather than to save. It is perceived as better to buy today because tomorrow the cost of the item will be much higher. In addition, interest rates on savings have not been able to keep up with inflation. Finally, inflation has pushed people into higher income tax brackets, leaving them with less disposable income in real terms, and, therefore, less available funds for savings. A second factor is the taxation of interest earned on savings which further reduces the effective yield on a savings account.

Relief from taxation on all or even a part of interest earned on savings would be of substantial assistance in efforts to increase thrift and decrease our alarming rate of consumption.

In a recent survey done for the Savings and Loan Foundation, it was determined that one-half of the adults nationwide would consider increasing their use of savings accounts if they received a tax incentive of only $100/$200 exclusion on interest. Significantly, 40% of people who do not now have savings accounts indicated that they would be inclined to establish such an account if a tax exemption on the interest earned were provided. The study found that the interest exclusion was particularly appealing to people in the moderate income brackets and people under 35. These are the very people who are not saving as much or at all, under current tax provisions. These increased savings would provide additional capital for investment in housing and updating of business and industrial equipment that will be needed in the coming years.

That tax incentives for savings do work is evidenced by the experience of a number of industrialized nations, particularly in Western Europe and Japan. While the level of savings in the United States has been rapidly declining, Great Britain, West Germany, France and Japan have maintained or increased their national level of savings. The British save 13% and the Japanese save 25%. This high rate of savings has occurred in part because these nations offer some kind of tax incentive to encourage their citizens to save.

It is time to take the consumption bias out of our tax laws and break the current circle of inflation-consumption-low productivity - low investment - more inflation by taking a

strong policy step to encourage higher savings rate. It is particularly significant that these hearings are taking place on the brink of the eighties. I would like to take this opportunity to relate the importance of savings to my own professional interest - housing - in the next decade. It has been estimated that roughly 43 million people will reach age 30 during the 1980s. This group will represent a major and unprecedented force in the housing market. Along with the expected household formation rate in the 80s the projected demand for housing in the next decade is in the range of 2.2 to 2.3 million housing starts each year. There must be increased savings to finance the building of and acquisition of homes for these people who will reach household formation age in the coming decade. I can assure you that current tax policies will not provide us with the savings base to meet the demand of these young families seeking home financing.

Mr. Chairman, exclusion of interest earned on savings would provide equity to the small saver. It will give the person who does not have the funds, the expertise or the ability to compete in other forms of investment a chance for a tax break. The survey conducted for the Savings and Loan Foundation found that broad interest in a tax exclusion on interest earned on savings came from these persons in the $10,000 to $20,000 income bracket. These are the people who need assistance and deserve equity in their return on their savings. The Congress has heard complaints from several groups pleading for "equity for the small saver." Hearings have been held on this subject by various

committees of the House and Senate. Several tax incentive bills are now pending before the Senate Committee on Finance and the House Committee on Ways and Means which would provide a concrete response to the small-saver issue. The exclusion of interest income from savings would reward savings and increase the effective yield on savings accounts.

Over the several years that this issue has been discussed there have been three arguments repeatedly made against the tax incentive approach. I want to address myself to these points.

Some people have argued that the proposed policy will not cause people to save more but simply give a "windfall" to current savings account holders. Frankly, none of us can prove, in an absolute sense, that a tax incentive will produce a higher rate of savings, but there is clearly evidence that it will. The experience of other developed industrialized nations suggests that it will. Furthermore, I submit that it is human nature to save if savings is rewarded and not save if savings is punished or consumption is rewarded to a greater extent. The latter is certainly the case now. Our present tax system creates a disincentive to save, especially in times of high inflationary expectations.

A second argument that has been made is that the benefits accrue disproportionately to higher income people. This argument looks only at the fact of tax brackets and the amount of tax savings to the individual. One could just as easily argue that a $500 exclusion is more beneficial to middle and low income

people because all or most of their interest income would be tax free, which would be a very meaningful incentive and would encourage those who do not save at all to start a regular savings plan.

A third objection to a tax incentive for savers has been the loss of revenue to the Treasury. While the actual figure for such loss will vary depending upon the size and character of interest exclusion authorized, most economists agree that some, if not all, of this cost will be retrieved from increased income and employment generated by the increased capital investment. Increased investment should produce more jobs, higher productivity, and more income subject to Federal income taxes. This in the long run helps to recover the initial costs to the Treasury.

In addition, one must look at the cost of continuing in our current sluggish economic situation. As the Chairman of the Joint Economic Committee stated in his introduction of the Joint Committee's Midyear Report, Outlook, 1980s:

> "Further, it is emphasized if no new steps are taken to address the problem of structural unemployment, lagging capital formation and a slow-down in productivity, then the American economy faces a bleak future."

We are plagued by rampant inflation, low productivity, and little or no growth in our gross national product. Continuation of this situation will prove more costly in the long run than taking the steps needed to put us back on a solid foundation of investment and savings.

Mr. Chairman, the issue of a tax incentive for savings is hardly new. Legislation such as S. 246 and S. 1488 have been introduced in both houses of Congress for the past several years. We would like to call to the Committee's attention that prior to the Revenue Act of 1932, there was a tax exclusion for the first $300 of interest earned on a savings account at a "building and loan association," a forerunner of today's savings and loan associations. In 1974, the House Ways and Means Committee reported H.R. 16994. The bill, which provided for an exclusion from gross income of up to $500 for an individual and $1,000 for a married couple, did not reach the House due to time constraints.

The Report of the Ways and Means Committee to accompany H.R. 16994 (No. 93-1500) is very timely reading today. The Report cites the decline in housing starts and resulting unemployment resulting from declining savings inflows into thrift institutions which in turn resulted from inflation and disintermediation.

The Committee went on to point out, and I quote:

> "One unfortunate consequence of this system is that the small saver, whose savings typically consist of passbook accounts at thrift institutions, must in effect subsidize mortgage borrowers. In times of high inflation, such as the present, the 5-1/4 percent interest rate is not even sufficient to maintain the real value of a savings account. The double-digit inflation of the past 18 months, for example, has meant that the real value of savings accounts has declined even in cases when the entire interest in the accounts has been kept in the account. Thus, an interest exclusion for these accounts is only equitable.

Testimony of C. C. Hope, Jr. and Jerry L. Jordan on Behalf of the American Bankers Association on S. 246 and Other Bills To Increase Incentives for Savings Before the Subcommittee on Taxation and Debt Management of the Committee on Finance, United States Senate, October 31, 1979

Mr. Chairman and members of the Subcommittee, I am C.C. Hope Jr., Vice Chairman of the First Union Bank Corporation of Charlotte, North Carolina, and President of the American Bankers Association, the major banking trade association whose membership includes more than 13,000 of the nation's 14,500 full service banks. I am accompanied by Jerry Jordan, Senior Vice President and Chief Economist at the Pittsburgh National Bank and a member of our Association's Economic Advisory Committee.

We are delighted to be here today to present our views on some of the bills being considered by the members of the Committee, and the more fundamental issue that motivates their consideration, the need for increased incentives to promote savings. I would like to discuss this more fundamental issue before considering the specific bills before your Committee. The problems which have created the need for such incentives are well known. Our tax system has an inherent bias against saving and in favor of consumption. The harmful effects of this bias are aggravated by the severe inflationary conditions that have plagued our economy. Savers of more modest means suffer from governmentally imposed, discriminatory deposit interest rate ceilings which significantly reduces their incentive to save.

The causes of these problems are not hard to find. Discrimination against small savers is caused by artificially low interest rate ceilings on bank time and savings deposits. Our association strongly supports H.R. 4986 as amended by the Senate Banking Committee. We feel it is a constructive approach to this problem. But the causes of the lack of adequate investment in productive assets are more complex and fundamental.

The major, but certainly not the only, cause has been inflation. Inflation has produced phantom corporate profits which are inflated because of inadequate depreciation schedules and then taxed as if they were real profits. Inflation has produced phantom capital gains in securities which were taxed as though they were real capital gains when, in real terms, they represented losses. Inflation

has produced excessively high interest rates, because lenders, quite properly, sought to obtain inflation premiums in their debt contracts merely to offset the decline in the purchasing power of the dollar. Yet the interest return embodied in these premiums is taxed in the same way as income which increases one's command over real resources.

Perhaps most important of all is what the uncertainty and instability created by the inflation rate has done to the investment climate. For the most part, investors are no longer concerned about which companies are well managed and most productive. Their main concern is how to hedge against inflation. For very good reasons, the investment media they are attracted to have changed dramatically in recent years. Table 1 at the end of our testimony shows the compound annual appreciation in selected investable assets. Investment in the three assets with the highest rate of appreciation, gold, stamps, and diamonds, represents virtually no jobs or production for the American economy. Farmland and single family houses did relatively well. Despite the drastic decline in the value of the dollar, four of the strongest foreign currencies managed to stay only three tenths of one per cent ahead of the average rate of inflation, which was 7.5 per cent. High grade corporate bonds, bank savings deposits, and common stocks, major sources of funds for investment in the factories and businesses that create the jobs and goods which enhance our standard of living, are all the bottom of the list. None of them has kept up with inflation.

Last, but not least, is the structure of the income tax system itself. The system was designed to be progressive on the theory that those who reap the greatest rewards from our highly productive economic system should bear a greater proportionate share of the tax burdens. We have no quarrel with this rationale and would certainly not suggest doing away with the progressive tax structure. But we must call attention to the pernicious ways in which this tax structure is interacting with the inflationary conditions of today's economy. Under non-inflationary

conditions the incentive to work and save is not significantly harmed by a moderately progressive tax structure. One can still be assured that a significant proportion of the increased rewards of extra work will accrue to those who put forth the extra effort. But when people are pushed into higher tax brackets merely because they try to assure that their wages keep up with inflation, the incentive to work even harder and produce more goods and services disappears.

In the 1970s one of the tools that was used to deal with inflation was basically self-defeating and injurious to incentives to save and invest. I am referring to governmentally imposed price controls. The failure of the price control programs instituted by the Nixon Administration are, by now, well recognized. They created distortions and shortages in product and labor markets, capacity shortages, and a lack of confidence in the potential returns to the investments needed to alleviate them. Although this is no longer true for the economy at large, it is true in the oil industry today. Price controls continue to exist in that sector. We are excessively dependent on foreign oil, and the profits needed to adequately develop our domestic industry seem to be considered unfair or excessive. When the government tries to control inflation by controlling profits, the savings needed to produce the capacity to alleviate the inflation will be invested elsewhere.

Even if we successfully eliminated inflation, the most important deterrant to savings, there still are some basic elements in our tax structure that act as deterrents to savings and productive investment. Some problems with the personal income tax structure have already been discussed. A major problem that has not yet been addressed by the Congress is the double taxation of corporate earnings. When returns to productive investments are taxed twice, and returns to appreciation of gold and similar unproductive investments are taxed only once, productive investments have an additional handicap. An equally important problem is the extent to which the government relies on corporate and personal income tax structures

which deter savings. If these are major sources of revenue, as they are in the United States, the deterrent effect is quite large. It is for this reason that several of our major trading partners in Europe have begun to rely more heavily on a value added tax. Chairman Ullman of the House Ways and Means Committee has also expressed an interest in it.

My main reason for discussing these broader aspects of the tax structure and the general problem of inflation is that we hope the Subcommittee will consider the bills before it within the context of the broad and fundamental economic problems facing our nation and its policymakers. Several of these bills are constructive and we support them. But we hope the subcommittee will not consider any of them to be the fundamental answer to our problems. This they are not. What is needed most urgently is strong Congressional support for the monetary and fiscal policies needed to control inflation, and a more broad and fundamental examination of our tax structure and the ways in which it deters savings and productive investment.

Now let me turn to the bills before your subcommittee, which specifically address this issue of tax incentives for savings. S. 246, sponsored by Senator Bentsen, would permit taxpayers to exclude from gross income up to $500 ($1,000 in the case of a joint return) of interest income earned from a savings account. S. 1488, sponsored by Senator Nelson, would provide an exclusion from gross income for interest earned from a savings account but only for the amount of interest that exceeds the amount earned the previous year. Up to $500 ($1000 in the case of a joint return) is the maximum amount excludable. S. 1846, sponsored by Senator Talmadge would raise the dividend exclusion in present law from $100 to $250 and permit this exclusion to apply to interest from savings accounts. All of these proposals are constructive, and we certainly support their general thrust. We are not prepared to say that one approach is better than the other because, as we stated previously, they can only be analyzed properly within the context of a general consideration of how all aspects of the tax

structure affect incentives to save. We also urge the Subcommittee to carefully consider their effects on the Treasury's overall fiscal position and the effect this has on efforts to control inflation. In addition, if interest exclusions of some form are granted for savings accounts, we strongly urge that they also be given to interest earned from time deposits.

S. 1543, sponsored by Senator Nelson and Bentsen would defer current Federal income tax on dividends reinvested in the original issue stock of a company. We support this proposal. Because the proposal is limited to plans which purchase original issue stock, it would directly impact the formation of new capital. The deferral of taxation when the dividends are reinvested in the corporation also represents an important step in the attempt to reduce the double taxation on dividend income. Furthermore, the proposed legislation would foster savings because dividends would automatically be reinvested at less cost to the saver. Finally, the proposed legislation allows equivalent treatment to both stock dividends and dividend reinvestment if such reinvestment is in orginal issue stock. A stock dividend is a non-taxable transaction because it is a capitalization of earnings. Dividend reinvestment in new issue stock is a similar transaction, the only difference being that the election to recycle these earnings into capital is made by the individual stockholder as opposed to a corporate decision.

We also support S. 541, sponsored by Senator Baker and Sasser, which would permit the executor of an estate to elect the alternate valuation date for estate assets even though the estate tax return is filed after the due date. There are specified penalties for the late filing of the return, which is due nine months after the date of death, and these penalties do not apply if there is reasonable cause for the late filing. However, currently §2032 (c) absolutely precludes the use of the alternate valuation date election if a return is filed late. We agree with the sponsors of S. 541 that this harsh result does not further any legitimate policy of the tax law. The alternate valuation date is six months after the date of

death which is three months before the estate tax return is due, so there cannot be any planned tax avoidance "loophole" created by enacting this legislation. The alternate valuation date election should be available in all situations and penalties for late filing of the return should be the only penalties imposed.

In addition to the legislative proposals currently before the Subcommittee, there are some other approaches to encouraging savings which we believe have considerable merit. One which deserves particular attention is a proposal to allow banks and other depository institutions to issue long-term, tax deferred certificates of deposit. The interest income from such instruments would not be taxable until the instrument matures and the interest is received. Not until 1970 did the IRS adopt the current practice of requiring holders of long term certificates of deposit to include annually in their taxable income a prorated share of the interest from such instruments even though the interest is not received until maturity. Going back to the old practice of taxing the interest income on long term certificates of deposit only when it is received would provide an additional incentive to save particularly among individuals near retirement age.

In conclusion, Mr. Chairman, let me reiterate that the bills before your Subcommittee are constructive attempts to deal with a difficult and fundamental problem facing our economic policymakers. While we support the general thrust of these proposals, we also urge that they be considered carefully within the context of a program of monetary and fiscal policies needed to combat inflation and a more general restructuring of the tax system that would, on balance, encourage savings and productive investment.

TABLE I

Average Annual Appreciation in Selected Investments

1972-79 (1)

		Percent
1.	Gold	25.0
2.	Stamps	22.0
3.	Diamonds	15.6
4.	Farmland	14.3
5.	Single Family Houses	11.0
6.	Foreign Currencies (2)	7.8
7.	High Grade Corporate Bond	5.7
8.	Bank Savings Deposits (3)	5.0
9.	Common Stocks	2.2

(1) Figures are as of June 30, 1979

(2) W. German Mark, Japanese Yen, Swiss Franc, and Dutch Guilder

(3) Figures are of year end 1978

Base Year 1968=100

Source: Salomon Brothers and the American Bankers Association

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®
Donald I. Hovde, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637-6800

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STATEMENT OF GIL THURM

VICE PRESIDENT AND LEGISLATIVE COUNSEL, GOVERNMENT AFFAIRS

ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

ON S. 246

REGARDING TAX INCENTIVES FOR SAVINGS

BEFORE THE SENATE FINANCE SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

OCTOBER 31, 1979

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,780 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 729,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry. Principal officers are: Donald I. Hovde, President, Madision, Wisconsin; Ralph Pritchard, President-Elect, Oak Brook, Illinois; and Jack Carlson, Executive Vice President. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington, office is located at 925 15th Street, N.W., Washington, D.C. 20005. Telephone 202/637-6800.

SUMMARY

Mr. Chairman and members of the Committee:

My name is Gil Thurm. I am Vice President and Legislative Counsel, Government Affairs division of the NATIONAL ASSOCIATION OF REALTORS®. I am accompanied today by John Ams, who is the Director of Tax Programs in the Government Affairs division of the Association.

The NATIONAL ASSOCIATION OF REALTORS®, with over 729,000 members, is the largest trade association in the United States. Our membership is concerned with all facets of the real estate industry - residential, commercial, industrial and agricultural real estate.

We appreciate the opportunity to express our views on S. 246, introduced by Senator Bentsen. S. 246 would increase the flow of capital to lending institutions and provide a more stable source of funds for the real estate industry, construction industry and homebuilding. At the same time, taxpayers would be encouraged to save for family health care, retirement, education or other worthwhile objectives.

S. 246, while encouraging an increase in savings, would also give taxpayers relief in the form of a tax cut, since the bill would exclude from gross income a certain amount of interest income from current savings accounts. The Association supports such tax relief because the inflation of general price levels over the past few years has tended to push taxpayers into higher tax brackets even though real income may have remained the same or, more likely, declined. S. 246 would correct this inequity by giving back to taxpayers a small portion of the income that in-

flation has taken away.

We recognize that there may be some concern regarding Treasury revenue estimates for the bill. If revenue is considered as a possible concern, this Committee may wish to consider a modification of the bill to provide a phase-in of the tax incentive over a period of five years. In the interest of tax equity, S. 246 could also be amended to allow an increased amount of dividend income to be excluded from gross income by allowing the exclusion proposed in the bill to consist of interest or dividend income, or any combination of the two. This increased exclusion of dividend income from gross income could be accomplished during the phase-in period outlined previously, if necessary.

The NATIONAL ASSOCIATION OF REALTORS® particularly supports S. 246 because of the effect of the bill on interest rates and residential and non-residential housing. As the members of this Committee know, the rate of interest on home mortgages is presently at the 13% level. We estimate that S. 246 would decrease long-term interest rates by .82% due to the higher rate of savings inflow into lending institutions. Concurrently, residential and non-residential construction would each increase by approximately 4.7% over current levels to accomodate the anticipated increase in housing demand.

Productivity and economic growth would also increase if S. 246 were enacted. As the increased amount of savings is spread throughout the economy, private investment would increase by $21.2 billion, a gain of 4.8%, with a corresponding increase in employment of 250,000 jobs and a rise in household per capita income of $210. The result of this increased economic activity is a rise in GNP of $9.5 billion.

The NATIONAL ASSOCIATION OF REALTORS® supports S. 246 because this increased economic activity is vitally necessary at a time when the high rate of inflation and low rate of economic growth is rapidly bringing the economy to a halt. We urge this Committee to favorably report S. 246.

BACKGROUND

The current system of Federal taxation on interest income has severely restricted savings and capital formation in this country. Personal savings play an important role in the economy as sources for investment and economic growth. The decline in the economy is related to the decline in savings and investment.

The rate of savings as a percentage of disposable income has steadily decreased over the last few years, from 7.7 percent in 1975 to 4 percent in the third quarter of 1979, according to the U.S. Department of Commerce. Given the 13% level of inflation we are currently experiencing, it is reasonable to assume that the rate of savings will decline even further in the fourth quarter of this year.

The low rate of personal savings in the United States is easily explained. The simple answer is that the real after-tax return on savings has been drastically reduced over the last few years, making it more difficult for people to save, especially those in the lower and middle-income groups.

Years ago, commercial banks and savings and loan associations offered interest rates of only two or three percent on demand deposits. Since inflation averaged 1.5 percent or less during those years, depositors still received a positive rate of return on savings, even after taxes. Today, the depositor can earn 5.5 percent on his investment in a thrift institution, however the rate of inflation is hovering at the 13 percent level in many areas. Consequently, in real terms there is a

loss of 7.5 percent. Nevertheless, the nominal interest received is taxed by both Federal and state governments, so that the total loss in real dollars can be as high as ten percent.

Of course, those who have $10,000 or more to invest have a variety of instruments available, such as money market certificates, that pay a much higher rate of interest than is available to the small saver. But the small saver - the lower and middle-income taxpayer - is precisely the individual who should be encouraged to save more and who finds himself or herself unable to save. The small saver finds it economically more attractive to buy an automobile or television set before the price goes up than to put his money into a savings account where the value of his money will go down.

This "buy now" attitude, although economically justifiable, tends to worsen our current inflation problem. As consumers buy products now to avoid higher prices in the future, the increase in demand results in higher prices now. Higher prices lead to greater loan demand and a reduced savings pool from which available funds can be loaned. All of this translates into higher consumer prices, a high inflation rate and the low savings rate of only 4 percent of disposable income.

In order to reverse this steady decline in personal saving rates, and to help stimulate capital formation and economic growth, this Association strongly supports legislation to provide tax incentives for savers. Given the exceedingly low level of savings at the present time and the high level of inflation, the tax incentive must be meaningful and at a level that would encourage a large amount of savings.

S. 246

The NATIONAL ASSOCIATION OF REALTORS® urges this Committee to favorably report S. 246. This bill, sponsored by Senator Bentsen, would exclude from gross income the first $500 in interest income received by a single taxpayer from time and demand deposits in commercial banks and thrift institutions. The exclusion would be $1000 for taxpayers filing a joint return. S. 246 would increase the flow of capital to lending institutions and provide a more stable source of funds for the real estate industry, construction industry and homebuilding. At the same time, taxpayers would be encouraged to save for family health care, retirement, education or other worthwhile objectives.

S. 246, while encouraging an increase in savings, would also give taxpayers relief in the form of a tax cut, since the bill would exclude from gross income a certain amount of interest income from current savings accounts. The Association supports such tax relief because the inflation of general price levels over the past few years has tended to push taxpayers into higher tax brackets even though real income may have remained the same or, more likely, declined. S. 246 would correct this inequity by giving back to taxpayers a small portion of the income that inflation has taken away.

We recognize that there may be some concern regarding Treasury revenue estimates for the bill. If revenue is considered as a possible concern, this Committee may wish to consider a modification of the bill to provide a phase-in of the tax incentive over a period of five years. In the first year, $100 of interest income could be excluded from a single taxpayer's gross income and $200 in the case of taxpayers filing a joint return. The tax exclusion could

increase by yearly $100 increments so that, in the fifth year, the exclusion could equal the amounts proposed by the bill: $500 for a single taxpayer and $1,000 for joint taxpayers.

In the interest of tax equity, S. 246 could also be amended to allow an increased amount of dividend income to be excluded from gross income by allowing the exclusion proposed in the bill to consist of interest or dividend income, or any combination of the two. This increased exclusion of dividend income from gross income could be accomplished during the phase-in period outlined previously, if necessary. Specifically, during the first year after enactment of the bill, a $100/$200 exclusion could be provided for both interest and dividend income. Thereafter, when the amount of the exclusion is increased, the taxpayer could exclude dividend or interest income in the aggregate amount of the available exclusion.

The enactment of S. 246, even with the modification outlined above, would result in significant improvements in many sections of the economy. The estimated economic impact of the bill as modified, together with the estimated cost to the U.S. Treasury, is set forth in Table 1 in the appendix to our testimony. Table 1 sets forth the average increases in investment, savings, employment, and other items as a result of the enactment of this bill.

As is evident from the Table, the increase in savings that would occur results in substantial increases in productivity and economic growth. Table 1 indicates that as the increased savings is invested and reinvested throughout the economy, private investment would increase by $21.2 billion, a gain of 4.8%, with a corresponding increase in employment of 250,000 jobs and a .9% rise in household per capita income of $210. The result of all

this increased economic activity would give rise to a .3% increase in Gross National Product of $9.5 billion.

This increased economic activity is vitally necessary at a time when the high rate of inflation is rapidly bringing the economy to a halt. The increased level of savings brought about by S. 246 would serve to help control inflation because individuals would save rather than spend a greater proportion of their disposable income. In addition, increased investment would bring our nation's economy back on track after the downturn we have experienced over the last year and, as a result of newer and more efficient equipment, output per man hour would increase by 1.2 per worker. And yet, all of this necessary and vital economic growth would only cost the U.S. Treasury the relatively modest amount of $5 billion in the fifth year after enactment of S. 246. As Table 1 indicates, the total cost to the Treasury would be a fraction of the rise in GNP that would occur if S. 246 were enacted. Table 2 and 3 indicate that this cost to the Treasury would really be tax relief to the low and middle income taxpayer, since more than 80% of all tax returns on which interest income is reported are filed by taxpayers earning less than $25,000.

The NATIONAL ASSOCIATION OF REALTORS® particularly supports S. 246 because of the effect of the bill on interest rates and residential and non-residential housing. As the members of this Committee know, the rate of interest on home mortgages is presently at the 13% level. Table 2 indicates that S. 246 would decrease long-term interest rates by .82% due to the higher rate of savings inflow into lending institutions. Concurrently, residential and non-residential construction would each increase by approximately 4.7% over current levels to accomodate the anticipated increase in housing demand.

FINANCIAL REFORM LEGISLATION

While the NATIONAL ASSOCIATION OF REALTORS® strongly supports legislation to provide tax incentives for savings, we are concerned that the United States Senate is presently considering financial reform legislation without considering tax incentives for savings legislation as part of the same package. The Senate is now considering a proposal for financial reform (H.R. 4986, Depository Institution Deregulation Act) that would lower the denominations of the current money market certificates from $10,000 to $1,000 in an effort to make the higher yields on these certificates more available to the small saver. We are in favor of permitting savers to share interest returns which more accurately reflect the rising costs of inflation. However, we feel that the concepts embodied in this legislation are not the way to achieve this end and that a distinction should be made between transient funds and permanent funds. It is our fear that while this legislation would certainly permit small savers to enjoy higher rates, these savings would represent just a simple transfer of existing passbook funds. The result would be no increase in the supply of available funds, but merely an increase in cost incurred by financial institutions, a cost which inevitably must be passed on to the consumer.

Not to consider financial reform and tax incentives to savers in tandem would be a lost opportunity indeed. Just when the tide is moving in the direction described, just when a national commitment to savings and not consumption alone is close to realization, the Senate of the United States is being asked to deal with the wholesale reform of the financial structure of this nation in a vacuum. Tax incentives would help replace current powers for thrift institutions which would be lost under the bill ap-

proved by the Senate Committee on Banking, Housing and Urban Affairs, and now before the entire Senate for consideration.

We oppose the lowering of minimum money market certificate denominations, and recommend following the precedent of the 1975 Financial Institutions Act, passed by the Senate, in not permitting the Financial Reform legislation to be considered until additional tax provisions, such as tax incentives for savers, become a part of that consideration.

In 1975 the Senate wisely tied tax incentives to financial reform. We request that they follow this wise approach once again.

CONCLUSION

The NATIONAL ASSOCIATION OF REALTORS® strongly supports legislation to provide tax incentives for savings as a means to help reduce interest rates, control inflation, and encourage vitally needed capital formation.

S. 246 will serve to accomplish these goals by providing a meaningful tax incentive to increase the low rate of savings we are experiencing today. The increased flow of savings into lending institutions will be invested and reinvested in new housing, structures and equipment and will serve to increase productivity and real economic growth. We urge this Committee to favorably report S. 246.

We thank the Committee for the opportunity to present our views on this important matter. We will be happy to answer any questions the Committee may have.

Table 1

EFFECT OF S. 246 AS MODIFIED

Economic Impact of Interest and Dividend Deductibility Phase-in over five years, assuming $500 exclusion for single taxpayers and $1000 exclusion for taxpayers filing joint returns

1980-85
(billions of 1979 dollars)

	1980	1981	1982	1983	1984	1985
Gross National Product	1.5	2.7	4.5	6.5	8.8	9.5
Inflation (GNP Deflator)	*	-0.2	-0.4	-0.5	-0.7	-0.8
Long-term Interest Rates (Mortgage Rates)	-.12	-.18	-.38	-.52	-.69	-.82
Average disposable income per household	20	56	82	134	182	210
Employment (number of jobs)	25,000	50,000	75,000	125,000	175,000	250,000
Private Investment	3.6	6.9	9.9	16.7	21.2	21.2
Percent Change	1.0	1.8	2.5	4.0	4.7	4.8
Housing	1.0	2.2	1.8	5.2	6.8	6.9
Percent Change	0.9	1.8	1.5	4.0	4.8	4.6
Non-Residential Structures	1.0	1.6	2.9	4.3	5.1	5.2
Percent Change	1.1	1.6	3.0	4.3	4.8	4.7
Equipment	1.6	3.1	5.1	7.2	10.2	10.2
Percent Change	1.0	1.8	2.9	4.0	4.7	4.4
Gross Tax Relief	1	3	5	7	9	10
Net Tax Relief	.25	1	2	3	4	5

*less than -0.1

Source: Assumptions and modelling by Dr. Jack Carlson and John Ams of the NATIONAL ASSOCIATION OF REALTORS® using both the Association's model and Data Resources Incorporated model and data base.

TABLE 2 Number of 1976 Non-Joint Return With Interest Received, By Income Group And Revenue Loss If S. 246 Were Enacted

Adjusted Gross Income	Number of Returns	Amount of Interest Received (000)	Average	Amount Exempt
Under $2,000	1,986,700	$ 592,300	$ 298	all
$2,000-$3,000	1,279,000	596,700	467	$127,900,000
$3,000-$4,000	1,286,400	1,137,400	884	128,640,000
$4,000-$5,000	1,010,600	979,600	969	101,060,000
$5,000-$6,000	1,009,400	990,500	981	100,940,000
$6,000-$7,000	1,003,600	955,700	952	100,360,000
$7,000-$11,000	3,227,100	3,187,500	988	322,710,000
$11,000-$15,000	2,139,800	2,256,200	1,054	213,980,000
$15,000-$20,000	1,407,800	1,858,700	1,320	140,780,000
$20,000-$25,000	471,300	982,200	2,084	47,130,000
$25,000-$30,000	208,300	676,300	3,247	20,830,000
$30,000-$50,000	219,500	1,031,500	4,700	21,950,000
$50,000-$100,000	73,600	554,700	7,536	7,360,000
$100,000-$200,000	16,300	210,800	12,932	1,630,000
$200,000 +	5,000	178,100	35,620	500,000
	15,344,400	16,188,200		

Total Non-Joint Returns 40,231,000; Non-Joint Returns with interest 15,344,400 or 38.1%

Source: Internal Revenue Service
Table prepared by Paul Maiham of the Economics and Research Division of the NATIONAL ASSOCIATION OF REALTORS®.

TABLE 3 Number of 1976 Joint Returns With Interest Received, By Income Group And Revenue Loss If S. 246 Were Enacted

Adjusted Gross Income	Number of Returns	Amount of Interest Received (000)	Average	Amount Exempt
Under $3,000	944,900	910,300	963	all
$3,000-$4,000	448,100	398,600	890	89,620,000
$4,000-$5,000	498,200	549,100	1,102	99,640,000
$5,000-$6,000	686,400	814,800	1,187	137,280,000
$6,000-$7,000	667,500	873,500	1,309	133,500,000
$7,000-$11,000	2,995,300	3,519,200	1,175	599,060,000
$11,000-$15,000	3,911,000	3,334,500	853	782,200,000
$15,000-$20,000	5,785,000	4,229,800	731	1,157,000,000
$20,000-$25,000	4,438,200	3,639,600	820	887,640,000
$25,000-$30,000	2,767,100	2,976,100	1,076	553,420,000
$30,000-$50,000	3,061,200	5,476,600	1,789	612,240,000
$50,000-$100,000	823,900	3,540,700	4,297	164,780,000
$100,000-$200,000	162,200	1,336,700	8,241	32,400,000
$200,000 +	35,700	807,500	22,619	7,140,000
	27,224,700	32,407,000		

Total Joint Returns 44,438,912; Joint Returns with interest 27,224,699 or 61.3%

Source: Internal Revenue Service

Table prepared by Paul Maihan of the Economics and Research Division of the NATIONAL ASSOCIATION OF REALTORS®.

Statement
of the
National Association of Mutual Savings Banks
on
Tax Incentives for Personal Saving
before the
Subcommittee on Taxation and Debt Management
of the
Committee on Finance
United States Senate
October 31, 1979

Mr. Chairman and Members of the Subcommittee, my name is Saul B. Klaman. I am President of the National Association of Mutual Savings Banks. I appreciate this opportunity to present the views of the savings bank industry on the critically important issue of providing tax incentives for personal saving. We are gratified that three of the bills under consideration -- S. 246, S. 1488 and S. 1846 -- address this issue.

As these bills illustrate, there are a variety of ways to provide savings-related tax incentives, including tax credits, exemptions, deductions or deferrals, applied either to incremental personal savings or to a portion of savings interest income. I believe that it might be most useful to the Subcommittee at this time, however, if I direct my comments to the major public policy issues involved, rather than to the specific approach embodied in any particular bill.

Public-Interest Benefits of a Savings Tax Incentive

The savings bank industry has long supported a tax break for this nation's inflation-battered saver-depositor. Our strong commitment to this objective is underscored by the recent formation of a special NAMSB Tax Incentive Task Force, which will be working vigorously to generate public support for prompt Congressional action to provide a tax break on personal savings and time deposit interest income.

We support a tax break for savers because such action is so clearly in the public interest. Specifically, a tax incentive for personal savings and time deposits would have the following public-interest benefits:

(1) It would be a major step in the struggle against inflation, since it would help to promote the increased saving needed to finance productive investment and a rising standard of living for all Americans;

(2) It would be the most expeditious and effective means of increasing real after-tax returns to the saver-depositor, and would thus directly address the need to provide "equity for the small saver" and increased returns to all depositors in an inflationary, high-interest-rate climate; and

(3) It would have significant benefits for mortgage borrowers and housing, both in terms of reduced borrowing costs and increased availability of mortgage funds.

The Budgetary Impact of a Savings Tax Incentive

I will expand on each of these points in the remainder of my testimony. But first, I have a few comments on the budgetary impact of a savings-related tax incentive.

A major counter argument to tax incentives for savings, of course, is the loss of federal tax revenues. This is an important point at a time when federal budgetary deficits need to be reduced. Over the longer run, however, an increased level of private saving and capital formation would provide more than offsetting economic benefits to the nation, particularly in its anti-inflationary impact.

Increased real economic growth, moreover, would generate increased tax revenues and thus help offset any initial revenue loss. And, of course, the tax deferral route would ultimately permit the U.S. Treasury to recover most of its initial revenue losses.

It should also be recognized that reducing the federal budget deficit through inflation-induced tax collections is bad public policy and is ultimately self-defeating. Indeed, the effect of rapid inflation in pushing taxpayers into higher tax brackets, and a weakening economy, are generating pressures for another round of tax reduction. This situation provides a golden opportunity to tailor tax relief from inflation, and overall contra-cyclical tax reduction, to the critical longer-run need to promote non-inflationary economic growth through increased private saving and capital formation.

The Anti-Inflationary Impact of a Savings Tax Incentive

The need to address our nation's savings-investment problem is critical, and is increasingly being recognized. This need has been underscored by the abysmally low overall saving rate in the United States, which plunged to only 4.1 percent of disposable income in the third quarter of this year, the lowest rate since the second quarter of 1951. And it has been underscored by the sharp and disturbing decline in our nation's productivity growth in recent years.

Thus, from 1947 to 1967, productivity in the private business sector grew at an annual rate of 3.1 percent a year. Over the past decade, however, productivity grew only half as fast -- at an average annual rate of 1.6 percent. In 1978, productivity grew by only 0.5 percent. And in 1979, productivity declined sharply during the first half and showed virtually no change in the third quarter.

These are truly disturbing statistics. Unless these trends can be reversed -- unless saving and productive investment can be increased -- there is scant hope that inflation can be brought under control.

To meet this challenge will require a basic change in our federal tax policies, and in other public policies as well. For ours has been a borrower- and consumption-oriented society, in large part because public

policy has consistently focused on the needs of borrowers and consumers. The needs of savers, and the economic and social value of saving have been virtually ignored. Little wonder that the United States is currently saving at one of the lowest rates in the Western World, little wonder that our productivity growth has slowed to a virtual standstill, and little wonder that we are plagued by double-digit inflation.

The anti-saver, pro-borrower bias in our economy has long been visible in our federal tax code. It is especially incongruous, in an age of rapid inflation against which we are sworn to do battle, that our tax structure encourages borrowing and discourages saving. Quite plainly, savings-related tax incentives demand serious consideration as a means of redressing the long-standing imbalance between borrowing and saving, and as a means of combating inflation. A wide array of such incentives is available in other advanced nations, and it is hardly coincidence that the overall rate of saving in these countries far exceeds ours.

Tax Incentives and the Saver-Depositor

The long-run effect of savings-related tax incentives in helping to reduce inflation will obviously be of great benefit to the saver-depositor. Inflation, of course, is the mortal enemy of thrift, since it erodes the real value of savings and reduces incentives to save.

And inflation is the root cause of the serious problems that presently confront savings banks and other thrift institutions. Savings banks are presently experiencing record disintermediation. Net deposit outflows at savings banks, excluding interest credited to depositors' accounts, totaled $4.4 billion over the April-September period of this year. In September alone, savings banks experienced a $1 billion net deposit outflow and large-

scale deposit outflows continued in October. The dramatic October 6 actions of the Federal Reserve, moreover, have clearly worsened near-term prospects for savings bank deposit flows.

The present problems of savings banks reflect, of course, the impact of inflation and of efforts to control inflation through high interest rates. Rapid inflation and high interest rates have also focused new attention on the plight of the saver-depositor, and especially on the need to provide higher returns to the small saver. Enactment of a tax break for savers would be the most important step to accomplish this objective in the shortest period of time. It would directly increase after-tax returns to savers and would also increase the ability of savings banks and other thrift institutions to compete for savings with money market mutual funds and other high-yielding open-market investments.

Tax Incentives and the Mortgage Borrower

Prompt action to provide a tax incentive for savings held at mortgage-oriented thrift institutions would not only benefit savers but mortgage borrowers as well. There is little need to dwell upon the harmful effects of disintermediation and soaring interest rates on mortgage borrowers and the housing market. In many areas, thrift institutions have been forced to cut back -- or even to cease -- new mortgage activity. If interest rates remain at current high levels or increase further in the months ahead, a sharp reduction in new housing activity and in existing home sales is inevitable.

In the short-run, a savings-related tax incentive would increase after-tax returns to savers and stimulate increased saving at thrift institutions. As a result, upward pressures on mortgage interest rates would be reduced and more funds would be available for mortgage lending. And similar

results would occur over the longer-run, reflecting the continuing stimulus to saving flows at mortgage-oriented thrift institutions that a savings tax incentive would provide.

Concluding Comment

In conclusion, the savings bank industry strongly supports immediate enactment of a tax incentive to promote increased private saving. Such an incentive is urgently needed to combat inflation; to provide increased rewards to all savers, and a better deal for the "small saver" in particular; and to promote an increased flow of essential housing credit at reasonable costs to borrowers. We hope that our comments will be useful to the Members of the Subcommittee as you consider this critical issue.

Evans Economics, Inc.

INDIVIDUAL SAVINGS ACCOUNTS

Testimony for the Senate Finance Committee

October 31, 1979

by Michael K. Evans

One of the major problems facing the U. S. economy in recent years has been the sharp decline in the growth rate of productivity, which has been one of the major factors leading to the spiraling rate of inflation during the 1970's. This decline can be directly related to the paucity of savings and investment in the U. S. economy compared to other countries. Indeed, as shown in Figures 1 and 2, the U. S. economy is dead last among major industrialized countries in both the ratio of savings and investment to GNP and the growth in productivity.

The changes in the tax laws during the past 15 years have tilted against savings and investment and toward consumption. While this has helped to increase GNP and employment in the short run, it has created an inflationary bias in the long run which has actually reduced the growth rate over the past decade. Thus it is clear that the time for changes in the tax code to stimulate savings and investment are overdue. One of the most important changes which can be undertaken is one which will give individuals a greater incentive to save in this era of high inflation.

The formation of Individual Retirement Accounts (IRAs) four years ago permitted individuals not covered by pension plans to invest $1500 each year tax-free, providing the money was not withdrawn before retirement age. We propose the creation of an Individual Savings Account (ISA) which would encourage savings by the small investor. Under this plan, each taxpaying unit could treat up to $1500 per year in interest income, dividend income,

Figure 1

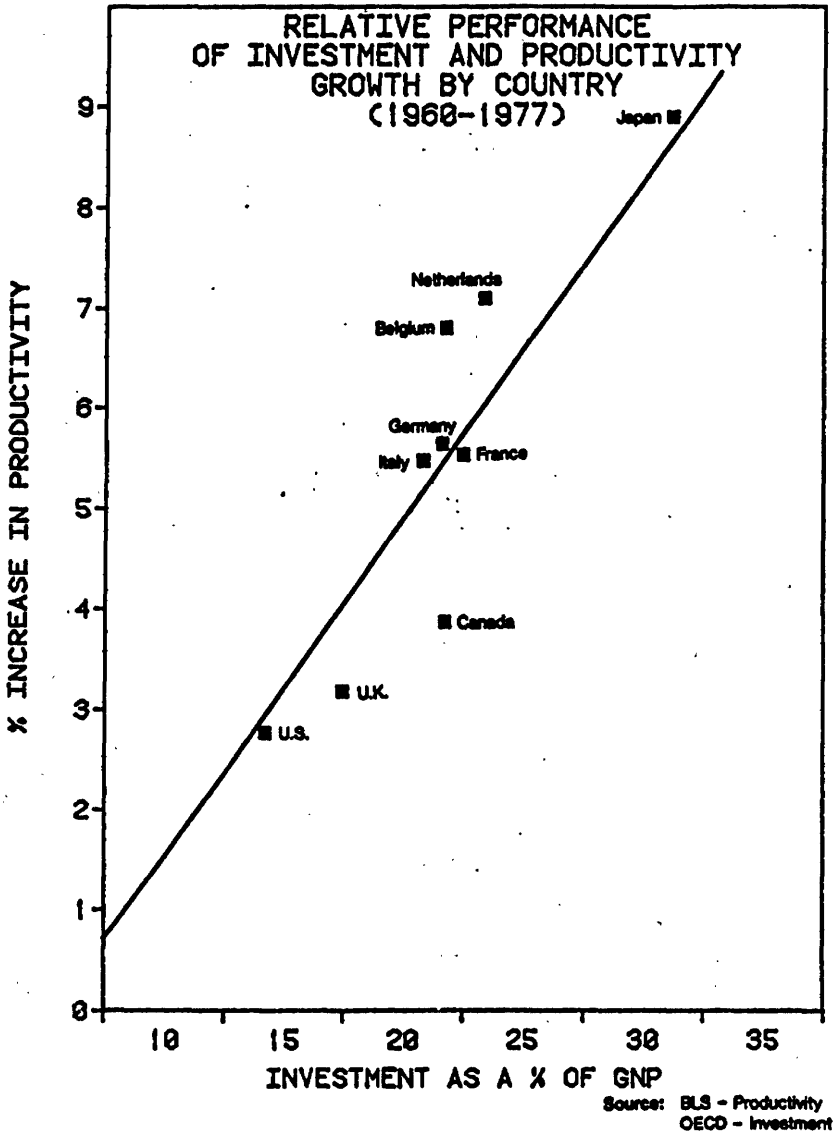
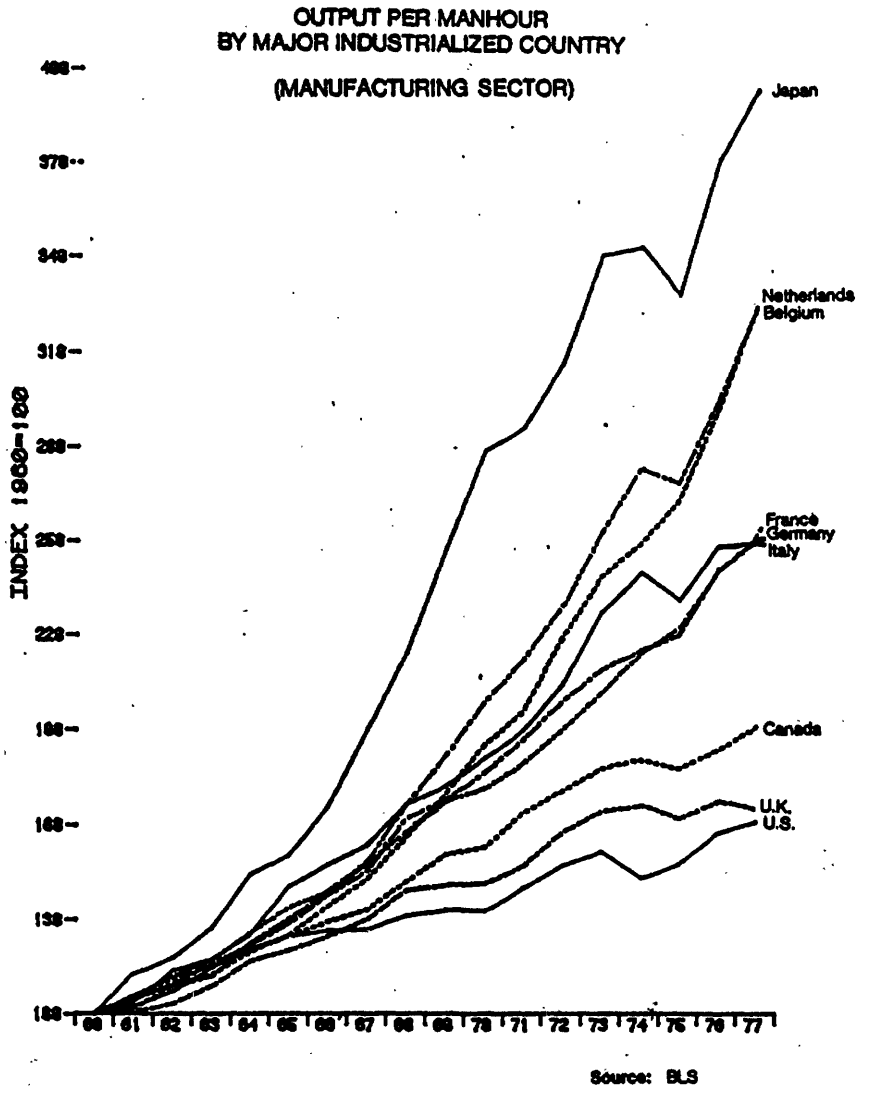

RELATIVE PERFORMANCE
OF INVESTMENT AND PRODUCTIVITY
GROWTH BY COUNTRY
(1960-1977)
% INCREASE IN PRODUCTIVITY
INVESTMENT AS A % OF GNP
0
1
2
3
4
5
6
7
8
9
10
15
20
25
30
35
Japan
Netherlands
Belgium
Germany
Italy
France
Canada
U.K.
U.S.
Source: BLS - Productivity
OECD - Investment

Figure 2


OUTPUT PER MANHOUR
BY MAJOR INDUSTRIALIZED COUNTRY
(MANUFACTURING SECTOR)
INDEX 1960=100
Japan
Netherlands
Belgium
France
Germany
Italy
Canada
U.K.
U.S.
60
61
62
63
64
65
66
67
68
69
70
71
72
73
74
75
76
77
Source: BLS

or capital gains rollover as tax-exempt income. Thus, for example, if an individual had a savings account of $10,000 on which he earned an average interest rate of 9% and dividend income of $1000, $1500 of that $1900 income would not be included in his gross taxable income. The plan would have certain strictures; taxpayers would have to keep their principal fully invested, although they could switch assets just as is the case for IRAs now. Any capital gains would have to be reinvested (rolled over) into other similar investments in order for that part of the exemption to qualify. However, the basic idea of an ISA would be that income generated from stocks, bonds, savings accounts, money market funds, or similar assets would be tax exempt as long as the principal remained invested in this class of assets.

This idea is a fairly new one for the U. S. economy, but virtually every other industrialized country already gives some tax breaks to the small saver. In fact, this one reason goes far to explain why the personal savings rate in the U. S. is so much lower than in other major countries. It also explains why personal savings is so much more attractive even in those countries where the rate of inflation is well above normal U. S. levels.

In Britain, for example, individuals may buy National Savings Certificates in amounts up to £1000 with the interest income completely free from income tax. Other plans, including British Savings Bonds, the various Save As You Earn schemes, and National Savings Bank accounts all pay interest which is partially or totally free from income tax.

Germany does not offer quite as wide a scheme of tax-free saving incentives, but the overall effect is much the same. Deposits at savings and loan associations and insurance companies are deductible up to a maximum which varies based on the size of the family, veteran status, and several other factors.

Japan treats interest income even more favorably. In fact, any person

receiving either interest or dividend income can choose to have *all* of this income taxed at the flat rate of 35%, compared to a maximum income tax bracket of 75%. Compare this to the U. S. tax tables, where interest and dividend income are taxed at a maximum rate of 70% instead of the 50% cap on earned income.

Small savers in Japan receive even further incentives to save. Interest income from a savings deposit of up to ¥3 million (about $15,000) is totally exempt. Furthermore, life assurance premiums are totally deductible from income tax up to an amount of ¥25,000 per year, and partially deductible up to ¥100,000 per year. Virtually no capital gains are taxed unless (a) the taxpayer has regularly engaged in security dealings during the year, (b) the gains are from the sale of shares accumulated with the object of manipulating their market price, or (c) the sales are a substantial part of a corporation.

Clearly the establishment of ISA would have many advantages. It would reduce the tax burden for savers, particularly smaller savers. It would stimulate savings and investment, and would pull the U. S. closer to being able to compete with other major industrialized nations in terms of gains in investment and productivity.

To try to determine the economic impact of ISAs, we need to answer several questions. The first is how much it will cost the Treasury. On an *ex ante* basis, we can get some clue to this by considering the 1976 tax returns (the latest available) and calculating the amount of interest and dividend income per tax return at various levels of income. These calculations are obtained in Table 1. Based on 1976 numbers, deduction of the first $1500 of interest and dividend income for all taxpayers would reduce Treasury tax receipts by $6 billion. After converting this to a 1979 tax number, providing the same relative tax structure still holds, this would be a revenue loss of about

TABLE 1

Interest and Dividend Income

Tax Bracket	Thousands of Returns	Total Dividend Income, Million $	Total Interest Income, Million $	Average Dividend & Interest Income per Return, $	Approximate Top Marginal Rate
Under $5,000	23,852	348	1,791	90	.10
$5,000-$10,000	19,891	1,646	7,848	477	.15
$10,000-$15,000	14,534	1,664	6,911	590	.2
$15,000-$50,000	25,087	8,398	20,608	1,156	.4
$50,000-$500,000	1,166	9,595	6,219	13,563	.5
Over $500,000	5	1,714	346	412,000	.7

SOURCE: Statistics of Income, Individual Income Taxes, 1976 edition.

$8 billion. Hence the tax reduction would be far less than the old-style tax cuts which are being readied to fight the recession.

How does the formation of ISA differ from just another personal income tax cut? The answer lies in the additional amount of savings which it creates. Here we face the question of the elasticity of savings on the real aftertax rate of return, an area which is being explored in the supply-side modelling work which we are performing under contract to the Senate Finance Committee. Before turning to our estimate, however, we can point out that theoretically the additional increase in savings -- above and beyond the normal marginal propensity to save out of a tax cut -- can be calculated as:

Potential increase in savings	x	Change in real aftertax rate of return	x	Elasticity of personal saving

One way of defining the potential increase in savings is to assume that all taxpayers could take advantage of this $1500 exemption, and just multiply the difference between $1500 and the average amount of interest and dividend income per return by the number of returns in each classification. Performing this calculation gives a total potential increase of $76 billion in 1976; adjusting upward by the growth in income yields a figure of about $100 billion at 1979 levels of income and taxes.

It will immediately be objected that most taxpayers with total income of under $5000 per year cannot be expected to have interest and dividend income of $1500 per year under any circumstances. We have no quarrel with this. However, estimates of the elasticity of savings are always done for *all* personal savings, not just savings of a certain upper-income group. Defining the group of savers more narrowly would undoubtedly increase the elasticity, so we have a trade-off between these two definitions.

Calculating the change in the real aftertax rate of return is also not straightforward. Under a situation where the interest rate received is equal to the rate of inflation, the real aftertax rate of return is negative under present regulations and would be zero with an ISA. One cannot calculate a percentage change under this set of conditions. Since we are talking about savers who probably have a marginal rate of about 40%, the most reasonable assumption seems to say that tax exemption would raise the rate of return by that percentage, namely 40%.

The elasticity of savings with respect to the aftertax rate of return is the hardest of these three variables to measure. Based on our estimates which have been generated in the Senate Finance Committee work, we think this elasticity is about 0.2. Under these assumptions, then, the increase in savings stemming from ISAs would be 100 x 0.4 x 0.2, or about $8 billion. We would expect that investment would be increased by approximately the same amount.

The ISA concept can also be defended from an equity point of view, since the small saver is clearly earning a negative rate of return at today's interest rates and inflation rates. Inflation will average over 13% this year; the small saver, if he is fortunate, may be able to earn about 12% for the year, although most savers will earn less. However, that does not even begin to deal with the problem. Assuming that the average saver is in the 40% marginal tax bracket, he must pay taxes of 4.8% on the earned interest income, leaving an after-tax return of some 7.2%. When compared with the inflation rate for 1979 this is a distinctly unpalatable alternative. It is small wonder that the personal savings rate in the last quarter declined to 4.1%, a 28-year low. With savings earning a negative return of 5% and inflation continuing to accelerate, more and more consumers have decided to

buy now before prices rise even further. A partial tax exemption would go far toward redressing this disequilibrium situation and restoring the incentive for savings.

While some legislation which has been introduced to stimulate savings covers only interest income, it is our belief that it should cover dividend income and capital gains rollovers as well. If this were not the case, investors would choose fixed income securities over equities, which would bias decision-making in the capital markets. Thus the tax exemption should extend to all sources of investment income.

In summary, the creation of ISAs for individual investors would raise approximately $8 to $10 billion per year in savings and investment, increase real GNP by approximately 0.5% per year in the first year and as much as 1.0% per year thereafter, and would eventually reduce the rate of inflation. While the initial effect would expand the Federal budget deficit, the positive longer-term effects of job creation and reduced inflation would far outweigh any negative ramifications of larger deficits.

Senator CHAFEE [presiding]. If we can have the next panel now, S. 1543.

OK, now, lady and gentlemen, you have 20 minutes to divide amongst yourselves, so now we have four. Are we missing somebody? Is Mr. Nathan here? Is Mr. Nathan coming?

Mr. NATHAN. Yes.

Senator CHAFEE. Mr. Alexander?

Mr. Cohn.

Mr. COHN. Right here, sir.

Senator CHAFEE. Mr. Lawrence.

Ms. Sullivan.

And Mr. Malone.

All right, that is 1, 2, 3, 4, 5, 6, into 20 minutes gives you something like 3 minutes apiece. And who wants to start?

Why don't we have——

Mr. COHN. Mr. Chairman, we have agreed among ourselves on the allocation of the time.

STATEMENT OF HERBERT B. COHN, CHAIRMAN, COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Mr. COHN. My name is Herbert Cohn. I appear here today as chairman of the Committee for Capital Formation through Dividend Reinvestment. The members of this committee are listed in the appendix to my formal statement.

Also appearing for our committee are Robert R. Nathan, our economic consultant, and Donald C. Alexander, our tax counsel. We very much appreciate this opportunity to appear and testify.

I should like to request, Mr. Chairman, that the formal statements by Mr. Nathan and myself be incorporated in the record.

Senator CHAFEE. Excellent, excellent.

Mr. COHN. And we will present merely a brief summary.

We strongly favor S. 1543. This bill, by deferring current taxes on dividends which are reinvested under qualified dividend reinvestment plans, would materially encourage increased reinvestment of dividends in new issue stocks, and materially increase capital formation.

The details of the bill are covered in our statements and were referred to a little bit earlier by Senator Nelson and Congressman Heftel.

We believe S. 1543 is the most direct and the most cost-effective proposal for encouraging new capital formation where it is urgently needed. It is most direct because the reinvestment of dividends in new issue stock represents instantaneous formation of new capital. You can actually see it happen. It represents a rifleshot which is 100 percent effective in providing new capital where it is urgently needed since dividend reinvestment plans for new issue stock are adopted only by capital intensive companies having a continuing need for additional common stock capital to finance their operations.

S. 1543 is highly cost effective since, as will be indicated by Mr. Nathan, it will provide a substantial increase in new capital formation, substantial new investment, and stimulation of the economy, and over a 3-year period will result in a net gain rather than a loss in tax revenues.

The counterpart bill in the House, H.R. 654, now has 60 sponsors. In addition, the substance of these bills has also been included in section 202 of Chairman Ullman's Tax Restructuring Act of 1979.

Adoption of S. 1543 would further important national objectives in the following respects. First, it would directly and substantially encourage new capital formation. Second, it would reduce the double tax on dividend income by eliminating the tax at the stockholder level when dividends are reinvested under qualified plans. Third, it would encourage thrift and assist participating stockholders in providing for supplemental income for their retirement. Fourth, it would be more equitable in treating the stock received on reinvestment of dividends as the equivalent for tax purposes of a conventional stock dividend, which is really what it looks like to the stockholder who receives it. Fifth, it would help in financing essential energy facilities since many of the companies having these plans are engaged in energy supply. Sixth, it would be anti-inflationary in absorbing cash dividends and in helping to finance increased productive facilities.

S. 1543 has wide support from stockholder groups and from a large number of capital intensive companies which must obtain their common stock capital requirements primarily through the continuing sale of common stock. It is also fully supported by a large number of associations including the Stockholders of America, represented here today by Mrs. Sullivan; the American Gas Association, represented by Mr. Lawrence; the United States Independent Telephone Association, representing 1,500 telephone companies throughout a large part of the United States, represented

here by Mr. Malone; the American Bankers Association, the principal association of commercial banks, represented in the preceding panel by Mr. Hope; and the Edison Electric Institute, the association of investor-owned electric power companies.

For all of these reasons, Mr. Chairman, we strongly urge your subcommittee to endorse and favorably report S. 1543.

Thank you.

Senator CHAFEE. Well, thank you very much.

Now, I would appreciate it if in the remarks of the following witnesses you would address the situation that we have in which we can't meet everybody's desires on how to proceed. There is intense interest in this body and in the House in encouraging greater capital formation. That is not debated. The question is how to proceed.

Now, there are various ways of proceeding, as we all know: Eliminate the double taxation on dividends; increase the investment tax credit to 12 percent; cut the corporate rate. But the one that has received the most support and indeed has 243 cosponsors in the House is more rapid depreciation, accelerated depreciation; what we call around here the 10-5-3 plan, basically 10 years on real property, buildings, 5 years on equipment, and 3 years on rolling stock, trucks, and so forth, with the suggestion that perhaps for government-mandated pollution control equipment, that it be 1 year or 2 years.

Now, we are all agreed that we want to do something, but have you considered that approach in coming here and fostering this approach?

Mr. COHN. Yes, sir, we have, and I would like to suggest, Mr. Chairman, if it is agreeable to you, that Mr. Nathan proceed. I understand he is going to cover the precise point that you put.

Senator CHAFEE. OK. Go to it, Mr. Nathan.

STATEMENT OF ROBERT R. NATHAN, CONSULTING ECONOMIST, COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Mr. NATHAN. Thank you, Mr. Chairman.

Just very briefly, I won't say anything more about capital formation because I agree 100 percent with the objective of this committee and the importance of modernizing our productive capacity.

Senator CHAFEE. Yes; there is no disagreement on that.

Mr. NATHAN. Right.

Now, let me talk mainly about the impacts on the economy—and by the way, I might say I certainly favor the depreciation acceleration plan, but there are many areas where the cost benefits will be different from one system to another, and one has to look at the magnitudes, and also there are different industry situations.

Now, what we have proposed here, what we have analyzed and studied, and what our testimony includes, is a careful analysis of the cost benefits, and this is to me, Mr. Chairman, the important element in making a decision as to whether you can choose one over the other, or two out of five, or three out of five different proposals.

What is important here is that in our judgment, as we have analyzed this, we believe that by the third year of the dividend

reinvestment plan, the feedback, namely, the additional capital formation, additional growth in GNP, the additional employment, the additional participation by the dividend recipients will more than make up for the revenue loss, and in our judgment, by the third year and thereafter, there will be no net cost.

In addition, we point out——

Senator CHAFEE. Well, except, you know, the Treasury Department has heard that song before, as we all know.

Mr. NATHAN. Yes.

Senator CHAFEE. And if you look at more rapid depreciation, in effect, that is not a tax cut, that is a tax deferral.

Mr. NATHAN. Yes.

Senator CHAFEE. Whereas this is a tax cut. But I don't want to debate that, and I am not choosing sides here. We have just got to advance the assumption that we can't do too many things. Next year is going to be our year. We have got to do something for the individual, and industry can't have too much. That is what the Congress is going to say.

So, you say this S. 1543 is better than the other approach, in your judgment.

Mr. NATHAN. I think the cost benefit of it, I think the magnitude, however, Senator Chafee, does not preclude the other. What we are talking about here is with a $1,500 cap for an individual income recipient, he is limited to this treatment of the dividends reinvested to only $1,500 a year, and for a joint return, to only $3,000. We compute that that cost in the first year will be $300 million.

Senator CHAFEE. But on looking at it the other way, Mr. Nathan, doesn't that really mean that industry is not going to have much plowed back into it?

As I look at this—and you will have to correct me—this seems de minimis, sort of. What is the utility industry going to get—and I know the president of the gas association is here—with the mammoth capital requirements they have, out of this? You know, $1,500 per stockholder, multiply it by—if everybody took it.

Mr. NATHAN. The $1,500 cap and $3,000 on the joint return will, in our judgment, increase the participation from $1¼ billion, which it is now, to a minimum of $2½ billion, and if the cap were lifted, it would be $6 billion.

Now, one might say, yes, but what is $1¼ billion?

Senator CHAFEE. The cap lifted, you mean not having any cap?

Mr. NATHAN. That's right, it would be $6 billion. You see, it would go from $1¼ billion presently, to $2½ billion participation if you have the caps, and to $6 billion if you didn't have the cap.

Senator CHAFEE. Yes, but you are not proposing no cap, are you?

Mr. NATHAN. No, no, we are taking that so——

Senator CHAFEE. All right, so let's not discuss that.

Mr. NATHAN. All right, The $1¼ billion in participation to roughly $2½ billion in common stock capital formation.

Senator CHAFEE. But isn't that peanuts, really, if we are trying to do a job here on real capital formation in this country?

Mr. NATHAN. It is not proposed, Mr. Chairman, as the only solution, but let me say this about the proposal—the utilities would be very, very substantial participants here. You must realize that on an accelerated depreciation method, the utilities have a very,

very serious problem with the regulatory agencies who do not want to allow that to be normalized. They want to pass it through to the customer, and therefore there may be zero increased internal availability of capital to the utilities for their essential expansion requirements.

On the other hand, this is all external funds. You see, these funds are money that otherwise, if not reinvested by the investor, would literally go to the investor to either be saved in some other channel, but probably in substantial measure go out for consumption and other uses, whereas this, if it is reinvested, is targeted, targeted. It is about as nearly 100 percent designed for investment results as any concept or any principle.

Senator CHAFEE. Oh, yes, I can see that there is no question about that. But it seems to me, you know, under the proposal, it is so little, and you know, there are all kinds of—I mean, why wouldn't somebody put their money into a Keogh plan, for example, which has about the same limitations or that type of—what is the other plan besides the Keogh one, the other one you can——

Mr. COHN. IRA.

Senator CHAFEE. What is it?

Mr. COHN. IRA.

Mr. NATHAN. Individual retirement account.

Senator CHAFEE. Yes, which are about the same, and it just—I am not going against your proposal. It just doesn't seem to me that it is doing the job.

Mr. COHN. Senator, may I add something to this?

Actually, what we are talking about is common stock capital formation.

Senator CHAFEE. I appreciate that.

Mr. COHN. This is all common stock capital. Now, we believe that the potential for this, if this legislation were adopted, is to double or better the reinvestment of dividends in common stock capital. We believe that that would create as much as 50 percent of the total common stock capital requirements.

Now, that will support and provide the basis for the debt and preferred stock financing, and therefore it is extremely important and extremely helpful in helping these companies to finance essential operations.

Senator CHAFEE. All right, I don't want to interrupt any more. There are others that want to speak.

Ms. Sullivan, or who is next at bat?

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, THE AMERICAN GAS ASSOCIATION

Mr. LAWRENCE. Could I just comment briefly, because I think it is relevant to the point they just raised.

As you mentioned, Senator, we do have in the gas industry some very significant capital requirements between now and the year 2000, something over $300 billion, but we think with that we can continue to provide 25 percent of our Nation's total energy mix. It is very desirable.

I support what Mr. Cohn just said, that this can be a considerable incentive for investment in common stocks and enhance the equity proportion of our capitalization.

Now, let me underscore, too, what Mr. Nathan said. We do support the other capital formation incentives, the Jones-Conable bill, but this one doesn't have that albatross of the flowthrough problem that we in the regulated industries, both the gas industries and the electrics have to fight daily, and I think we have surveyed our member companies and we find now that over half of them do have these dividend reinvestment mechanisms in place. They could act on it immediately.

We think it would be a tremendous incentive, and we think it is one pebble on the scale that ought to be put there quickly. We support it strongly.

Senator CHAFEE. What is Treasury's estimate of the revenue loss on this, anybody know?

Mr. COHN. Yes, sir, there is a letter that was written by—excuse me, not the Treasury, the Joint Economic Committee staff to Congressman Pickle which gives some revenue estimates, and the figure for the first year receipts, first fiscal year receipts is $240 million revenue loss. That is the gross numbers.

And I will be glad to supply that letter for the record.

Senator CHAFEE. Well, I am sure the staff has got it, so I won't. All right.

Mr. COHN. Mrs. Sullivan perhaps.

Senator CHAFEE. Ms. Sullivan, go to it.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Ms. SULLIVAN. Thank you very much. We, the Stockholders of America, are very much in support of the 10-5-3. We have written about it, and we are filing a statement to that effect. We were not able to get on the panel when the hearings were heard because of the time limit.

I am Margaret Sullivan. I am president of Stockholders of America. It is a 7-year-old organization. It is national, it is nonprofit, it is nonpartisan. It is dedicated to representing the interests of stockholders and their role in publicly held American corporations and their importance to our capitalistic system.

Now, I am here today in support of S. 1543 and to speak from the stockholder's point of view, and I might say at the outset, I have even greater expectations from S. 1543 than my learned colleagues here, the economists and the lawyers, since I am neither one. I have to speak from the stockholder's viewpoint. And there are 25 million of us, and it is kind of hard to talk about 25 million people in 3 minutes, but I am going to do it.

In all of our surveys of stockholders' opinion, and they are continuous, we find that the No. 1 sore point with them is the unfair double taxation on dividends, and this legislation would eliminate that situation in part when dividends are reinvested in the corporations having qualified reinvestment plans. It is a step in the right direction.

Senator CHAFEE. Would they ever, under this plan, would the stockholder be caught on the tax at some later time?

Mr. NATHAN. Yes.

Senator CHAFEE. What would the basis be when he puts it in?

Mr. ALEXANDER. Zero.

Ms. SULLIVAN. And you have to keep the stock for 1 year.

Senator CHAFEE. I see. So he gets picked up on the gain on the capital.

Mr. NATHAN. Just like on stock dividends.

Ms. SULLIVAN. We feel it is an incentive to the individual investor; it is an attraction and it is badly needed. It will encourage savings and help the individual's investment grow.

Now, even though there are still 25 million stockholders in this country, this number has dropped from 32 million in the early 1970's, according to the New York Stock Exchange, to the 25 million.

Now, for the first time since 1952, when census statistics were recorded, the stockholder population did not increase. This is dangerous. We had 32 million people in the market, and now we have 25 million, and it was estimated one time a few years back that we needed 50 million stockholders in this country to meet the growing labor force in this country and the capital needs.

Now, the market needs the individual investor. It is this large, diversified base of people, owners, really, that have made our capitalistic system, sometimes called free enterprise or people's capitalism. It makes it work. It has built a great industrialized nation, a nation——

Senator CHAFEE. OK. I hate to cut you short, Ms. Sullivan.

Ms. SULLIVAN. That's all right.

Senator CHAFEE. I won't argue with the words you say, and I think I understand that pretty well.

Ms. SULLIVAN. I am sure you do, better than I.

Senator CHAFEE. No, I wouldn't say that.

Ms. SULLIVAN. I would think so.

Senator CHAFEE. Any other comment?

Yes.

STATEMENT OF WILLIAM R. MALONE, VICE PRESIDENT, GENERAL TELEPHONE & ELECTRONICS CORP., ON BEHALF OF THE U.S. INDEPENDENT TELEPHONE ASSOCIATION

Mr. MALONE. I appear here this afternoon on behalf of the 1,500 independent—non-Bell—telephone companies, who are represented by the U.S. Independent Telephone Association. We have submitted a statement for the record, which we would like printed with an amendment in the first paragraph to reflect Senator Hollings' cosponsorship earlier this month of S. 1543, which we do support.

In addressing—supplementing the responses, really—to your question, Senator, on our preference between S. 1543 and the 10-5-3 bill, I would point out first of all that I think this bill, S. 1543, is really an individual tax cut rather than a corporate tax cut. As it is, shareholders participating in automatic reinvestment plans must pay taxes on dividends without having received any hard cash with which to pay the tax. This is particularly burdensome to small shareholders who, as a group, have a much higher level of participation in existing dividend reinvestment plans. Our chart shows that as to GTE shareholders, those with fewer than 50 shares are 10 times more likely to reinvest their dividends than are GTE shareholders with over 1,000 shares.

Analysis shows that 84 percent of our plan's participants own 100 shares or less, and I think that S. 1543 is intended to remove this burden on small shareholders.

I think it is also important because it removes the discrimination against utilities, which are peculiar in that they have a substantial and continuous requirement for new capital. When a young couple moves into a home, they pay a $35 or $50 installation charge for a telephone. We have $1,000 or $1,500 or $2,000 of investment behind that. And when they move in, we must have the money there ready. And with the market in the condition it is, with stocks selling at or near book, we are not in a position to go to the market with large stock issues.

The shareholder reinvestment plans have proved a reliable, continuous, and materially significant source of those funds.

Senator CHAFEE. Well, I think the points you make are very good ones, and I think particularly the point that it is not a corporate cut, as it were, it is an individual cut, is a very important one, and it is an individual cut for a small group, for a group who is interested in this just like those who—I don't think, I suppose, these things should all be mutually exclusive. The bill we just discussed with interest, here something deals with dividends, and I think it all fits into a useful package which would help the common objective of increasing capital investment.

Mr. MALONE. Both are intended to remove existing discriminations in the tax laws.

Senator CHAFEE. Right, and also I think the point you make about utilities is a good one, too.

Anything else?

Mr. LAWRENCE. Senator, just a housekeeping point. We do have prepared statements.

Senator CHAFEE. Fine. We will certainly print those in the record.

Mr. COHN. Mr. Chairman, I would just like to make one point in response to a comment you made.

There is more than a narrow group of people involved.

Senator CHAFEE. I didn't mean to say narrow group.

Mr. COHN. Well, there are now about 1 million participating stockholders, and we think there would be a lot more if this legislation were passed.

Senator CHAFEE. Yes. They are, of course, having to pay the tax now.

Mr. COHN. They now have to pay the tax, that's right.

Ms. SULLIVAN. That's right.

Senator CHAFEE. OK, fine.

Well, thank you very much, Ms. Sullivan, gentlemen. We appreciate your being here, and if you will leave your statements, they will be part of the record.

Ms. SULLIVAN. Thank you, Senator.

Mr. COHN. Thank you, Senator.

Senator CHAFEE. And I think the cause you espouse is going to have a good year, next year, next calendar year.

Mr. COHN. Thank you, sir.

Ms. SULLIVAN. Good.

[The prepared statements of the preceding panel follow. Oral testimony is continued on p. 403.]

STATEMENT OF HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF S. 1543
BEFORE THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
OCTOBER 31, 1979

SUMMARY SHEET

A. Our Position - We urge favorable consideration of S. 1543 which, by deferring current taxes on dividends reinvested under qualified dividend reinvestment plans, would encourage materially increased reinvestment of dividends in new issue stock and materially increased capital formation.

B. Economic Impact - Adoption of S. 1543 would in 1979 dollars and in the third full year after its adoption:

1. Increase dividend reinvestment to about $2.5 billion;
2. Increase national output by approximately $2.7 billion annually;
3. Increase business fixed investment by about $1.0 billion annually;
4. Add about 50,000 jobs per year; and
5. Involve a net revenue loss of some $350 million in the first complete year of operation, a wash in the second year, and an annual net revenue gain of $600 million in the third year and thereafter.

C. Furthering National Objectives - Adoption of S. 1543 would further important national policies in at least six respects:

1. It would provide, on a highly cost effective and rifle-shot basis, substantial, direct and immediate help in the formation of new capital where it is urgently needed.
2. It would reduce the double tax on dividend income by eliminating the tax at the stockholder level when dividends are reinvested.
3. It would encourage thrift and providing for supplemental retirement income.
4. It would be more equitable in treating receipt of stock under a qualified dividend reinvestment plan as the equivalent, for tax purposes, of a conventional stock dividend.
5. It would help in financing essentially needed energy facilities.
6. It would be counter-inflationary in absorbing cash dividends and financing increased productive facilities.

STATEMENT OF HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF S. 1543
BEFORE THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
OCTOBER 31, 1979

My name is Herbert B. Cohn. I am associated with the law firm of Morgan, Lewis & Bockius in Washington, D. C. I appear here today as Chairman of the Committee for Capital Formation Through Dividend Reinvestment.[1/] Accompanying me are Robert R. Nathan, Chairman of Robert R. Nathan Associates, Inc., our economic consultants, and Donald C. Alexander of the law firm of Morgan, Lewis & Bockius, our tax counsel.

We strongly urge your favorable consideration of S. 1543 originally introduced by Senator Nelson on behalf of himself and Senator Bentsen, and subsequently also sponsored by Senators Schmitt, Tower and Hollings.[2/]

The Provisions of S. 1543 - In essence, S. 1543 would encourage materially increased reinvestment of dividends in new issue stock and materially increased capital formation by deferring current taxes on dividends which are reinvested (with an annual limitation of $1,500 for an individual taxpayer and $3,000 for a joint return) under qualified dividend reinvestment plans.

A qualified dividend reinvestment plan is defined as a plan which does, in fact, provide for reinvestment of a cash

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1/ The members of this Committee consist of the 34 companies listed in Appendix A.

2/ The House counterpart of S. 1543 is H.R. 654, originally introduced by Congressman Pickle, which now has a total of 60 sponsors. Section 202 of H.R. 5665, introduced on October 22 by Chairman Ullman of the House Ways and Means Committee, includes similar provisions.

dividend in new common stock capital.[3/] The stock received on reinvestment of such dividend would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend, which is, of course, not now subject to any current income tax.[4/]

Economic Impact and Revenue Loss Estimates - Last year our Committee retained the firm of Robert R. Nathan Associates to carry out a study of the economic impact of a similar proposal (which did not contain any dollar limitations) introduced in the 95th Congress. In its Report, the Nathan firm concluded that adoption of that proposal by the third year of operation would:

1. Increase dividend reinvestment by more than 500% to some $6 billion;

3/ It had been suggested that a corporation having no need for new common stock capital might buy in its existing common stock and then adopt a dividend reinvestment plan for an equivalent amount. This would be contrary to the primary objective of the proposal to stimulate new capital formation and new capital investment; and S. 1543 includes statutory provisions to prevent it. Such provisions would establish a presumption (rebuttable on a showing of a proper business purpose) that the tax benefit would not be available where a corporation purchased its own common stock within one year of the issuance of stock under a dividend reinvestment plan.

4/ It had been suggested that the proposal could be circumvented by stockholders who, while not desiring to increase their investment in the corporation, would reinvest their dividends and then immediately sell an equivalent number of shares in the marketplace. To minimize any such motivation, S. 1543 provides that (a) the basis of stock received under the dividend reinvestment plan would be zero and the holding period would commence on the date of its issuance, and (b) sales within one year after receipt of stock under a dividend reinvestment plan would be deemed to include the stock so received within the preceding year.

2. Increase national output on the order of $10 billion annually;

3. Stimulate business fixed investment by close to $3.5 billion annually; and

4. Add the equivalent of 200,000 jobs per year.

The Report concluded that the proposal "certainly seems to be in the national interest."5/

The Report stated that if the proposed tax treatment were made applicable only to a specified amount per taxpayer, there would be a related reduction in all quantitative effects -- i.e. in all costs and all benefits. (See Nathan Report, p. viii, n. 1). The Nathan firm has now concluded that adoption of S. 1543, which includes a $1,500/$3,000 cap, would in 1979 dollars and in the third full year after its adoption:

1. Increase dividend reinvestment by more than double to about $2.5 billion;

2. Increase national output by approximately $2.7 billion annually;

3. Increase business fixed investment by about $1.0 billion annually; and

4. Add about 50,000 jobs per year.

Addressing itself to the effect on tax revenue losses, and after giving consideration to forecasted increases in both plans and participation, and to their economic effects, the

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5/ 25 copies of the Nathan Report have been filed with the Staff Director of the Finance Committee.

Nathan firm estimates that, in 1979 dollars, adoption of S. 1543 would result in a net revenue loss of some $350 million in the first complete year of operation, a wash in the second year, and an annual net revenue gain approaching $600 million in the third year and thereafter.

We understand that the Staff of the Joint Committee on Taxation has estimated that adoption of S. 1543 would result in gross revenue loss in receipts for the first fiscal year, running from January 1 to September 30, of $240 million. We further understand that the estimates of the Joint Committee Staff increase in succeeding years but are in no case more than $1.1 billion per year and that such figures do not take into account any "feedback" by reason of increased capital formation and economic stimulation.

Characteristics of Companies Adopting Dividend Reinvestment Plans for New Issue Stock and Extent of Participation - About 130 companies now have dividend reinvestment plans for new issue stock. These companies vary in size, geographical location, type of business and otherwise. In general, they are, however, alike in the following respects:

First, they are capital-intensive; they cannot obtain all the capital they require through internal generation of cash; they must place substantial reliance on external financing; and they have a continual need to obtain additional common stock capital to finance their business.

Second, they find it increasingly difficult and expensive to attract the necessary capital through large public offerings in the marketplace.

Third, they have found that dividend reinvestment plans, under which their stockholders have the option of automatically investing cash dividends in additional new issue stock of the company, can be a most effective vehicle for obtaining new common stock capital they require.

About 2 million stockholders now participate in such plans. Surveys have shown that the large majority of participants are the smaller stockholders. The average holdings of the participating stockholders are less than the average of all stockholders and are generally in the range of 150 to 200 shares. In 1978 some $1 billion of dividends was reinvested under these plans.

The Benefits of S. 1543 - Under existing tax law, federal income tax is imposed currently on the value of the stock received by a stockholder who opts to participate in a dividend reinvestment plan and to take stock instead of cash. It is clear that this discourages participation by those stockholders who may be pressed to use the cash dividends to pay the current tax. It is equally clear that deferral of the current tax would greatly encourage increased participation. The extent of such increased participation can, of course, only be a matter of opinion. But, as has been indicated, the Nathan Report

estimated that adoption of the original proposal, without limitation of the tax benefit per taxpayer, would increase the reinvestment of dividends into new issue common stock by more than 500% to some $6 billion; and the Nathan firm has more recently estimated that adoption of S. 1543 (which includes the $1,500 - $3,000 annual cap) would more than double present participation to a level of about $2.5 billion of reinvestment of dividends into new common stock capital where it is most urgently needed.

Such increased capital formation would obviously be of major help in assisting capital-intensive companies to obtain the common stock capital which is essential to finance their needs and to provide a cushion for debt and preferred stock financing. It would provide an alternative (at least in part) for the periodic need to sell large blocks of additional common stock in the marketplace -- with the associated market pressure which frequently leads to market prices well below book value and continued dilution exerting further pressure to depress market prices.

Adoption of S. 1543 would also help larger numbers of stockholders, who do not at the time need the cash dividend, to participate in a simple, convenient and economical way to invest relatively small amounts which might otherwise be dissipated; and to obtain the advantages associated with a periodic savings plan, the principles of "dollar averaging", and the

compounding effect, to assist in building an investment to provide larger cash dividends when the stockholder has need for such income.

From the broader perspective of the national interest -- we believe that adoption of S. 1543 and the resulting increased participation in dividend reinvestment plans for new issue stock would further important and desirable national policies in at least six respects:

1. Capital Formation: It would provide, on a highly cost-effective basis, substantial, direct and immediate help in the formation of new capital -- a most important national objective. It is difficult to envisage any clearer or more direct way in which capital formation takes place than through a dividend reinvestment plan for new issue stock -- where the reinvested dividends are immediately converted into new common stock capital. The tax incentive to increase such capital formation is, in this case, a rifle-shot which is fully and directly effective. And, as has been indicated, the dividend reinvestment plans have their greatest appeal and, in general, have been adopted only by the most capital-intensive companies having the greatest need for new capital. Accordingly, under these plans, capital formation is taking place where it is urgently needed.

2. Eliminating or Reducing the Double Tax on Dividends. Elimination -- in whole or in part -- of the double tax

on corporate dividends also has wide support as a desirable national objective. S. 1543 would represent a step in this direction in eliminating the current tax imposed at the stockholder level when the dividends are reinvested in the corporation. There would appear to be particular logic for taking this step and eliminating the second tax under these circumstances -- since the stockholder is not receiving the cash dividend and since the cash is, instead, being plowed back into the corporation where, if invested profitably, it would lead to additional taxable earnings at the corporate level.

3. Encouraging Individual Savings to Provide Supplemental Income for Retirement. Many -- and probably a large majority of participants in dividend reinvestment plans -- have elected to participate during a period in which they do not require the cash dividends in order to be able to look forward to larger cash dividends at a later time when such income is needed as a supplement to social security and pension income. S. 1543 would materially encourage thrift and assist participants in providing for their own supplemental retirement income. In this respect, the dividend reinvestment plan is analogous to the Keogh and IRA programs which represent similar desirable national objectives and which have been encouraged by similar favorable tax treatment.

4. Fairness and Equity for the Participating Stockholder as Compared with the Recipient of the Conventional Stock

Dividend. Many companies have the option available to reduce or eliminate cash dividends and declare alternative or supplemental stock dividends. In such cases, the recipient of the stock dividend pays no current tax. But companies whose stock has historically been purchased on a yield basis cannot, as a practical matter, reduce their cash dividend and substitute a conventional stock dividend. At the same time, there are many stockholders of such companies who, while they wish to remain as investors in such companies, would prefer, at least during certain periods in their working years, to take the equivalent of a stock dividend rather than cash. In the context of the practical realities, it would seem to be fairer and more equitable to permit the stockholder also to have the option of stock dividends and to treat his receipt of stock under a qualified dividend reinvestment plan for new issue stock as the equivalent, for tax purposes, of a conventional stock dividend.

5. Assisting in the Financing of Essential Energy Facilities and in Dealing with our Energy Problem. An essential need in reducing our dependence on imported oil is to provide new facilities for the production of increased domestic energy supply. Limitations on financing capability represent a real and significant obstacle to providing such new facilities. A large number of companies engaged in energy supply require continuing infusions of new common stock capital and have adopted and are using dividend reinvestment plans as a vehicle

to obtain at least a part of the common stock capital they require. Increased participation in such plans would produce additional common stock capital and help materially in financing essentially needed energy facilities.

6. Helping to Reduce Consumer Demand and Counter Inflation. Surveys indicate that the majority of participants in dividend reinvestment plans are the smaller stockholders. Encouraging increased participation in such plans increases the reinvestment of cash dividends into productive capital facilities and absorbs cash which, in many cases, would otherwise be used to add to consumer demands. In helping to increase new productive facilities and decrease consumer demand, S. 1543 would, therefore, also help in the effort to counter inflation.

In sum, S. 1543 would make a substantial contribution to a healthier economy; would further several highly important national objectives; and would do so with a net revenue loss which, over a three year period, would be either nominal or non-existent.

APPENDIX A

COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

Participating Companies

Allegheny Power System
American Electric Power Company
American Telephone & Telegraph Company
Baltimore Gas & Electric Company
Brooklyn Union Gas Company
Central & South West Corporation
Columbus and Southern Ohio Electric Company
Commonwealth Edison Co.
Continental Telephone Co.
Dayton Power & Light Company
Delmarva Power & Light Company
General Public Utilities Corporation
Gulf States Utilities Co.
Houston Lighting & Power Co.
Illinois Power Company
Kansas City Power & Light Company
Kansas-Nebraska Natural Gas Company, Inc.
Long Island Lighting Company
Manufacturers Hanover Corp.
Minnesota Power & Light Company
Montana Power Company
New England Gas and Electric Association
Orange & Rockland Utilities
Pacific Power & Light Co.
Pennsylvania Power & Light Company
Philadelphia Electric Company
Potomac Electric Power Company
Public Service Company of Colorado
Public Service Electric and Gas Company
Rochester Gas & Electric Company
United States Steel
Virginia Electric and Power Company
Wisconsin Electric Power Company
Wisconsin Power and Light Company

SUMMARY OF PRINCIPAL POINTS INCLUDED IN STATEMENT OF ROBERT R. NATHAN ON S.1543 BEFORE SENATE FINANCE SUBCOMMITTEE, OCTOBER 31, 1979

1. On the basis of analytical work done by Robert R. Nathan Associates, Inc. over the past year and a half, we strongly support and endorse the proposal embodied in S.1543.

2. This bill provides for a reduction of individual income taxes in a way that directly targets re-invested dividends to capital formation purposes by corporations that have a continuing need for external equity financing.

3. The proposed tax-change meets many of our national objectives. It would facilitate plant modernization and expansion in industries that have had difficulties in raising required capital. It would improve productivity, increase employment, raise national output, and make our goods more competitive in domestic and international markets, thus helping the nation move toward price stability and better trade and payments balances.

4. Our estimates indicate that by its third full year, the tax incentive provided would more than double present participation in qualifying reinvestment plans, expanding it to a total of $2.5 billion and generating an increase of $1.0 billion in fixed private business investment, a level of national output $2.7 billion more than it would otherwise be, and the creation of 50,000 jobs.

5. The resulting increases in employment, wages, and profits would provide a "feedback" in Federal revenues so that in the third full year of operation of the measure there would be an annual net gain in Federal tax liabilities approaching $600 million. We estimate a net loss of revenue in the first full year of about $350 million, but this would disappear in the second year. On a gross basis, excluding "feedback," tax collections in the first fiscal year (with the proposed effective date of January 1) would be reduced by approximately $250 million.

STATEMENT OF ROBERT R. NATHAN ON S.1543
BEFORE SUBCOMMITTEE ON TAXATION AND DEBT
MANAGEMENT OF SENATE FINANCE COMMITTEE,
OCTOBER 31, 1979

Mr. Chairman and Members of the Committee:

I am Robert R. Nathan, Chairman of the Board of Robert R. Nathan Associates, Inc., an economic consulting firm in Washington, D.C. Based on analytical work done by our firm over the last year and a half, I am here to support and strongly endorse the proposal embodied in S.1543 (and H.R.654). This bill would generally treat dividends automatically reinvested in new (original issue) stock of corporations under qualified dividend reinvestment plans (DRPs) the same as stock dividends. It would defer taxes until the shares are sold and provide for capital gains tax treatment.

In this testimony, I will briefly list and evaluate some of the principal benefits of this legislation and discuss its impact on the economy and on Treasury's tax revenues.

Principal Benefits

1. The proposed tax incentive would substantially increase investor participation in DRPs and thus make more equity capital available to qualifying corporations. These companies would use the funds for investments in new plant and equipment.

2. In fact, only receivers of dividends from corporations that have a continuing need for external financing of their plant and equipment expenditures would be qualified to take advantage of this opportunity. This is so because it is only such corporations that would adopt DRPs for new issue stock. Provisions of the bill have been designed to make it difficult for other companies to adopt qualified plans.

3. The bill would thus enable qualifying corporations to obtain readily and at lower cost the equity capital most of them have had great difficulty in obtaining in recent years. A larger and more readily accessible volume of private equity capital for investment would thereby be made possible.

4. The business sector of the economy would be directly stimulated by this measure even though the tax reduction is provided for individuals and not for the corporations themselves. Those who reinvest their dividends would receive the tax benefits. What should be particularly emphasized is the fact that the funds reinvested are directly targeted for capital formation purposes.

5. Through this change in the individual income tax, the capital formation benefits would not be related to a company's profits but would flow to corporations that have DRPs for new issue stock and continue dividend payments. Unlike various proposals for reduction in the corporate income tax, the situation of "the bigger the business profits, the bigger the tax reduction" does not apply.

6. Through the $1,500/$3,000 "cap" on qualifying dividends, the tax reduction for individual income taxpayers is also limited. (Incidentally, our studies have shown that small shareholders represent the largest number of participants in existing DRPs.)

7. To sum up: Compared to most proposals for tax reductions to foster capital formation, the cost of S.1543 will be small and its effectiveness will be large in achieving the purpose for which it is intended.

Impact on the Economy

Last year, on behalf of the Committee for Capital Formation Through Dividend Reinvestment, our firm prepared a detailed study of a different version of this bill, a version without any "cap." Such a bill would have provided a much greater impetus to private capital formation and a much larger immediate impact on Treasury revenues than the bill now before you. At the time, we estimated that the incentives provided by such a measure would, in its third year and in dollars of 1978 purchasing power, expand participation in original issue DRPs fivefold to about $6 billion, increase private fixed investment by close to $3.5 billion, raise total national output by about $10 billion, and create about 200,000 jobs per year.

To take account of the "cap" in the present bill, the estimates of participation, revenue loss, and economic impact would be substantially reduced. Inflation, on the other hand, would tend to raise the dollar figures

if they were converted to the purchasing power of present dollars. Thus, in 1979 dollars we estimate that the bill now before you would, in its third full year, more than double present participation in qualifying DRPs to a level of about $2.5 billion, and generate:

-- The creation of about 50,000 jobs per year;

-- An increase in fixed private business investment of about $1.0 billion; and

-- A level of national output approximately $2.7 billion higher than it would otherwise be.

The impacts in the first and second years would be smaller, and a greater degree of uncertainty surrounds them, because of the time it would take for (1) qualified corporations and taxpayer-shareholders to become familiar with the legislation and process the required exchanges of documents and (2) the pervasive impacts of the increases in investment to ripple through the economy.

It is now almost universally accepted that a higher level of business investment is required to achieve the kind of improvement in the productivity of our economy which is essential in our current fight against both recession and inflation and in support of a strong dollar. Our poor productivity performance in recent years is an appropriate source of deep national concern. Enactment of S.1543 would represent an important step toward these objectives. It would facilitate plant modernization and

expansion in industries that have had difficulties in raising the required capital, improve productivity, increase employment, raise national output, and make our goods more competitive in domestic and international markets, thus helping to move toward price stability and better trade and payments balances.

Effect on Treasury's Revenue Collections

Obviously, the economic effects described above would be accompanied by increases in employment, wage payments and business profits. These increases would result in higher Federal revenue collections. This "feedback" of revenues to the Treasury is a significant factor that should be taken into account in estimating the budget-cost of S.1543.

Last year, at the request of Senator Nelson, we scaled down the revenue estimates we had made for the bill without a "cap" to fit a measure identical to the one now under consideration. Taking the revenue "feedback" into account, we wrote to Senator Nelson that the net revenue loss with the proposed "cap" would, in the first year, "be about $300 million; this would disappear in the second year; and there would be a net revenue gain in the neighborhood of one-half billion dollars thereafter." These estimates, again, were in 1978 dollars.

To reflect the passage of another year, including particularly the current rate of inflation, these figures would be higher in 1979 dollars. Making the same adjustments as those made to the macroeconomic estimates mentioned above, we now estimate that in the first complete year of operation the net revenue loss would be approximately $350 million, there would still be a "wash" in the second year, and an annual net revenue gain approaching $600 million thereafter.

"Gross" Revenue Loss

We understand that the Staff of the Joint Committee on Taxation has estimated that if S.1543 became effective on January 1 of this year or next year, the gross loss in tax collections for the fiscal year ending nine months later would be in the neighborhood of $250 million. This estimate appears reasonable to us. If the legislation were enacted close to the time of its effective date, we believe there would also be some partial offset due to economic "feedback," but it would probably be relatively small in the first nine months after enactment. For the longer run, on the other hand, it is much too significant to overlook.

However, we realize that revenue loss estimates conventionally prepared for your Committee by the Staff of the Joint Committee do not reflect the economic "feedback" that we believe must be considered to provide a clear understanding of the true cost of tax legislation. Gross revenue loss estimates of the nature prepared by the Staff were, of course, essential inputs to a derivation of the net figures mentioned in the preceding section of

this testimony. Our gross revenue loss estimates comparable to the after-"feedback" estimates I cited above (in 1979 dollars) are, in round numbers, $700 million for the first complete year of operation of the measure and $900 million for each of the next two years.

These estimates are not a great deal different from the calendar year estimates of tax liabilities that the Joint Committee Staff told us they have developed. The differences certainly seem to be within the margin of estimating error. We have exchanged data and discussed various estimating issues with the Staff. There are some differences in view between us, and they are largely differences in judgment for which no specific quantitative data are available to provide guidance. Fortunately, these differences do not seem to have affected the estimates of tax liabilities substantially.

I should also mention that we did not specifically translate our estimates of calendar year tax liabilities into fiscal year collections, but we do realize the procedural importance of fiscal year estimates in relation to the concurrent budget resolutions.

Most significantly, I want to emphasize again the importance of this measure in increasing private business capital formation. Because of the economic benefits such increases will provide the nation, I believe it essential that your Committee take account of the revenue "feedback." The initial net cost to the Government of S.1543 will be less than the gross revenue loss estimate and, in a few years, this bill will provide the Treasury with substantial net revenue gains.

ECONOMIC IMPACT OF A TAX INCENTIVE FOR THE REINVESTMENT OF DIVIDENDS

Prepared by

Robert R. Nathan Associates, Inc.
Consulting Economists
Washington, D.C.

for

The Committee for Capital Formation
Through Dividend Reinvestment

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EXECUTIVE SUMMARY AND CONCLUSIONS

1. Since the mid 1960s, and particularly since 1973, the downward drift of fixed business investment relative to the nation's output of goods and services has been disappointing, if not disturbing.

2. Private capital formation in the United States must rise substantially if economic expansion and high levels of employment are to be attained without the kind of huge federal budget deficits that have been experienced in recent years and if we are to compete effectively in the increasingly demanding international markets.

3. A tax incentive that could impart a significant stimulus in this direction at a relatively small (and only an initial) cost is embodied in H.R.12182,[1] a bill introduced by Representative Pickle of Texas. This bill provides that when dividends are reinvested through original-issue dividend reinvestment plans (OI DRPs), current taxes will be deferred and the stock received through such investment will be taxed in the same manner as conventional stock dividends.

4. Such legislation, if enacted, would have some stimulative impact on the economy in the first year, and by the third year would, in dollars of 1978 purchasing power:

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1. Reintroduced on May 31, 1978 as H.R. 12905 by Mr. Pickle on behalf of himself and Messrs. Brown of Michigan, Burleson of Texas, Crane, Ketchum, Forsythe, and Bafalis.

- Increase national output on the order of $10 billion, or by about one half of one percent

- Stimulate business fixed investment by close to $3.5 billion or 1.5 percent

- Add the equivalent of 200,000 jobs per year, thus reducing the national rate of unemployment by about two tenths of 1 percentage point (or by 3.3 percent).

5. On a static basis, considering only present participation in OI DRPs and not reflecting the economic impact of the legislation, the revenue loss to the U.S. Treasury is estimated, at the maximum, to be in the range of $300 to $400 million the first year.[1]

6. After giving consideration to forecasted increases in both additional plans and additional participation in such plans, and to their economic effects, the legislation is estimated to result in a net revenue gain to the Treasury on the order of $1.5 to $2.0 billion by the third and fourth years after enactment. In its first full year it is estimated to reduce federal tax receipts by something more than $1 billion, but the revenue loss would disappear by the second year. These estimates reflect the taxes paid on the increased business profits and wage income resulting from the higher levels of economic activity stimulated by the measure.

7. The projected economic impulse of the legislation reflects the effect of a surge in the participation of personally received dividends in OI DRPs. Although corporations that do not have regular, continuing needs for new fixed investment are not likely to offer such plans, the dividend-paying capital-requiring firms will find them a very advantageous source of additional common stock capital

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1. These figures would be substantially less if, as has been suggested, the proposed tax treatment were made applicable only to a specified amount per taxpayer. But in such a case there would, of course, also be a related reduction in all other quantitative effects.

at lower cost. And the increased after-tax return to personal investors is such that about 20 percent of all dividends received annually by persons are likely to be reinvested in OI DRPS. The rate of dividend reinvestment in plans of the companies needing capital is estimated to average on the order of 40 percent.

8. While no precise count is available of the total amount of dividends reinvested in the 80-odd OI DRPs that now exist, we believe approximately $6 billion that would be reinvested under the proposed legislation, representing an increase of some 500 percent.

9. The increased after tax return to participants would lead to significant increases in the prices of the common stock of firms that offer these plans, to lower flotation costs, and to somewhat higher ratios of dividends (including the DRP stock purchases) to net income. Averaged over all common stocks, the effect on Standard and Poor's stock price index would be an increase at least on the order of 3 percent and, more likely, about 5 percent. The cost of capital would be reduced. These effects have been taken into account in the output, investment, and employment estimates noted above.

10. The beneficial economic effects and the resulting gains to the national Treasury, while relatively modest, are indeed large when viewed at the margin -- in terms of the annual increments required to achieve and maintain high levels of employment, utilization of plant capacity, and the improvements in national productivity that could, in the longer run, lead to meaningful reductions in the rate of inflation. The Pickle Bill or legislation similar to it certainly seems to be in the national interest.

11. Responses to a questionnaire received from more than 20 of the firms that now offer OI DRPs (i.e., from about one quarter of all such firms) indicate that the benefits from the legislation will be widely shared and they show the following patterns:

- To date, these plans have attracted a higher proportion of small than large shareholders. The OI DRP reinvestors receiving less than the average amount paid in annual dividends participate to a much greater degree, relatively, than larger dividend receivers.

- The prospective investment requirements of the firms surveyed are rising. Because many of them are utilities with already high debt ratios, the need for equity capital is urgent and large. On the average, their investment requirements for the 5 years, 1978-82, are projected to be 50 percent more than in the preceding 5 years, with one firm projecting an increase of over 250 percent.

- The introduction by a few of the firms of a 5 percent discount (from market) in the purchase price of stock bought through OI DRPs greatly stimulated participation in these plans. The amount of this price reduction which, in effect, is now taxable, as though it were an addition to the cash dividend, increased the after-tax yield on the investment much less than would the provisions of the Pickle Bill.

PREFACE

In recent years, in their quest for more capital investment in equity shares, many publicly held corporations have adopted organized plans by which stockholders may choose to have their dividends invested automatically in additional common stock of the enterprise in lieu of receiving the dividends in cash. Under a relatively small number of these plans[1] -- particularly those of the most capital intensive companies -- new common stock is issued directly by the company and the reinvested dividends increase the common stock of the company. These are known as original issue, or OI, plans.

The Committee for Capital Formation Through Dividend Reinvestment is made up of 21 such firms. The Committee believes that (1) OI dividend reinvestment plans (DRPs)

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1. A recent survey of Georgeson & Co. (100 Wall Street, New York) indicates that almost 900 companies offer dividend reinvestment plans, but only about 9 percent of these are original issue plans. The other 91 percent are market purchase plans.

could serve an important national interest through encouraging and facilitating capital formation, and (2) this contribution to the national interest would be significantly enhanced by a modification of the tax laws.

To obtain an independent appraisal, the Committee asked Robert R. Nathan Associates, Inc. (RRNA) to analyze the potential impact of such a revision of the Internal Revenue Code on the economy of the United States. This study reports the results of that analysis. It consists of two major parts. Part 1 deals with the economic analysis itself. Part 2 presents the results of a questionnaire survey of a group of corporations that have OI DRPs. The survey was undertaken to obtain current information that might be useful in forming judgments and carrying out the analysis in Part 1.

Various references in this report are made to the Pickle Bill. This bill, H.R. 12182, was introduced in April 1978, by Representative Pickle of Texas. The statement made by Representative Pickle in introducing the legislation (Congressional Record, April 18, 1978, page E1933) indicates that its objective is the same as or similar to that of the

Committee for Capital Formation Through Dividend Reinvestment. That is, to encourage, through treating reinvested dividends the same as stock dividends, an increase in common stock investment to, in Mr. Pickle's words, "facilitate the financing of capital facilities..." and thereby "provide an important stimulus to construction, employment opportunities, and a healthier economy."

Viewed more narrowly or more directly, the Committee's objective is to obtain a federal tax incentive that would encourage more OI DRPs, and greater participation by investors in OI DRPs, of those companies that tend to have a continuing need for common stock capital for investment purposes. The analysis in this report assumes this objective. We doubt that firms requiring little or no external capital, or those with infrequent or non-recurring requirements would find original issue plans attractive, or be interested in initiating them, despite the proposed tax advantage offered to participating shareholders. However, if firms without recurring or continuing needs for external capital sought to take advantage of a legislative provision to provide these tax benefits

to their stockholders without a comparable increase in their capital investment, we assume that any such tax provision would be interpreted and applied or, if necessary, would be amended to prevent any such actions.

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PART 1. ECONOMIC IMPACT OF THE TAX PROPOSAL

I. INTRODUCTION

Purpose

The purpose of Part 1 of this report is to present the results of an analysis of the probable economic effects of amending the Internal Revenue Code to provide that the stock received on the reinvestment of dividends under original-issue dividend reinvestment plans (OI DRPs) of public corporations be treated for tax purposes like conventional stock dividends. H.R. 12182, introduced in April 1978, by Representative Pickle of Texas, is an example of such an amendment.

The main objective of the proposed change in the tax laws is to benefit the U.S. economy as a result of increasing capital formation. Such benefits include higher rates of employment, productivity improvement through modernization of plant and equipment, strengthened competition, and other

salutary effects that derive from increasing the nation's capacity to produce goods and services.

Content of The Report

This part of the report is divided into three main sections. Chapter II discusses the incentive effects of the proposed tax change on participation in DRPs. Chapter III presents estimates of the proposal's impact on key economic magnitudes.

It is our hope that the contents of Chapters II and III can be read and generally understood by informed laymen. The Appendices, on the other hand, provide supporting data and underlying analyses that would be more understandable to the technician or the professional. Appendix A and Appendix B describe the technical analyses underlying Chapters II and III, respectively. Appendix C discusses the details of the method used to estimate the effects on federal tax revenues, while Appendix D discusses its likely impact on stock prices.

Summary, in Brief

The estimates presented in Tables III-1 through III-3, at the end of Chapter III, show what we regard as the most probable effects of the Pickle Bill or similar legislation, on key economic magnitudes. They suggest that the proposed tax change would be quite stimulative, leading to increases of Gross National Product (GNP) in 1978 dollars on the order of $10 billion in the third year after introduction. Business fixed investment in that year would be increased by as much as $3.5 billion. These increases would be accompanied by the creation of some 200,000 additional jobs.

Although the proposed measure would have an adverse effect of something over $1 billion on federal tax receipts in the initial year, this would be more than compensated for by later-year favorable effects. By the third year, the stimulative impact of the measure on economic activity is estimated to result in a net increase in federal tax receipts

of about $1.5 billion in current dollars. As with any measure which stimulates overall economic activity there would tend to be some inflationary pressures, but they are estimated to add an average of only about one tenth of 1 percentage point to the annual rate of price change.

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II. RELATIVE ATTRACTIVENESS OF DIVIDEND REINVESTMENT UNDER THE PRESENT LAW AND THE PICKLE BILL

In order to appraise the likely economic and tax-revenue effects of the proposed change in tax-treatment of original issue DRPs, an estimate must first be made of the degree to which corporate dividends will be reinvested in such plans. A majority of those respondents who addressed this question in reply to the questionnaire survey, described in Part 2 of this report, indicated at least a doubling of the existing percentage. If such an increase occurred for all these firms that already have OI DRPs, the proportion of dividends that would be reinvested would rise, from the present range of roughly 15 percent to at least 30 percent.

While this judgmental or opinion-type response is informative, we believe it essential to analyze the economic factors at work before we determine whether such an estimate is reasonable. From an economic viewpoint the degree of

participation, other things remaining unchanged, will depend in large measure on the increase in yield investors would realize from such participation.

To address this question we examine the effects of the bill introduced by Congressman Pickle on the rates of return available from dividend reinvestment. The detailed underlying technical analysis is contained in Appendix A. The effects themselves vary somewhat with assumptions about brokerage rates and expected appreciation in the price of the stock in question. Accordingly, several cases need to be considered. The first is:

Case A: Ignoring Brokerage and Assuming No Change in Expected Stock Price

Consider a stock selling for P dollars per share and expected to pay d dollars per annum in dividends, and an individual expecting to participate for T years in the associated DRP (which is assumed neither to charge for participation nor to offer discounts for shares purchased through it). Under present law the after-tax net rate of return, r say, will be given by the formula:

$$r = \frac{d}{P}(1-t_p)$$

where t_p is the applicable personal income tax rate for the individual.[1] In essence, it is the ratio of the amount of dividend per share remaining after personal income tax to the price per share.

One method of measuring the advantage provided by the Pickle Bill is to find the highest price the investor could afford to pay for the above stock (paying d dollars in annual dividends) and still come out with the same net rate of return as under the present law. Denoting this highest price by P', the price premium measure, P'/P, varies with the holding period (T) in the DRP, with the tax bracket of the investor (t_p) and with the yield available without the Pickle Bill (r). An economic derivation of these values is presented in Appendix A. It is logical and consistent in

1. That is, t_p would be equal to the individual's "marginal" tax rate, the highest rate at which some of the individual's income is taxed.

its concept and theory. One cannot be certain, however, how informed all investors will be or how they will perceive the effect of this tax change in relation to all other factors that affect their investment decisions and stock market values. This is especially true for small investors and at the present time, according to our survey, small shareholders participate in OI DRPs to a relatively greater extent than large shareholders.

It can be seen from the tables presented in Appendix A that the price premium as measured by the ratio P'/P is larger when the values of r, T, or t_p are higher, and that it is more sensitive to changes in t_p than to changes in either r or T, at least over the range of values considered. Because of this, a convenient approximation to P'/P is given by the formula $\frac{1-t_g}{1-t_p}$. Table II-1 shows the values given by this approximation over a range of tax rates (t_p).

It may be helpful in summarizing Case A to use the figure in Table II-1 for t_p = 40 percent, which is the estimated marginal federal tax rate corresponding to the

average dividend recipient.[1] This figure, namely 1.33, implies that a DRP participant in a tax bracket (i.e., marginal rate of tax) corresponding to that of the average dividend recipient might, other things (including dividends) being equal, be willing to pay as much as one third or more for a stock which had reinvested dividends treated as contemplated by the Pickle Bill. Of course, the attitudes and perceptions of all investors about many stocks, and the fact that all "other things" rarely remain equal have also to be considered. The increase in stock price could be substantially tempered, for example, by the willingness of non-DRP participants to buy and hold the stock at a lower price.

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1. Appendix C discusses this estimate.

Table II-1. Value of $\frac{1-t_g}{1-t_p}$ As the Measure of P'/P for Various Values of t_p

Tax rate	P'/P (approximately)
t_p = 20 percent	1.125
t_p = 40 percent	1.333
t_p = 50 percent	1.500
t_p = 70 percent	2.167

The case just examined ignored brokerage charges. The implications of this factor as well as the stock price response will be considered in Cases B and C below.[1]

1. Another complication, namely the offering of new shares purchased through a DRP at a 5 percent discount is easily dealt with since, in effect, it is equivalent from the participant's standpoint to the stock having a 5 percent (approximately) higher dividend, the differential effect of the Pickle Bill under these circumstances would be deduced from Table II-1. (Note that the 5 percent discount is currently taxable as ordinary income.)

Case B: Considering Brokerage but Assuming No Expected Change in Stock Price

For relatively small brokerage fees the appropriate P'/P values given for Case A above would not be very different. As an approximation the formula becomes:

$$P'/P = \frac{1-t_g}{1-t_p}(1-b)$$

where b is the brokerage rate expressed as a decimal, e.g., b = .04 corresponds to a 4 percent commission rate.

From the answers to the questionnaire discussed in Part 2, later, it seems that the typical individual DRP participant holds about 100 shares.[1] At a typical current share price for these companies of about $20, the applicable brokerage charge would be about 4 percent.[2]

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1. This average refers to individual personal investors. The questionnaire responses include business and institutional participants and the overall average is close to 150 shares.
2. Based on Merrill Lynch current schedule of rates as reproduced in Appendix Table A-5.

Accordingly, the approximate effect of taking brokerage into account would reduce the values by 4 percent from those in Case A. For example, the figure 1.333 used in connection with the typical 40 percent federal tax bracket would be reduced to 1.280.

Case C: When Stock Is Expected to Appreciate In Value[1]

It may be argued that if an investor has expected a large part of the return from buying a stock to be in the form of share-price appreciation, taxable at capital gains rates, and has purchased low-dividend payout stocks, then the advantageous taxation of dividends provided by the Pickle Bill would be of less relative importance. This intuitively plausible argument has some merit in the case of a stock expected to appreciate by a fixed dollar amount each year, say $2.00 per year. If, however, the investor expects

1. Brokerage is ignored in analyzing this case.

appreciation more in terms of a certain percentage appreciation per year, and it is assumed that the same factors making for this expectation would also be present under the Pickle Bill, it should turn out that the relative stock price appreciation (P'/P) would be about the same as in Case A.

In summary, the analysis of Cases A through C suggests that, in general, the relative advantage of the Pickle Bill to the traditional participant in DRPs is well approximated by the formula $\frac{(1-t_g)}{(1-t_p)}$ which accords well with the notion that the Pickle Bill would tax reinvested dividends at capital gains rates rather than ordinary rates.

A Possible New Investment Strategy

The analysis in Appendix A suggests that under the Pickle Bill, participation in DRPs could become attractive to a new type of investor. This would be an individual who while participating in the DRP, would periodically sell some shares of the company involved. In effect he could be

obtaining his dividend income, with some delay, and benefit from the lower capital gains tax rate.

While this strategy would probably be employed by some investors, it seems unlikely to happen in the great mass of cases where only small amounts of stock are obtained through dividend reinvestment plans. And large income taxpayers who regularly seek to invest part of their income would face the question of how to invest the income obtained from use of this strategy. If firms with OI DRPs become as attractive investments under the Pickle Bill as we think they will, it would clearly be to the advantage of such investors to continue participating in such plans and continue deferring tax payments.

Somewhere in the middle, between the small and large taxpayer and investor, there could be a group that would adopt this strategy of periodic "cashing in." Looking at the investing community as a whole, we believe it would occur only to a limited extent (that we are unable to measure).

Conclusion

Legislation such as that proposed in the Pickle Bill would tend to increase after-tax yields in common stock investments, and consequently increase the relative prices of the stocks involved. The enhanced attraction of these stocks to investors and the potential attractiveness of such dividend reinvestment plans are obvious. More capital financing for companies requiring equity capital should become available, through dividend reinvestments. An increase in DRP participation of at least the kind estimated in the responses to our questionnaire survey seems reasonable.

The new type of investment strategy discussed at the end of this section as well as the need to direct the tax incentive to its capital formation objective, strongly suggests the desirability of limiting the benefit to original issue DRPs and to those firms that must raise capital regularly to meet continuing real investment needs.

The possible new type of investment strategy described can itself have beneficial effects. To the extent it attracts additional investors to OI DRPs, it would increase the funds available for equity investment. It would also tend to improve the efficiency of the capital markets in directing the added funds to firms that are increasing their investment in real plant and equipment. This improvement, as well as the more orderly increase in common equities purchased through DRPs, would seem to provide for a more steady market in these stocks than frequent, large public offerings.

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III. MACROECONOMIC EFFECTS OF THE PROPOSED TAX CHANGE

Since the mid 1960s there has been a downward drift in the relationship of real business fixed investment to the nation's total output of goods and services. And since the 1973-74 cyclical trough the growth in real business investment has been at a much slower rate than in earlier post-World War II business cycles.

There is general agreement among economists of most persuasions that a substantial increase in private business capital formation is essential to continued economic expansion, high levels of national employment, modernization and improved productivity, more price competition, and meaningful reductions in the huge federal budget deficits the

nation has been experiencing since 1975.[1] In fact, the Economic Report sent to Congress by President Carter earlier this year noted, "The investment performance in the current expansion is disturbing..."[2] The technological innovation and modernization of plant that can be brought about by an increased rate of capital formation will also tend to improve productivity, reduce unit labor costs, enable us to compete more effectively in international markets, and, in the long run, slow down the rate of inflation.

Our analysis of the macroeconomic effects of a legislative change such as that embodied in the Pickle Bill indicates that it represents a significant step toward facilitating and obtaining an increase in capital formation, with the favorable production, employment, and budgetary effects just mentioned.

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1. For example, see Economic Report of the President transmitted by President Ford January 18, 1977, pps. 23 and 162, and transmitted by President Carter January 20, 1978, pp. 66 ff.
2. Op. cit., p. 66.

Present Dividend Participation In OI DRPs

In response to our questionnaire survey (discussed later in Part 2), 18 companies reported the total amount of dividends reinvested by their shareholder DRP participants in 1977. For 17 of those 18, the reinvested dividends ranged from $700,000 to $12,800,000. The eighteenth firm, however, is one of the largest in the country in terms of number of shareholders and annual dividends paid. It is also the largest in our sample in terms of the percentage of shareholders participating in DRPs and the percentage of annual dividends so reinvested. The dollar total of dividends reinvested through its DRP in 1977 was almost 9 times as much as the corresponding reinvestments of all the other 17 responding firms combined.

Our examination of the Georgeson survey of all dividend reinvestment plans (mentioned earlier) suggests that except for this one large firm, the average amount of dividends reinvested per firm in the remaining 80 firms with OI DRPs

might be closely approximated by the average of all the respondents in our survey except the very large company.[1] Further, although the Georgeson study is recent, we have learned that several new companies have adopted OI DRPs since it was prepared. If we assume 90 companies in all had OI DRPs in 1977, one of which is the largest company in our survey and 89 are firms with reinvested dividends averaging the same as our group of 17 respondents, the total annual dividends reinvested in existing OI DRPs would be less than $800 million. Allowing for some growth in 1978, the total reinvested dividends of 1978 participants would be about $1 billion.

The average marginal tax bracket for all individual dividend receivers is 40 percent (as discussed later and in Appendix C). Since our questionnaire survey disclosed that small shareholders participate in OI DRPs to a greater degree than large shareholders, the immediate tax loss due

1. Georgeson lists 16 of the 18 firms providing these data as original issue plans, the other 2 having started their OI plans in July 1977 or later.

to the enactment of such legislation as the Pickle Bill might be more appropriately calculated at a smaller rate than 40 percent, but we use this rate to obtain a maximum estimate. For a range of $800 million to $1 billion, we thus obtain a maximum first year tax loss of between $300 and $400 million.[1]

This estimate does not take into account the growth in DRPs and participation in them that we believe is likely under the Pickle Bill. Nor does it reflect the economic stimulation and resulting increase in federal tax revenue (frequently termed "feedback") which we believe such legislation would induce. The remainder of this part of our analysis deals with the more dynamic aspects and effects of the legislation, covering projected increases in dividend participation in OI DRPs, and increases in economic activity and in the federal revenue loss or gain after taking account of "feedback".

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1. If, as has been suggested by some, an annual limit per taxpayer were imposed on the amount entitled to the more favorable tax treatment, these figures would, of course, be reduced.

Projected Rate of Participation in OI DRPs

The relative attractiveness of the Pickle Bill or similar legislation in encouraging participation in OI DRPs has been described in Chapter II of this report. There can be little question that such legislation would encourage a greater rate of investor participation than prevails in already existing OI DRPs. Before estimating economic or federal revenue effects, however, we must determine the higher proportion of dividends paid to individual income taxpayers which will be reinvested through such plans.

It should be noted that corporations that do not require external capital financing regularly would, in our view, not be likely to offer an OI DRP. They would be concerned about dilution of stock values and they might find excess liquidity posing tax and earnings problems. In fact, in response to requests made by the Committee for Capital Formation Through Dividend Reinvestment, many firms with existing market-purchase DRPs expressed no interest in converting to original

issue plans.[1] Further, it is not the objective of the proposed tax legislation to cover these corporations.

The firms responding to our questionnaire survey (described in Part 2 of this report) are probably representative of those corporations which have a continuing need to raise funds externally for financing new capital investment. For such firms we estimate that the tax treatment proposed by Congressman Pickle would result in a substantial percentage of dividends received by individual income taxpayers being reinvested in OI DRPs. The rate of participation, of course, would not be uniform. For some firms it would be above about 40 percent, and for others, below. Our estimate is that, on average (and after the lapse of sufficient time for firms and investors to understand and act on the changed tax requirements), 40 percent of the dividends paid to persons by OI DRP firms would be reinvested, and it is based upon the following facts:

1. The reinvestment of dividends for all the highly capital-requiring firms responding to our questionnaire, combined, amounted to 15.6 percent of total dividend payments.

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1. This view is supported by the recent Georgeson compilation which shows that less than 10 percent of corporate DRPs are original issue plans.

2. A majority of the respondents expressed the view that the Pickle Bill tax change would "at least double" the percentage of dividends being reinvested.

3. Many of the reporting firms have only recently initiated their OI DRPs. Even without the tax change, further growth is expected, and there is also evidence of some continued upward trend among the older plans. Such growth has been assisted in the past by innovations such as split-share participation (i.e., less than 100 percent of shares being reinvested), and this is likely to become more widespread under legislation like the Pickle Bill.

4. Large increases in investor participation have been observed in existing DRP plans by the introduction of a 5 percent discount (taxable as current income similar to cash dividends) which leads to much smaller increases in rates of return than would occur under the Pickle Bill.

5. Many firms requiring additional external capital, especially utilities, have had great difficulty in recent years in floating new common stock issues. Market prices of many of these stocks were below book value and the values of existing shareholders were diluted. To attract new and keep old shareholders, a high payout policy was frequently adopted, leaving small retained earnings and exacerbating the need for obtaining outside capital. As a result, these firms had to resort unduly to floating bonds and some engaged in variable-rate borrowings and extensive equipment leasing practices. With high and rising debt ratios, their financial structures were weakened and their interest coverage ratios fell precariously. Their bonds were downrated and interest costs were increased. These companies should be greatly interested in legislation like the Pickle Bill. They would be expected to adopt and expand OI DRPs as a means of meeting their strong financing needs by obtaining additional common stock through reinvested earnings. This would help them restore quality and stability to their financial structures.

6. On the other hand, some investors would have need for the cash, or, as in the case of tax exempt institutions, would not have the same tax-saving incentive to participate.

On balance, an average participation of 40 percent of dividends paid to individuals seems reasonable for the utility sector (broadly defined to include transportation and communication as well as electric and gas companies) of the economy and for those firms in other sectors which also have continuing substantial needs to invest in new plant and equipment and which must also obtain a substantial portion of the needed capital through external financing. We estimate that this average of 40 percent participation of dividends for all firms with regularly recurring and sizable requirements for additional external equity capital could apply to about one-half of the total corporate dividends paid to individuals. Thus, for all dividends, the participation rate in OI DRPs is estimated to be 20 percent. This estimate was developed as follows:

1. Total dividends paid each year to individuals are much greater for firms in the non-utility sector than for utilities. According to the latest available data, such dividends paid by utility firms (again broadly defined) are 29 percent of the total and all others are 71 percent.[1]

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1. Data for years 1973 through 1976; Department of Commerce, Survey of Current Business, July 1977, page 52.

2. Taking new flotations as indicative of a continuing need for new common stock capital, we find that these proportions are almost reversed. During each of the past 3 calendar years, new stock issues in the utility sector accounted for approximately two thirds of all stock flotations.[1]

3. Many of the new stock issues by manufacturing and commercial corporations in the remaining one third undoubtedly represent financing for nonrecurring types of needs, rather than the continuing capital needs which are characteristic of a large part of the utility sector. Assuming, reasonably, in our judgment, that about 30 percent of the dividends in the non-utility sector are paid by the firms with recurring capital stock needs, that the 40 percent participation rate for utilities applies to these firms as well, and that the other non-utility firms would not be interested in or qualify for OI DRPs, we obtain a participation rate for the non-utility sector as a whole of 0.30 x 0.40, or 12 percent.

4. A combination of this 12 percent participation rate for the 71 percent of personal dividends received from non-utility enterprises with the 40 percent rate for the utility sector's 29 percent of total dividends yields a participation rate for all corporate dividends of approximately 20 percent (0.12 x 0.71 plus 0.40 x 0.29).

5. Looked at another way, the 40 percent participation rate applies to the 29 percent of total personal dividends that are paid by utilities and to three tenths of the 71 percent of total dividends paid by other corporations. That is, it applies to 0.29 plus 0.3 x 0.71, which adds to 50 percent of all dividends. And a 40 percent participation rate for half of the total dividends matches the aggregate 20 percent participation rate derived just above.

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1. Calculated from Federal Reserve Bulletin, May 1978, Table 1.48, p. A36, "New Security Issues of Corporations."

At the estimated average 20 percent participation of dividends, some $6 billion of the total of approximately $30 billion dividends expected to be reported on 1978 individual income tax returns (see Appendix C)[1] would qualify for Pickle Bill tax treatment. There would undoubtedly be some time involved in the transition to this new situation. Our estimate for 1978, therefore, should be interpreted as being a first-full year effect.

Methodology and Estimating Assumptions

The measurement of macroeconomic impacts must be based on various assumptions and the analysis of relevant data. We found it convenient to start with an unrealistically high estimate of the potential consequences of the proposed amendment to the tax code. In fact, it might even be termed "totally unrealistic." But it allowed us to draw upon, with appropriate modifications, a study published by the Securities Industry Association (SIA) based on econometric work done by Data Resources Inc. (DRI).[2] This overestimate was then

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1. We use the round figure of $30 billion. As shown in Appendix Table C-1, $30 billion represents the amount of dividends estimated to be reported in 1978 as adjusted gross income (i.e., after the dividend exclusion). The total actually reported as dividend income is estimated at somewhat over $31 billion. Our tax estimates have taken into account the dividend exclusion.

2. Tax Policy, Investment and Economic Growth, March 1978, particularly Table 2, p. 44.

modified and scaled down to more likely estimates of the likely effects of the Pickle Bill. Technical details and the results of the high estimate's impacts, as well as additional details related to our "most likely" estimates are presented in Appendixes B and C.

In addition to the 20 percent dividend participation rate discussed earlier, and based on the analysis in Section II, several other assumptions are made consistent with the incentive aspects of the legislation. Specifically, the effects of the tax change would:

1. Result in an increase of close to 3 percent in the Standard and Poor's Stock Price Index. The price of common stock of the companies with OI DRPs would, of course, increase by much more.

2. Lead to a similar relative rise in the ratios of dividends (including the stock purchased with reinvested dividends) to companies' net earnings.

3. Result in a Federal Reserve monetary policy that, while it might be called "accommodating" would not prevent some increase in interest rates.

The "basic" estimates of the economic impact of the Pickle Bill under these assumptions are presented at the end of this chapter in Table III-1. If stock prices rise by more than assumed above, say by 5 rather than 3 percent, the economic impacts would be somewhat greater. These results are shown in Table III-2. Table III-3 modifies the projections in Table III-1 to take into account the reduction in the cost of capital due to reduced flotation costs. While the estimates in Table III-1 reflect the decrease in the cost of capital resulting from higher stock prices, they do not reflect the lower flotation costs associated with the smaller and less frequent public offerings as a result of increased participation in OI DRPs.[1] We therefore believe Table III-2 or Table III-3 may be a more accurate reflection than Table III-1 of the impacts of the legislation.

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1. More details on these three sets of calculations are provided in Appendix B.

Summary of Economic Impacts

Drawing on the figures in Tables III-1 through III-3, the impact of the proposed tax change is summarized below, assuming (as in the tables) that the Pickle Bill or similar legislation had become fully effective starting with the full year 1978. The effects in the first year, 1978, are generally smaller than in later years. The full economic impact begins to be felt in 1980 the third year. Dollar amounts are expressed in constant dollars of 1978 purchasing power, except for the projections of tax receipts and budget deficit which are stated in current dollars.[1]

Business fixed investment is estimated to increase by about one-half billion dollars in 1978, with the increase rising thereafter and exceeding $3 billion in 1980.

National output, by the third year, is up by $10 billion or more, which is about half of 1 percent of the current level of gross national product (GNP).

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1. This is consistent with the DRI projections and reflects the belief that in considering taxes and budget, government officials are chiefly concerned with current dollar forecasts.

Consumer purchases provide much of the initial impetus to the rise in GNP, increasing by more than $2 billion in 1978 and by roughly $8 billion in 1980. Such an initial impetus is consistent with the microeconomic effects of the legislation under consideration. As described in Appendix B, these include additional consumer purchases resulting from (1) higher stock prices and their "wealth effect" on household financial assets, and (2) increases in spendable personal income from the projected higher ratios of dividends (including those reinvested through OI DRPs) to net earnings and from the lower effective tax rates of DRP participants. These effects would be only partly offset by an increase in the savings of participants, and this matter is also discussed in Appendix B.

Federal tax receipts, after allowing for the stimulative effects of the tax change on the economy, are estimated to be reduced by $1.3 billion in the first full year. By the second year the revenue loss would disappear, and by the third and fourth year, the taxes derived from increased

levels of GNP, business profits, and personal income resulting from the legislation would provide a net revenue gain to the U.S. Treasury of approximately $1.5 billion per year. Appendix C describes the methodology and provides some of the details supporting these estimates.

Employment additions resulting from the new tax treatment of dividends would be about 40 thousand person-years in 1978, rising to the neighborhood of 200 thousand by 1980. In 1980, the corresponding reduction in the rate of unemployment would be about two tenths of a percentage point.

The rate of inflation, during the projected period, on the other hand, would tend to show a small unfavorable effect. The change would be imperceptible in the first year, and would amount to about one tenth of one percentage point later.

The Federal budget deficit would show an improvement over the projected period, after the first year's revenue loss, but the improvement in later years is not likely to be as great as the corresponding additional tax receipts. The

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underlying reason is that incrased federal spending for interest on the national debt, with the somewhat higher interest rates prevailing in the stronger economy, is likely to be a bit larger than the savings due to lower unemployment benefits and somewhat smaller deficits.

If the build-up to the estimated increased participation in OI DRPs were to take longer than has been assumed, both the annual revenue losses and the stimulative economic offsets would be reduced accordingly. However, our estimates did not take into account the potential additional investment through cash option purchases[1] that could be stimulated by the legislation. Cash option purchases have been facilitated by the use of DRPs and have, themselves, represented substantial additional investments. The cash option purchase would not receive the proposed tax advantage. Yet such purchases could add to the stimulative economic effects, and to the extent they would, our estimates understate the benefits of increased OI DRPs and participation in them.

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1. The cash purchase option is discussed in Chapters VI and VII.

Table III-1. Basic Estimates of the Probable Effects of the Pickle Bill on Key Economic Magnitudes, 1978-82[a]

(Money amounts in billions of dollars of 1978 purchasing power[b] and represent changes from the baseline)

Item	1978	1979	1980	1981	1982
Gross National Product	2.6	6.1	8.7	8.8	8.0
Business fixed investment (nonresidential)	0.3	1.0	1.9	2.0	1.5
Personal consumption expenditures	2.2	4.9	7.0	8.1	8.4
Federal government:					
Budget deficit[b]	1.4	0.3	-0.7	-0.8	-0.3
Federal tax receipts[b]	-1.4	-0.2	1.0	1.2	0.8
Additional man-years of employment (thousands)	39	113	169	169	137
Unemployment rate (percent):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.3	5.8	5.3	5.1
Difference	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation rate (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.1	5.7

a. Based on an average reinvestment of 20 percent of personal dividends.

b. Changes in budget deficit and federal tax receipts, unlike the other dollar amounts, are in current dollars.

Table III-2. Basic Estimates with Assumed Higher Stock Price Effects, 1978-82[a]

(Money amounts in billions of dollars of 1978 purchasing power[b] and represent changes from the baseline)

Item	1978	1979	1980	1981	1982
Gross National Product	3.1	8.4	11.6	11.7	11.2
Business fixed investment (nonresidential)	0.5	2.1	3.3	3.5	3.1
Personal consumption expenditures	2.5	6.6	9.1	10.3	10.7
Federal government:					
Budget deficit[b]	1.3	-0.3	-1.4	-1.5	-1.0
Federal tax receipts[b]	-1.3	0.3	1.7	1.9	1.5
Additional man-years of employment (thousands)	45	155	225	225	191
Unemployment rate (percent):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.3	5.7	5.2	5.1
Difference	-0.1	-0.1	-0.2	-0.2	-0.1
Inflation rate (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.1	5.7

a. Based on average reinvestment of 20 percent of personal dividends.
b. Changes in budget deficit and federal tax receipts, unlike the other dollar amounts, are in current dollars.

Table III-3. Basic Estimates with Allowance for Reduced Flotation Costs, 1978-82[a]

(Money amounts are in billions of dollars of 1978 purchasing power[b] and represent changes from the baseline)

Item	1978	1979	1980	1981	1982
Gross National Product	3.1	7.5	10.2	10.3	9.5
Business fixed investment (nonresidential)	0.5	2.0	3.4	3.5	3.1
Personal consumption expenditures	2.2	5.5	7.7	8.7	9.1
Federal government:					
Budget deficit[b]	1.3	-0.1	-1.1	-1.1	-0.6
Federal tax receipts[b]	-1.3	0.1	1.3	1.5	1.1
Additional man-years of employment (thousands)	45	138	197	197	165
Unemployment rate (percent):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.3	5.7	5.2	5.1
Difference	-0.1	-0.1	-0.2	-0.2	-0.1
Inflation rate (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.1	5.7

a. Based on average reinvestment of 20 percent of personal dividends.

b. Changes in budget deficit and federal tax receipts, unlike the other dollar amounts, are in current dollars.

PART II. SURVEY OF DIVIDEND REINVESTMENT PLANS

IV. THE QUESTIONNAIRE SURVEY

Limitations of the Survey

Because the United States Congress is currently considering changes in the Internal Revenue Code, The Committee For Capital Formation Through Dividend Reinvestment desired that the survey results be completed and made available as rapidly as possible. In the interest of time, the questionnaire was sent initially only to the firms which were members of the Committee. The cooperation of these firms in supplying the requested information quickly seemed to be assured. An effort to obtain responses from a few additional firms was made later, after personal contacts indicated their willingness to cooperate.

Although RRNA designed the questionnaire with the help of company officials who were members of the Committee, there was no time for a pilot test with any of the firms'

financial officers or other employees who would have to provide the data from company records. As a consequence, responses to some questions seemed inconsistent. The questions may have been interpreted differently by different firms. Some respondents could not provide all the information requested. Through telephone calls, inconsistencies were generally removed. Where this was not possible, all the information provided in response to a few questions has been eliminated from this report.

As a condition of obtaining cooperation, RRNA assured respondents that the individual questionnaires would be kept confidential, that data would be summarized, and that individual firms would not be identified. Many of the results are reported in terms of percentages or average-type measures.

Corporations Covered

The Committee for Capital Formation through Dividend Reinvestment has 21 member firms. They are listed in Exhibit IV-1. Twenty of the 21 are utilities, mostly electric or combined electric/gas distribution companies.

One, United States Steel Corporation, is a large industrial enterprise. Five other industrial corporations that offer OI DRPs were selected later and questionnaires were sent to them. Four of these five companies responded to the questionnaire. These four companies are also listed in Exhibit IV-1.

Responses were also received from all member firms of the Committee. Accordingly, of the 25 responses received, 20 were from utilities and five were from industrial firms. Three were not usable because one firm had not yet offered a DRP, another began its plan only in January 1978, and the third supplied only general information and did not reply to questions about its DRP. Thus, the data summarized in the following sections of this report have been derived from the 22 usable responses received.

Exhibit IV-1. Companies Responding to Survey Questionnaire

A. Membership of the Committee for Capital Formation Through Dividend Reinvestment

Allegheny Power System
American Electric Power Company
American Telephone and Telegraph Company
Baltimore Gas and Electric Company
The Brooklyn Union Gas Company
Columbus and Southern Ohio Electric Company
Dayton Power and Light Company
Delmarva Power and Light Company
Illinois Power Company
Long Island Lighting Company
Minnesota Power and Light Company
Montana Power Company
New England Gas and Electric System
Orange and Rockland Utilities, Inc.
Pacific Power and Light Company
Pennsylvania Power and Light Company
Potomac Electric Power Company
Public Service Company of Colorado
United States Steel Corporation
Virginia Electric and Power Company
Wisconsin Electric Power Company

B. Additional Companies Responding

Allied Chemical Company
International Paper Company
Pioneer Corporation
Seaboard Coastline Industries

V. GENERAL CHARACTERISTICS OF THE REPORTED DIVIDEND REINVESTMENT PLANS

Present DRPs are Young Plans

For the majority of the 22 respondents, a DRP offering original issue stock is a relatively recent program. Thirteen of these firms (59 percent) began their plans in January 1976 or later; eight of these 13 plans were not initiated until sometime in 1977. Some of the firms, however, did offer market-purchase reinvestment plans before they offered original-issue plans.

Diversity in Shareholdings

The 22 reporting firms range from relatively small local companies to large regional or national enterprises. This diversity is reflected in their number of common stock shareholders and the average number of shares per common stock shareholder. The range in the number of shareholders

is extremely large, with the largest firm having more than 200 times as many as the smallest. The median firm has almost 63,500 shareholders; that is, just as many firms have fewer than 63,500 as have more than 63,500.[1] The average number of shares[2] held by common stockholders of each of the 22 reporting corporations ranges from a low of around 200 to a high of almost 775. Both the median and the simple average are in the neighborhood of 350 shares per shareholder. The data on shareholders and the size of their holdings include institutional as well as individual stockholders. Data reported on institutional holdings are not clear and cannot be meaningfully segregated.

Dividends and Dividends Per Share

There is also great diversity in the total dollars paid out in dividends on common stock, depending on both the number of outstanding shares and the dividends per share.

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1. Because of the extremely heavy weight of the largest firm, noted supra, the arithmetic mean (or average) distorts the representativeness of an average firm. Unless otherwise mentioned, therefore, we use the median measure in this report to represent the average firm.
2. Here an arithmetic mean or average (i.e., number of outstanding shares divided by number of shareholders) was reported by the firms.

For the 22 reporting companies, total dividends paid out in 1977 amounted to over $3.7 billion, and the average (i.e., median) firm paid out almost $50,000,000.

Dividends per shareholder in 1977 ranged from an arithmetic mean of approximately $340 for the lowest to a high of $870, with the average firm paying $630 per shareholder. The average firm's dividend was less than $2 per share.

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VI. NATURE OF PRESENT DIVIDEND REINVESTMENT PLANS

The DRPs of the 22 firms vary somewhat from firm to firm. Many allow holders of preferred as well as common stock to reinvest dividends in original issue common stock; one firm also allows its bondholders to participate in the DRP.

Cash Option Purchases

All the firms provide a cash purchase option, permitting DRP participants to purchase original issue stock directly for cash. All but one firm have limits on these purchases. The most limiting are those DRPs in which the participant cannot purchase common stock in excess of $1,000 per quarter. Most such limits, however, range between $3,000 to $5,000 per quarter.

Charges for DRP Participants

None of the firms charge their stockholders for participating in the DRP, but some do charge a fee when the company is requested to sell the stock for the shareowner.

All responding firms allow fractional shares to be purchased with the reinvested dividends, usually up to three decimal places. Eight of the 22 companies allow DRP participants to split dividends; that is, to reinvest part of their dividends and take the remainder in cash. The others require 100 percent participation per shareholder account, but many allow shareholders to split their holdings into more than one account.

DRP Purchase Discounts

Two fifths, or nine of the 22 firms, offer a 5 percent reduction below market in the purchase price to participants in the DRP. This reduction, however, does not extend to cash option purchases of common stock, which are made at 100 percent of the market price.

VII. NATURE AND EXTENT OF PARTICIPATION IN THE DRPs

Shareholder Participation

The proportion of common stockholders who participate in the DRPs of the 19 respondents reporting these data[1] varies considerably from firm to firm. For the company with the highest rate of participation, more than one fifth of the common stockholders were participants in 1976 and 1977. This company also had the longest continuing DRP, having started in 1969. The lowest participation rates in 1977, between 7.0 and 7.5 percent, occurred in three of the 11 companies reporting these data which initiated their present plans in 1976 and 1977.

Participation in many of these 11 recently initiated plans, however, was much higher, with two firms reporting

1. Because of lack of comparability, the data have been excluded for one firm which reported total shareholder and DRP participants as of different dates in 1978. This firm seems to have a participation rate of at least 20 percent. Two other firms did not report this item.

rates of approximately 19 percent. In fact, the median rate for these 11 plans begun in 1976-77 was about the same as the 13.3 percent for the entire reporting group of 19.

The data suggest a tendency for a rising degree of participation in the early years of DRPs. For example, while the average DRP firm in the entire group of 19 showed a 13.3 percent rate in 1977, the average rate in 1976 was 11.5 percent for the ten firms reporting comparable data that year and 9.4 percent in 1975 for the six firms reporting.

A slackening in the rate of growth does seem to set in early for some of these plans. For example, the increase in the participation rates for four of the six firms for which we have data for the last 3 years was about twice as great between 1975 and 1976 as between 1976 and 1977. The increase was about the same each year for a fifth firm. The sixth showed a greater increase in participation from 1976 to 1977 than from 1975 to 1976; this, however, coincided with the introduction of a 5 percent reduction in the purchase price to participants in the DRP. The change in plan through the introduction of the 5 percent reduction probably stimulated

growth beyond what would otherwise have occurred. It seems clear that a change in the tax laws to provide an added incentive (or remove a disincentive) for reinvestment would significantly stimulate the growth in participation in DRPs.

The Firms Offering a 5 Percent Discount

Nine of the reporting firms now offer a 5 percent reduction from the purchase price of common stock to the participants of their DRPs. These firms tend to rank highly among the 19 in our sample[1] in terms of the proportion of shareholders who are DRP participants; the number of shares held per participating shareholder; and the amount of dividends reinvested per participating shareholder.[2] Table VII-1 presents some relevant comparative data.

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1. Here again, two firms did not report and one firm is excluded because of lack of comparability as described in the preceding footnote. This latter firm does not offer any discount on DRP purchases; the former two do.
2. This is particularly interesting because seven of the nine allow split shares.

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Table VII-1. Median Shareholder Measures of Dividend Reinvestment Participants Only, Comparing All 19 Reporting Firms with the Seven Offering Participants a Reduction in Purchase Price

Shareholder measure	Median of reporting firms, 1977	
	All firms	Those with 5 percent reduction in stock purchase price
Percent of total shareholders	13.3	14.4
Number of shares per shareholder	147	161
Dividends reinvested per shareholder[a]	$226	$307

a. For this measure only 15 firms reported, six of which offered the 5 percent reduction.

There seems to be little doubt that the rate and dollar amount of participation in the DRP are generally higher in firms that offer a 5 percent reduction in the purchase price of common stock.

Share and Dividend Participation

Our questionnaire asked the surveyed firms to describe participation in their DRPs by groupings of (1) the amount

of dividends reinvested by participants per year, and (2) the number of shares held by participants. For many firms the requested details were not available. For 1977, 10 firms were able to provide the groupings of participant shareholdings as requested; for 1976, only five. For 1975, of the seven firms that offered an OI DRP, only three submitted complete data. For 1973 and 1974, when only two firms in the sample offered such a DRP, both did respond to this question.

It appears from the responses that the DRPs attract a higher proportion of small shareholders than large. As the annual dividends per shareholder increase, the rate of participation in DRPs seems to decline.

In 1977, of those shareholders who received less than $100 in dividends per year, the median participation rate in DRPs of the responding firms was an average of about 17 percent. For all except one of the 10 firms that responded to this part of the questionnaire, the percentage of participation for these under-$100 per year reinvestors is larger than the participation rate of all shareholders.

As shown in Table VII-2, the DRP shareholder participation rate drops by more than a quarter from the smallest annual dividend grouping of less than $100 to the next grouping of $100 to $499. It declines even more sharply for higher dividend recipients. Thus, the smaller the annual dividend, the greater seems to be the propensity of shareholders to reinvest the dividend. This might be attributable to institutional and investment firm holdings about which we have no significant data.

Table VII-2. Median Rate of Shareholder Participation By Amount of Shareholder Dividends Reinvested in 1977, for 10 Dividend Reinvestment Plans

Shareholder dividends reinvested in 1977	Median shareholder participation rate (percent)
Less than $100	16.9
$100 to $499	10.6
$500 to $999	7.0
$1,000 and more	4.0
All shareholders	13.6

For nine of the 10 firms reporting 1977 data, the percentage participation in the two highest dividend groupings

in Table VII-2 was substantially smaller than the percentage of total shareholders participating.

Added evidence that the DRPs have attracted the smaller shareholders can be seen from a comparison of the rate of shareholder participation and the percentage of total dividends on common stock that are reinvested through DRPs. In 1977, in each of the 15 firms for which data are available, the percent of shareholder participation was greater than the percent of dividends reinvested.

The attraction of the smaller shareholders to the DRPs can also be seen, as might be expected, from the responses on participation by the number of shares held by stockholders. In almost all cases (19 of 21), the shareholding per DRP participant is smaller than the average of all shareholders. The simple average of the number of shares per participant for the 21 firms reporting these data is 204, and the corresponding average for all the shareholders of these reporting firms is 364.

The Cash-Purchase Option

All firms in the sample allow the participants in the DRP to make additional cash purchases of original issue stock at the same time their dividends are reinvested. On the average, almost 12 percent of the participants in the DRPs utilized this option in 1977 (based on reports from 12 firms).

The cash option permits the participant to purchase odd lots at the market price and save brokerage fees, but no further discount is provided even by those firms that offer dividend reinvestors a 5 percent reduction in purchase price. It is not possible to determine, of course, how many of these investments would have been made by purchases in the market if the cash purchase option were not available, but it seems doubtful that many of the smaller odd lot purchases would have been made in the market.

In 1977, the average (in this case, the arithmetic mean) number of shares sold to cash-option participants ranged from 11 by the firm with the smallest average cash-option sale to more than 500 by the firm with the largest

average sale. The median firm sold an average of about 40 shares, with nine of the 12 firms showing an average of less than 100 cash-purchase option shares per participant.

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VIII. CAPITAL FORMATION THROUGH DRPs

Equity Financing through the DRP

In designing the questionnaire, RRNA had hoped to be able to determine whether a significant trend had occurred in the proportion of original issue common stock that was purchased through DRPs for each of the past 5 years. Upon examining the returned questionnaires, however, it became evident that this kind of year-by-year analysis could not be meaningfully pursued for three reasons. First, only a few firms were able to provide the requested data. Second, the majority of these firms did not initiate original issue DRPs until 1976 and 1977. Finally, there are firm-by-firm variations that would make annual comparisons misleading. Several firms made no public offerings of original issue common stock in one or more of the 5 years. When this occurs, almost all the proportion of original issue stock is purchased through the DRP. The same firm might have a public offering the next year and, looking only at the proportions and comparing the 2 years, the considerable

decrease would have no meaning in relation to the relative importance of DRPs. We conclude regretfully that we must forgo the analysis we had sought to undertake.

New Investment Requirements

Sixteen of the reporting firms were able to provide projections of their total investment requirements for each of the years 1978 through 1982. These data were compared with actual total investment data for the years 1973 to 1977. Looking at the two sets of data as 5-year blocks, in only one case out of the 16 was a decrease in total investments projected, this being slightly less than 10 percent. On the average, the firms projected around a 50 percent increase in needed investment over the next 5 years. One firm projected an increase of more than 250 percent.

IX. POSSIBLE EFFECT OF A CHANGE IN THE TAX LAWS ON REINVESTED DIVIDENDS

The RRNA questionnaire asked the responding firms a few subjective judgment questions about the possible effects of a change in the tax laws on participation in the DRPs and related impacts.

DRP Participation

One question asked for an estimate of the increase in shareholder participation that might be expected if the stock received through the reinvested dividends were treated for tax purposes like conventional stock dividends. The responses were checked through a telephone survey that asked, "If reinvested dividends were to be treated for tax purposes like conventional, nontaxable stock dividends, what percentage of total dividends do you think the reinvested dividends in your firm will be?"

Six of the 10 firms willing to respond expected that such a change in the tax laws would at least double the existing percentage of dividends being reinvested. Those that did not currently offer a 5 percent reduction in the purchase price of the stock to their DRP participants believed the introduction of such a discount along with the tax law change would increase the percentage even more. Three of the 10 firms expected an increase in the percentage of dividends currently reinvested through DRPs to be between 25 and 50 percent.

The maximum indicated percentage of total dividend payments that would ever be reinvested through DRPs, even with the suggested legislative change, was 50 percent.

Effect on Market Price of Stock

The firms were asked how they thought the increased participation in their DRPs would affect the market price of their common stock. Four of the 21 respondents thought there would be no effect on the market price. Two more answered "negligible," while five others predicted a "minimal or modest" increase. One suggested only that increased

participation would "stabilize the stock price." Four firms predicted specific percentage increases in the market price of their stock, ranging from 10 to 30 percent, and another four predicted a "positive effect." The remaining respondent considered the effect "unmeasurable." These responses, of course, were made from the viewpoint of each firm.

Other Projected Effects

For most of the reporting firms the respondents thought the DRPs were too recent a program and the market variables too complex to permit any quantitative responses to the remaining questions. Most of the 21 corporations, however, did express the opinion that, given the assumption (or guess) they had made as to the levels of DRP participation under the suggested change in tax law, the major effect of the new equity raised through DRPs would be to decrease the size and frequency of public offerings of common stock. Since smaller, less frequent issues tend to be easier to sell, this could result in a decrease in the cost of equity. With financing easier and less costly, greater DRP participation could also encourage more rapid modernization and an increase in plant expansion.

APPENDICES

APPENDIX A. TECHNICAL BACKGROUND TO CHAPTER II

Case A: Ignoring Brokerage and Assuming No Change in Expected Stock Price

Present Law

Assuming a price P for one share of stock expected to remain constant in value and pay d dollars per annum in dividends, the strategy of reinvesting all dividends for T periods involves a rate of return, r, given by the solution of:

$$P = \frac{P(1 + \frac{d}{P})^{T-1}}{(1 + r)^{T}} + \frac{d(1 + \frac{d}{P})^{T-1}}{(1 + r)^{T}} - t_p d \sum_{i=0}^{T-1} \frac{(1 + \frac{d}{P})^{i}}{(1 + r)^{i+1}} \quad [A.1]$$

which is $r = \frac{d}{P}(1-t_p)$ where t_p is the personal income tax rate for the individual involved. It is assumed, of course, that T is greater than 1, and also that there are neither charges to participate in a dividend reinvestment plan (DRP) nor any discounts available for shares purchased through it.

Pickle Bill

To achieve the same yield r under the new law (treating dividends reinvested in the DRP (OI) the same as present stock dividends)[1] the price of the security, P', would need to be such that

$$P' = \frac{P' + P'\{(1 + \frac{d}{P'})^T - 1\}(1 - t_g)}{(1 + r)^T} \qquad [A.2]$$

where t_g is the tax rate on capital gains for the individual involved. (A.1) and (A.2) together imply:

$$\frac{P'}{P} = \frac{r}{(1 - t_p)\left[\sqrt[T]{\frac{\{(1 + r)^T - 1\}}{(1 - t_g)} + 1} - 1\right]} \qquad [A.3]$$

Tables A-1 and A-2 show the P'/P values implied by this formula for T = 2 and T = 10, respectively, and for various values of r and t_p (with $t_g = .5t_p$). (Under the Pickle Bill we assume that reinvested dividends are treated like conventional stock dividends in that they "inherit" the holding period of the parent shares.)

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1. See Attachment 1(A) for a description of the tax treatment of stock dividends.

It is seen from Tables A-1 and A-2 that P'/P is an increasing function of r, T, and t_p with greater sensitivity to changes in t_p than to r or T over the ranges of values considered.

Table A-1. Values of P'/P for T = 2

	Yield		
Tax rate	r = .02	r = .06	r = .10
t_p = .2	1.126	1.129	1.131
t_p = .4	1.337	1.343	1.348
t_p = .5	1.505	1.514	1.522
t_p = .7	2.278	2.199	2.219

Table A-2. Values of P'/P for T = 10

	Yield		
Tax rate	r = .02	r = .06	r = .10
t_p = .2	1.135	1.152	1.165
t_p = .4	1.361	1.405	1.439
t_p = .5	1.541	1.607	1.657
t_p = .7	2.263	2.413	2.527

It is possible to approximate P'/P by $\frac{(1-t_g)}{(1-t_p)}$ which is the value of P'/P corresponding to T = 1. Table A-3 shows the values of $\frac{(1-t_g)}{(1-t_p)}$ for the range of t_p values considered in Tables A-1 and A-2 (and $t_g = .5t_p$).

Table A-3. Values of $\left(\frac{1-t_g}{1-t_p}\right)$ for Various Values of t_p as a Measure of P'/P

Tax rate	P'/P (approximation)
$t_p = .2$	1.13
$t_p = .4$	1.33
$t_p = .5$	1.50
$t_p = .7$	2.17

Case B: Considering Brokerage and Assuming No Change in Expected Stock Price

If it is assumed that brokerage fees are at a rate of b for initial and terminal transactions, the appropriate P'/P values for the dividend reinvestment strategies described in Case A above would not be very different if b is of the order of .02 (or 2 percent). For example, the entries in Table A-3 instead of being given by the formula $P'/P = \frac{1-t_g}{1-t_p}$ would be generated by $P'/P = \frac{1-t_g}{1-t_p}(1-b)$.

Case C: Ignoring Brokerage but Assuming Stock is Expected to Appreciate by the Same Percent per Year

Assuming a one period holding with stock from reinvested dividends immediately sold, it is easy to show that the entries in Table A-3 would be unchanged. For a general holding period the formula is quite complicated, but appears not to differ very much in its value from those of Case A. For example, with $T = 2$ and $t_p = 0.4$, a stock expected to appreciate 3 percent per year and costing $P = 100$, if its dividend is expected to be $10 per year, would yield 8.3 percent after taxes (under current law) if the holder participates in a DRP qualified for the proposed new tax treatment. To yield 8.3 percent under the Pickle Bill the initial price would have to be $P' = 130$. This P'/P value of 1.30 compares with a value of 1.34 implied by equation (A.3) for the analogous case assuming no appreciation.

Attractiveness of DRP Under the Pickle Bill to an Income-Oriented Investor

The above examples assume that stock acquired through a DRP, even if it is immediately sold, will not, under the Pickle amendment, give rise to any tax liability different

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from what would have been incurred due to receipt of a conventional stock dividend. Under these circumstances, it would appear possible that taxable investors would find it profitable to enlist in DRPs even while meeting income needs through the sale of an amount of stock equivalent to that reinvested. As described in Chapter III, use of this strategy is likely to be limited. Nonetheless, as a matter of public policy, the new tax treatment should -- and is likely to -- be applied only to original issue DRPs of firms that have to raise new external capital regularly for plant expansion, replacement, and other real capital formation.

Otherwise, for example, consider an investor under current law planning the purchase of N shares of stock valued at P dollars per share which is not expected to appreciate. If the expected dividend is d per year and the investor's marginal personal tax rate is t_p, the expected internal rate of return where the brokerage rate is b and the holding period T = 2 (years), is the solution for r of:

$$NP + bNP = \frac{(1 - t_p)Nd}{(1 + r)} + \frac{(1 - t_p)Nd}{(1 + r)^2} + \frac{NP - NbP + 2t_g NbP}{(1 + r)^2} \qquad [A.4]$$

where t_g is the capital gains (losses) rate.

If the same investor were to participate in a DRP under the Pickle Bill but sell amounts of stock equivalent to the reinvested dividends, then it is of interest to find the increase in yield for the same price P of the stock which would accrue under the same t_p, t_g, and T values as above.

Initially, N shares are purchased for an outlay of NP + bNP. After period 1, dividends of Nd are expected to be received and reinvested in $\frac{Nd}{P}$ new shares, while at the same time $\frac{Nd}{P}$ shares are to be sold at an expected price of P each and at a brokerage rate of $\bar{b} > b$. For tax purposes, these shares would each have a basis of:

$$\frac{NP+NbP}{N+\frac{Nd}{P}} = \frac{P(1+b)}{1+\frac{d}{P}}$$

and the taxable gain (or loss) realized would be $Nd(1-\bar{b})$ minus $\frac{Nd(1+b)P}{P(1+\frac{d}{P})}$. After tax the investor would expect to have receipts in period 1 of:

$$Nd(1-\bar{b}) - t_g[Nd(1-\bar{b}) - \frac{Nd(1+b)P}{P(1+\frac{d}{P})}] \qquad [A.5]$$

If after the end of period 2 it is expected that another dividend payment of Nd dollars will be reinvested through the DRP in $\frac{Nd}{P}$ shares which will be sold the next day along with the original N shares at a price P each, and at brokerage rate b, the investor would have gross expected receipts in period 2 of (NP+Nd)(1-b). The basis of the shares sold would be $\frac{(NP+NPb)N}{(N+\frac{Nd}{P})^2}$ and a taxable gain of:

$$(NP + Nd)(1 - b) - (N + \frac{Nd}{P})\frac{(NP + NPb)N}{(N + \frac{Nd}{P})^2} \qquad [A.6]$$

results.

The total taxable gain in periods 1 and 2 is simply total dividends paid, 2Nd, less total brokerage paid, $2bNP+bNd+\bar{b}Nd$. To see what increase in yield is involved it is helpful to consider a numerical example.

If P = 10, d = 1, b = .02 (2 percent), $\bar{b}$ = .05 (5 percent), N = 100, t_p = .4, and t_g = .2, it can be shown that with T = 2 net receipts for an investor not participating in a DRP are $60 in the first period and $1,048 in

the second. For the initial outlay of $1,020, this yields r = .043.

For an investor, the Pickle Bill would allow the $100 received in dividends to be reinvested in 10 new shares through the DRP with no current tax due. However, the basis of the 110 shares would become 1020/110 = $9.2727 each. If the next day, 10 shares are sold for $100 less a brokerage fee of $5, a capital gain of 100 - 5 - 92.73 = $2.27 would be realized. A capital gains tax of .2 (2.27) = $0.45 would be payable, leaving net receipts of 95 - 0.45 = $94.55. The basis for the remaining 100 shares is $927.27. If at the end of period 2, another $100 of dividends are reinvested in 10 new shares the basis for each would become 927.27/110 = $8.429752. If all 110 shares are sold the next day for $1,100 less brokerage of $22, a taxable gain of 1,100 -22 -927.27 = $150.73 will be realized. This will give rise to a tax of $30.15 and the investor will net $1,047.85. This strategy giving net receipts of $94.55 after period 1 and $1,047.85 after period 2 yields r = .061. Here $\frac{r'}{r}$ = 1.419

so that to an investor with basic interest in cash income, a higher yield of over 40 percent would be available under the Pickle Bill even after paying a 5 percent brokerage fee on the smaller amount of stock sold.

To continue the comparison, suppose the investor has a T = 5 holding period. For an initial outlay of $1,020, the non-participating investor would have net receipts as follows:

End of period	1	2	3	4	5
Net receipts ($)	60	60	60	60	1,048

This corresponds to a yield of r = .053. Under the Pickle Bill, for the OI DRP investor selling 10 shares per period, the net receipts are:

End of period	1	2	3	4	5
Net receipts ($)	94.55	92.86	91.33	89.93	1001.73

This corresponds to a yield of r' = .072 and r'/r = 1.358.

Under the Pickle Bill the taxable dollar gain and tax paid are as follows (with of taxes of a non-participant for comparison):

	For Participants Under the Pickle Bill		
End of period	Taxable gain	Tax	Tax for a non-participant
1	2.27	.45	40.00
2	10.70	2.14	40.00
3	18.35	3.67	40.00
4	25.35	5.07	40.00
5	381.33	76.27	32.00
Total	438.00	87.60	192.00

It is noteworthy that the sum of the taxable gains ($438) under the Pickle Bill would be the total dividends paid of $500 less the sum of initial brokerage of $20 and the subsequent brokerage charges (of $5 in each of four periods followed by the terminal charge of $22). This shows that dividends would not only qualify for capital gains tax treatment, but could also qualify for deferral of payment of major parts of these taxes.

The percentage increase in yield which would be available under the Pickle amendment varies with the investors' personal tax rate and with the level of yield currently available. Table A-4 illustrates these differences by showing the approximate percent increase in available yield implied by above equations [A.4] through [A.6] for a T = 2 holding period on a P = 10 stock with brokerage rates b = .02 and $\bar{b}$ = .05, and with annual dividends d alternatively 0.50, 1.00, and 1.50.

Table A-4. Approximate Percent of Increases in Yield

	Dividend		
Tax rate	d = 0.50	d = 1.00	d = 1.50
t_p = .2	15	10	10
t_p = .4	60	40	35
t_p = .7	800	200	150

Table A-5 below shows Merrill Lynch's schedule of brokerage rates which indicates that the 5 percent rate used on smaller amounts in the above example may be too low for truly small amounts. For example, on Citizens Utilities A

Table A-5. Rate Schedule for Stocks, Rights and Warrants for Domestic and International Customers

Following are the schedules for computing the charge on orders for stocks, rights and warrants executed for a Merrill Lynch customer. The charge on these transactions is based on the total amount of money and total number of shares involved, as per definition of an "order."

A. Schedule of Rates for Stocks, Rights and Warrants Selling for Less than $1.00 per Share

$0 up to and including $300 ..... 10 percent of money involved
Over $300 up to and including $1,000 ..... 10.7 percent of money involved
Over $1,000 up to and including $5,000 ..... 6.42 percent of money involved plus $42.80
Over $5,000 up to and including $10,000 ..... 6.634 percent of money involved plus $46.01
Over $10,000 ..... 5.35 percent of money involved plus $176.55

B. Schedule of Rates for Stocks, Rights and Warrants Selling for $1.00 per Share or More

	Charge		
Money involved	Basic rate	Plus	Subject to a maximum of
		-----For orders up to and including $5,000 principal value-----	
$300 or less	10 percent of money involved	$.0749 per share on all shares involved for orders of 101 shares up to and including 1,000 shares	$80 on orders up to and including 100 shares
Over $300 up to and including $800	2.568 percent of money involved plus $8.03	or	or
Over $800 up to and including $2,500	1.605 percent of money involved plus $16.05	$.0535 per share on all shares involved plus $21.40 for orders in excess of 1,000 shares	$.80 per share on orders of over 100 shares
Over $2,500 up to and including $5,000	1.177 percent of money involved plus $27.82		
		----------For orders above $5,000 principal value----------	
Over $5,000 up to and including $20,000	1.177 percent of money involved plus $29.96	$.0803 per share on all shares involved for orders of 101 shares up to and including 1,000 shares	$85 on orders up to and including 100 shares
Over $20,000 up to and including $30,000	.803 percent of money involved plus $107.00	or	or
Over $30,000 up to and including $300,000	.535 percent of money involved plus $188.32	$.0535 per share on all shares involved plus $26.75 for orders in excess of 1,000 shares	$.85 per share on orders of over 100 shares
$300,000 and over	.214 percent of money involved plus $1,150.25		

Note: The minimum charge will be $30.00 for transactions with a principal over $300. The charge on a round lot or a combination round lot/odd lot transaction will not exceed the charge applicable to a 100 share transaction multiplied by the number of round lots and fractions thereof in the order (i.e., the charge for 200 shares can never be more than two times the 100 share charge).

Source: Merrill, Lynch, Pierce, Fenner & Smith, Inc.

series, Merrill Lynch quoted (on a day when the price per share was 39-3/4) the following commissions[1]:

Transaction	Commission	Brokerage rate
10 shares	$ 30	7.5 percent
100 shares	75	1.9 percent
1,000 shares	481	1.2 percent

The Pickle amendment would seem to make DRP (OI) plans attractive to investors for whom the difference between their personal income tax rates and capital gains tax rates exceeds the applicable brokerage rates on smaller amounts.[2]

Distribution of Dividend Income Among Personal Income Taxpayers

Information in the latest available IRS Statistics of Income, Individual Tax Returns (1974) shows over 90 percent of dividends received as being reported on returns with at least $1,000 in dividend income.

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1. The significance of this particular stock is that, as explained in Appendix D, it offers its holders a tax advantage comparable to that proposed by the Pickle Bill and although its dividends are paid in stock, they may of course be sold for income purposes.
2. To the extent that odd lots (i.e., less than 100 share lots) are sold at a price somewhat lower than the market price used to calculate the amount of stock to be issued for reinvested dividends, this cost has been disregarded in the foregoing analyses.

On average, in 1974, the 25 percent marginal tax bracket corresponded to adjusted gross income (AGI) of about $15,000. Returns with $15,000 or higher AGI accounted for 77 percent of all dividends reported. Of these, 80.5 percent reported dividend income of at least $5,000, so that 62 percent of all dividends were reported on returns showing both adjusted gross income in excess of $15,000 and dividends of $5,000 or more.

The corresponding 1963 IRS Statistics of Income volume reports that for returns showing dividend income, the average number of paying corporations listed by the taxpayer was two. An article by Marshall E. Blume and others indicates that as of 1971, diversification of portfolios as measured by the number of different stocks held, had not changed much from 1963.[1] The 1963 average of two stocks per return is heavily weighted by the large number of (probably mostly very small) investors with perhaps only one stock held. The 1971 data reveals that at adjusted gross income of about $100,000, the average number of stocks held was about 10.

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1. Marshall E. Blume, et. al. "Stock Ownership in the United States: Characteristics and Trends." U.S. Department of Commerce, Survey of Current Business (November 1974).

ATTACHMENT 1(A). DESCRIPTION OF CURRENT TAX TREATMENT OF STOCK DIVIDENDS[1]

Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable to the shareholder. However, for exceptions to this rule, see Chapter 10. If stock dividends are not taxable, you must redetermine your basis for your old stock and determine the basis for your new stock.

New and old stock identical. It is only when your new stock, received as a dividend, is identical to the old stock on which the dividend is declared that you can use a simple mathematical computation to arrive at the basis of the old and new stock. The adjusted basis of the old stock must be divided among the shares of old stock and the shares of new stock received as a dividend.

Example. You own one share of common stock that you purchased for $45. The corporation distributed two new shares of common stock for each share held. You then had three shares of common stock with a basis of $15 each, if you owned two shares before the distribution, one purchased for $30 and the other for $45, you would have six shares after the distribution; three with a basis of $10 each, and three with a basis of $15 each.

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1. Your Federal Income Tax 1978 Edition (IRS)

APPENDIX B. TECHNICAL BACKGROUND TO CHAPTER III

The approach to measuring macroeconomic impacts was facilitated by starting with the assumption (which is obviously unrealistic and invalid) that under the proposed amendment to the tax code 100 percent of the dividends received by persons would be reinvested in OI DRPs. The results of this totally unrealistic overestimate was then related to what is believed to be a more reasonable and realistic assumption, namely that only 40 percent of one half the dividends (or 20 percent of the total corporate dividends received by persons) would be so reinvested.

Three sets of "basic" estimates, representing the most likely effects, were derived utilizing somewhat different assumptions as to stock price effects and flotation cost savings, as presented in Chapter III.

Unrealistically High Estimates

The basis for these estimates is the reported simulation of the effects of a partial integration (of personal and corporate taxes) scheme whereby individual taxpayers receive a credit for corporate taxes attributed to dividends and are taxed on dividend income "grossed up" by the factor $\frac{1}{1-t_c}$ where t_c is the effective corporate tax rate. The Securities Industry Association (SIA) publication Tax Policy, Investment and Economic Growth (March 1978) discusses the nature and results of this simulation performed on the Data Resources, Inc. (DRI) econometric model.[1]

Why is this SIA-DRI simulation considered relevant?

1. It simulates a measure which raises individuals' yields on equity investments (by about 40 percent irrespective of the individual's tax bracket).

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1. Similar results are reported in Christopher Caton, Otto Eckstein, Allen Sinai, "Tax Reform Studies," Data Resources Review (August 1977) pp. 10-19.

2. It assumes the tax measures would lead to the Standard and Poor's stock price index being 10 percent higher than it otherwise would be. Also assumed is an increase in dividend payout ratios (of 10 percent).[1]

3. The simulation assumes an initial revenue cost (before feedback) of $8.4 billion. This amount is as big as the entire estimated tax bill on personal dividend income in 1978.

In comparison, the Pickle Bill:

1. Would, as the illustrations in Appendix A indicate, also increase yields significantly for the investor in the (estimated) average marginal federal tax bracket of 40 percent.[2]

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1. The change in stock prices was assumed to take place smoothly over the first 5 quarters. That of dividend payout ratios was phased in over 3 years.
2. See M. Feldstein and D. Frisch "Corporate Tax Integration: The Estimated Effects of Capital Accumulation and Tax Distribution of Two Integration Proposals," National Tax Journal (vol. XXX, no. 1, pg. 49), for this estimate.

2. Might, as discussed in Appendix D, possibly lead to significant increases in general stock market prices and also would lead to increases in dividend payout ratios.

3. Would involve initial revenue "costs" without feedback[1] that would be at the $8.4 billion level under the obviously unrealistic assumption of virtually 100 percent participation by taxable shareholders spelled out in Appendix C.

Additionally, the SIA-DRI simulation of the integration proposal is considered relevant because the channels whereby its effects are transmitted seem to be similar to what could be expected from the Pickle Bill. The main channels are:

1. The effect of higher stock prices on business fixed investment via the cost of capital.

2. The effect of higher stock prices on consumer purchases via the "wealth effect" on household financial assets.

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1. I.e., without taking into account the revenue gain from the stimulative effect of the proposed legislative action on the economy.

3. The effect on consumer spending of higher dividend payout ratios via disposable income.

4. The effect of lower taxes on consumption via spendable personal income.

With respect to the last item, it may seem strange that increased dividend reinvestment participation would lead to higher consumer spending. As discussed in Appendix A, the Pickle Bill could lead to incentives for participation even by some who were using equity investments for income purposes. Such individuals would have higher after tax income. In addition, the additional participation of savings induced by the Pickle Bill would not necessarily create corresponding reductions in consumer purchases. This is because the Pickle Bill would allow something which might be termed tax-favored "homemade individual retirement accounts." Extra savings in this form could be expected to substitute to some extent for other types of saving. In addition, there are

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undoubtedly those with fixed dollar savings goals who would save less in response to the higher yields.[1] Finally, the increased dividend payout ratios (including as dividends the stock purchased with reinvested dividends) that would probably follow from the Pickle Bill would lead to greater disposable income for nonparticipants.

Details of Derivation of Unrealistically High Estimates

The DRI simulation of the partial integration proposal assumed a 1978 (i.e., first full year) revenue cost (before feedback) of $7.9 billion.[2] Since this estimate (unlike our estimates for the Pickle Bill) also assumed repeal of the $100 dividend exclusion, estimated to cost $0.5 billion in 1978, the Securities Industry Association (SIA) partial integration simulation was taken to have a revenue cost

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1. However, recent work by Michael Boskin suggests that the overall elasticity of personal savings in response to changes in yields is positive and substantial. See his "Taxation Savings and the Rate of Interest," Journal of Political Economy (April 1978, part 2). This is important since the extra investment stimulated by the Pickle Bill needs to be matched by extra saving, and that will be forthcoming with smaller increases in interest rates if the elasticity of savings is relatively high.
2. Caton, Eckstein, Sinai, op. cit., p. 13.

of $8.4 billion for 1978. For reasons discussed in Appendix C, the effects of the Pickle Bill or similar legislation, like that of partial integration, are expected to be largely on the dividend income of individuals, and, assuming that such dividends would grow between 1978 and 1982 at the same rate as the DRI forecast of nonfinancial corporations' gross internal funds,[1] the estimated revenue cost under the Pickle Bill (assuming 100 percent reinvestment of dividends reportable on individual tax returns through OI DRPs), compared to the assumed SIA-DRI revenue cost would be as in Table B-1 below.

The growth in the Pickle Bill revenue cost, even assuming 100 percent reinvestment, is not as great as for partial integration because some extra revenues are received as stock is sold and capital gains tax is collected. Nonetheless, the gross revenue costs for the two situations are quite close over the years, and that is why the SIA estimates are considered as suitable for indicating upper limits on the possible effects of the Pickle Bill.[2]

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1. SIA-DRI study, op. cit., Table 19, p. 61.
2. Except possibly for the investment estimates, as explained below.

Table B-1. Comparison of Gross Revenue Costs

Item	1978	1979	1980	1981	1982
Pickle Bill assuming 100 percent reinvestment[a]	8.4	9.0	9.6	10.7	12.1
SIA partial integration[b]	8.4	9.2	10.0	11.3	12.9

a. The derivation of these figures is explained in Appendix C.

b. The SIA-DRI method of calculating revenue cost is as a fixed proportion of dividends received by persons. Accordingly the revenue cost has been assumed to grow in accordance with the growth of dividends.

Based on the unrealistically high (and certainly invalid) assumption of 100 percent dividend reinvestment, the macroeconomic effects of the legislative proposal are presented in Table B-2, assuming also that the Pickle provision had been in effect as of January 1, 1978. One additional assumption made here by the authors of the SIA-DRI study, and reflected in these estimates, should be noted. It is that the Federal Reserve Board would take "accommodating" actions to prevent interest rates from rising as the economy was gaining momentum under the impetus of the tax change. This assumption is modified in our formulation of most-likely estimates below.

Table B-2. Unrealistically High Effects of the Pickle Bill on Key Economic Magnitudes, 1978-82[a]

(Money amounts in billions of dollars of 1978 purchasing power[b] and represent changes from the baseline)

Item	1978	1979	1980	1981	1982
Gross National Product	9.2	22.6	35.1	39.3	38.3
Business fixed investment (nonresidential)	0.9	3.3	6.2	7.7	7.6
Personal consumption expenditures	7.8	17.7	26.6	31.5	32.9
Federal government:					
Budget deficit[b]	4.7	0.0	-6.0	-9.1	-8.9
Federal tax receipts[b]	-4.8	-0.2	5.7	8.7	8.5
Additional man-years of employment (thousands)	134	410	667	755	690
Unemployment rate (percent):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.1	5.4	4.9	4.7
Difference	-0.1	-0.3	-0.5	-0.5	-0.5
Inflation rate (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.7	5.8	6.4	5.9

a. Based on reinvestment of 100 percent of personal dividends and action to prevent an increase in interest rates. However, for reasons discussed later in Appendix B, the estimates for business fixed investment are not necessarily regarded as being on the high side.

b. Changes in budget deficit and federal tax receipts, unlike other dollar amounts are in current dollars.

Details of Derivation of Basic (Most Likely) Estimates

With the 20 percent rate of reinvestment of personal dividends regarded as likely under legislation like the Pickle Bill, the gross revenue costs would not be as in Table B-1, but rather as in Table B-3 below.[1]

Table B-3. Gross Revenue Cost of Pickle Bill With 20 Percent Reinvestment

	1978	1979	1980	1981	1982
Gross Revenue Cost	2.4	2.7	2.8	3.1	3.6

Source: See Appendix C.

The gross revenue costs in Table B-3 average between about 27.5 percent and 29.5 percent of the gross revenue costs of the SIA-DRI figures in Table B-1. Accordingly, after averaging the figures in the SIA-DRI study (in its Tables 2

1. The reason gross revenue cost is estimated at 2.4 billion with 20 percent participation, and at only $8.4 billion with 100 percent participation, is that revenue cost with 100 percent participation is computed at the average tax rate on dividends (28 percent) while revenue cost at 20 percent participation is computed at the typical marginal rate (40 percent).

and 11, pages 44 and 53) corresponding to accomodating and nonaccommodating monetary policy, 28.5 percent of the resulting estimates was taken to yield the estimates in Chapter III, Table III-1.[1] Because of the change in assumptions from Table B-2 regarding investor participation, the estimates in Tables III-1 and III-3 assume a 2.87 percent increase in stock prices and dividend payout ratios while those in Table III-2 assume 5 precent (rather than the 10 percent in Table B-2 and the SIA-DRI study.)

It is argued in Appendix D that the effect of the Pickle Bill on stock prices might well be as large as a 5 percent increase, and the estimates in Table III-2 reflect this change from the assumptions underlying Table III-1. The means of making the Table III-2 estimates was provided by information in the SIA-DRI study (p. 41), and the previously cited DRI study of Caton, Eckstein, and Sinai (p. 13) on the effects of changing stock market prices while keeping tax laws and dividend payout ratios unaltered.

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1. An exception had to be made for estimates of federal tax revenue changes since they were not reported annually in the SIA-DRI study. See Appendix C for treatment of these.

A feature of the SIA-DRI study which makes it less suitable for projecting the effects of the Pickle Bill is that it makes no allowance for the reduction in flotation costs which firms experiencing increased dividend reinvestment would enjoy under the Pickle Amendment. The estimates in Table III-3 of Chapter III are based on the assumption of a 5 percent saving in flotation costs on the extra reinvested dividends, with other underlying factors being assumed the same as for Table III-1.[1] The means of making this estimate were provided by the estimates of the effects of a change in the rate of investment tax credit on equipment investment in the Caton et al. DRI study (page 17).

It may seem strange that figures for business fixed investment in Tables III-2 and III-3 show some increases for 20 percent reinvestment which seem unduly large in relation to the unrealistically high 100 percent reinvestment assumed

1. The 5 percent figure was based on data in Cost of Flotation of Registered Issues, 1971-1972 (U.S. Securities and Exchange Commission, December 1974), and statements by executives in relation to justification of offering a 5 percent discount in DRPs.

in Table B-2. The reason for this is that without the assumed stock market effect the SIA-DRI study would have shown an adverse impact on investment. Consumption and overall GNP would still have risen but, because of higher dividend payout ratios and interest rates, investment would have been reduced on balance. It is believed that these effects would be substantially mitigated under the Pickle Bill, since higher payout ratios are compensated by reinvestment and the funds so generated reduce pressure on external capital rates. For this reason, it is felt that the estimates for the effects of the Pickle Bill on investment would be more like those of Tables III-2 or III-3 (rather then Table III-1).

Another point relating particularly to the estimates of economic impact deserves comment. To judge from the questionnaire survey discussed in Part 2 of this report, a substantial number of respondent utility firms anticipated there would not be <u>any</u> near term change in volume of new facilities put in place due to expansion of dividend reinvestment. This opinion is understandable from the perspective of such individual respondents in view of the long lead times in utility facility planning and installation.

It is also in line with the theoretical proposition (associated with the Averch-Johnson model) of a utility subject to a rate of return constraint not expanding investment in response to a reduction in "cost of capital."

However, this latter proposition is essentially a static one and there is evidence of considerable responsiveness of electric utility investment to past investment tax incentives after 3 years or so have elapsed.[1]

Also the individual respondent's perspective may well ignore the effects on capital markets and other industries of the reduced demands for raising funds due to the increased volume of reinvested dividends available.

To measure such effects requires a model which is reasonably rich in financial sector detail. Again the SIA-DRI model provides a basis for estimation, and these effects have been reflected in our estimates.

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1. See Henry G. Rennie, "Federal Tax Effects on Electric Utility Investment." Engineering Economist (Winter 1977), pp. 97-118.

APPENDIX C. METHOD OF ESTIMATING FEDERAL TAX REVENUE IMPACTS

It was decided that, because of the 85 percent exclusion rule and other features of the tax laws, only a very small fraction of dividends which are received by corporations, pension funds and other "nonindividuals" would be affected by the Pickle Bill. The bulk of its impact would be on the recipients who must report such income on individual tax returns. Accordingly, the revenue loss estimates concentrate on this group of dividend recipients.

By the use of data from IRS corporate and individual tax return statistics, and from the national income and product accounts, it was determined that the IRS measure "Dividends in Adjusted Gross Income (AGI)" has averaged some 68 percent of the national income accounts concept of dividends, and that dividends in AGI plus the dividend exclusion have averaged about half of domestic corporate distributions to stockholders (other than in stock).

The basic assumptions underlying our estimates of revenue loss are (1) that the above-mentioned relationships between the various measures of dividends would continue through 1982, and, (2) that the national income accounts measure would grow in line with the SIA-DRI study forecast of gross internal funds of nonfinancial corporations.[1] This led to the "baseline" forecast of dividends reported on individual tax returns shown in Table C-1 below.

Table C-1. Forecast of Dividends on Individual Tax Returns

	1978	1979	1980	1981	1982
Dividends in adjusted gross income	30.1	33.0	36.2	40.6	46.4
Dividend exclusion[a]	1.2	1.3	1.3	1.4	1.5
Dividends on individual tax returns	31.3	34.3	37.5	42.0	47.9

a. These estimates are based on Estimates of Federal Tax Expenditures, prepared by the staff of the Joint Committee on Taxation, March 14, 1978, p. 19.

1. SIA-DRI study, op. cit., Table 19, p.61

The next phase in developing gross revenue cost estimates involved forecasting the pattern of capital gains taxes which would be collected as stock acquired through dividend reinvestment was sold. The basis for these estimates was information on the holding period of corporate equities contained in Martin David's book, Alternative Approaches to Capital Gains Taxation, (Brookings Institution, 1968) p. 79.

These (David) estimates imply that only 8 percent of corporate stock (by value) would be sold in any given year. The same source estimates at about 50 percent the proportion of transactions in stock sold in any 1 year where the stock has been held less than 12 months.[1] Tax on sales of stock acquired via reinvested dividends when underlying stock is held less than 12 months would essentially involve taxation of the dividends at ordinary income rates and so be unaffected by legislation such as the Pickle amendment.

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1. The 50 percent estimate is roughly in line with a more recent estimate (of somewhat over 60 percent) in a study of holding periods of stock purchased in 1964. See Gary Schlarbaum et al., "Realized Return of Common Stock Investments: The Experience of Individual Investors," Journal of Business (April 1978).

Based on these sources the following formula was developed to compute gross revenue costs (RC) in the i^{th} year (RC(i)):

$$RC(i) = T(i) - \sum_{t=1978}^{i} C_{i-t} RD(t),$$

where RD(t) is the amount of dividends reinvested in the t^{th} year, C_{i-t} is a constant ($C_0 = .01200$, $C_1 = .00800$, $C_2 = .00560$, $C_3 = .00416$, $C_4 = .00320$) and T(i) represents the difference in current income tax liability on dividend income under the Pickle Bill and under the present law.

Because only 8 percent of stock is assumed sold in any year, the pattern of realization of extra capital gains taxes due under the Pickle Bill is spread out over time. For example, if $10 billion of reinvested dividends were affected by the Pickle Bill, (and we realize this is probably much too large a figure), the estimated extra capital gains taxes would be as in Table C-2.

Table C-2. Illustration of Pattern of Capital Gains Tax Realization
(Billions of dollars)

	1978	1979	1980	1981	1982
Qualifying reinvested dividends	10.00	10.00	10.00	10.00	10.00
Extra capital gains taxes	.12	.20	.26	.30	.33
Reduction in current tax liability	4.00	4.00	4.00	4.00	4.00
Gross revenue cost (RC)	3.88	3.80	3.74	3.70	3.67

Because dividends received by individuals are expected to grow over time, the associated gross revenue costs also rise. For the unrealistically high estimates of appendix Table B-2 and the basic estimates employed in developing text Tables III-1 through III-3, gross revenue costs estimates are as shown in Table C-3 below.

Table C-3. Estimated Gross Revenue Costs

	1978	1979	1980	1981	1982
Unrealistically high	8.4	9.0	9.6	10.7	12.1
Basic	2.4	2.7	2.8	3.1	3.6

The reason the basic estimates (corresponding to 20 percent participation in reinvestment plans) are more than one fifth as large as those for the unrealistic high-side (corresponding to 100 percent reinvestment plan participation), is that the latter assumes taxation at the average rate (of 28 percent) on all dividend income implied by the Feldstein and Frisch study cited earlier.[1] The former assumes taxation at the average marginal rate of 40 percent found by Feldstein and Frisch (and confirmed by RRNA staff for 1974 data by matching dividend income distribution by AGI class with taxable income and marginal tax rates by AGI class).

Of course, the "gross" estimates in Table C-3 totally ignore the stimulative changes in economic behavior which would result from the Pickle Bill. In contrast, the estimates in Tables B-2 and III-1 through III-3 relate to the bill's net effects on federal tax revenues and the budget deficits. These net estimates were derived by scaling the appropriate

1. Joseph Minarik of the Brookings Institution kindly let us see some preliminary computer runs on a pilot sample of individual returns, which confirm the 28 percent figure as the total due to all dividend income.

SIA-DRI estimates of key economic magnitudes as described in Appendix B, and the changes in federal tax receipts were then taken to be in proportion to the corresponding changes in GNP. Furthermore, and more precisely, the tax effects shown in Table B-2 were developed from a 5-year total, 1978-82, reported in the SIA-DRI report, and then generally apportioned annually in accordance with the annual changes in GNP. The tax receipts estimates in Tables III-1 through III-3 were scaled down from B-2 values similarly.

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APPENDIX D. ESTIMATION OF EFFECTS ON STOCK PRICES

The most probable impact of the Pickle Bill on stock market prices is felt to be in the neighborhood of a 5 percent increase. This estimate is based on several facts:

1. The observed premium in the price of Citizens' Utilities Series A stock over its Series B. Series A stock pays dividends per share in stock which are of exactly equal value to the cash dividend paid on a share of Series B stock. The two types of stock have the same voting rights and Series A is convertible into Series B on a one for one basis at the option of the holder. By not taking cash dividends the holders of Series A leave the company in substantially the same financial position, as though they had reinvested cash dividends in original issue stock. By a "grandfather" authority, dividends on Citizens Utilities A series are treated for tax purposes in the same way as

reinvested dividends would be treated under the Pickle Bill. Since Series A and Series B stock share in the same earnings, the bulk of the price difference between them should reflect the tax advantage of Series A.

Accordingly, the Citizens Utilities case offers a real-world measurement of the premium investors would be willing to pay for the tax advantage conferred by the Pickle Bill. The observed premium (which has varied between zero and 20 percent over the last 10 years, and averaged close to 15 percent over the month or so prior to this writing) is regarded as not fully representative of the corresponding premium associated with the Pickle Bill. This is for the following four reasons:

a. The Series A can be forcibly converted into Series B shares on a one for one basis at the option of the Board of Directors.

b. The tax advantage of Series A seems not to be widely understood. For example, neither Moody's nor Standard and Poor's standard literature on the company makes any mention of it. Put another way, relatively few investors

may be aware of the different nature of the A Series dividend compared to the less attractive conventional stock dividend.

c. Presumably because of the timing of issuance of new Series A stock dividend shares, the way the company's financial results have been stated has shown an earnings per share lower on Series A than on Series B, even though dividends per share are guaranteed to be of equal value.

d. The stock has been somewhat of a growth stock with both Series A and B averaging an annual growth of 3 percent over the last decade.

2. The difference in yields between tax-free municipal bonds and comparable corporate bonds has averaged 30 percent. This corresponds to the maximum premium that would be paid by an investor in the 30 percent federal income tax bracket. If the same federal tax bracket were to be decisive in determining the value of a tax privilege like that contemplated by the Pickle Bill, the corresponding premium can be

calculated by $\frac{(1-t_g)}{(1-t_p)}$ with $t_p = .30$, $t_g = .15$ namely 1.21 (or a premium of 21 percent.

Although it is believed that a 21 percent premium would be a reasonable outcome if the Pickle privilege were confined to a relatively small portion of dividends, it is felt that a 5 percent increase is more appropriate for the stock market as a whole if dividend participation in OI DRPs is at the rate anticipated in basic (most likely) estimates.

3. The authors of the SIA-DRI and the DRI studies cited in this report assumed a 10 percent stock market price increase as likely to follow from the partial integration tax reduction on dividend income. This proposal would have increased the yield on equity investments by about the same proportion as the Pickle Bill would do for the average investor. However, the authors of these studies did not mention (and might not have been aware of) the fact that their gross revenue loss (i.e., ignoring feedback) of $8.4 billion corresponded to the abolition of <u>all</u> tax on personal dividend income.

4. For comparative purposes it may be noted that Michael K. Evans, President of Chase Econometrics, in a recent letter to the Wall Street Journal, stated that a careful study of relations between capital gains tax rates and stock price changes (as well as other factors) led to the conclusion that a reduction in gains taxes to 1969 levels would lead to a 40 percent increase in stock prices.

TESTIMONY OF GEORGE H. LAWRENCE, PRESIDENT, THE AMERICAN GAS ASSOCIATION BEFORE THE TAXATION AND DEBT MANAGEMENT GENERALLY OF THE SENATE FINANCE COMMITTEE ON S. 1543 OCTOBER 31, 1979

Mr. Chairman and Members of the Subcommittee:

I am George H. Lawrence, President of the American Gas Association (A.G.A.). A.G.A. is a national trade association made up of over 300 natural gas transmission and distribution companies in all 50 states. In serving over 160 million customers, A.G.A. member companies account for approximately 85% of all gas utility sales in our nation. We appreciate this opportunity to present our views on S. 1543.

A.G.A. is undertaking a survey of approximately 200 Chief Executive Officers of A.G.A. member companies, we have learned that, of 87 responses thus far, 52 of the CEOs report having a dividend reinvestment program of some type. Therefore, legislation providing an incentive for such reinvestment programs which ultimately result in increased capital formation is highly desirable.

Summary of A.G.A. Comments

- Generally, studies reveal that dividend reinvestment would have a stimulative impact on the economy and ultimately result in a net tax revenue gain. (see I, infra)
- Dividend reinvestment relieves, to a certain extent, taxation of dividends at the shareholder level and thereby provides an incentive to capital formation which is particularly desirable in light of the present recession. (see II, infra)

- Dividend reinvestment is an equitable measure insofar as it provides benefits to its participants which are similar to those a shareholder receives from a conventional stock dividend program. (see III, infra)

- The dividend reinvestment program creates an incentive encouraging individual savings which can be used as supplemental retirement income. (see IV, infra)

I. S. 1543 Would Have a Stimulative Impact on the Economy

An independent appraisal of the potential economic impact of a dividend reinvestment program (substantially similar to S. 1543) was conducted by Robert R. Nathan Associates, Inc. (RRNA) and revealed the following findings:

- Such legislation would have a stimulative impact on the economy and after three years (measured in 1978 dollars) would:

  -- increase national annual output on the order of $10 billion;

  -- stimulate business-fixed investment by close to $3.5 billion annually; and

  -- reduce national rate of unemployment by adding approximately 200,000 jobs per year.

- Such legislation would have a range of tax revenue effects. In the first year, on a static basis, there would be a revenue loss of $300 - $400 million; and on a dynamic basis (i.e., accounting for increased participation and feedback effects) there would be more than a $1 billion loss. A "wash" is forecast for the second year while there would be a net revenue gain of $1.5 to $2 billion in the third and fourth years.

  (It should be noted that RRNA arrived at these figures for a bill proposed in the 95th Congress. That bill, although substantially similar to S. 1543, did not include a "cap" limiting a shareholder's annual participation to $1,500 for an individual and $3,000 for a joint return. The Nathan firm's revised estimates show that a "cap" similar to that in S. 1543 would reduce the first year revenue loss to about $300 million; result in a "wash" the second year; and yield a net revenue gain of about $500 million in the third and successive years, respectively.)

- In light of the beneficial economic efforts and the resulting gains to the national Treasury, legislation such as S. 1543 is in the national interest.

II. Capital Formation Incentives Are Desirable

The most salient policy feature of the S. 1543 dividend reinvestment program is that it would encourage capital formation. At a time when many economists are predicting a long-lasting recession, such encouragement is highly desirable. Because the dividends are immediately converted into new common stock capital, the dividend reinvestment program provides substantial and direct aid in the formation of new capital. Generally speaking, such programs have been adopted in companies having the greatest need for new capital; therefore, this legislation would allow capital formation to take place where it is most urgently needed at present.

A.G.A. estimates regulated gas industry capital requirements of more than $300 billion (1978 dollars) through the year 2000. This breaks down generally into $85 billion for pipeline construction and maintenance; $85 billion for exploration and development; and $130 billion for total supplemental requirements. These figures appear particularly large in light of the regulated gas industry's total capitalization of less than $60 billion on December 31, 1978.

Additionally, to the extent that regulated industry is required to flow through tax incentives intended to aid capital formation, a general corporate tax rate reduction may not benefit regulated industries. Therefore, A.G.A. acknowledges this legislation as a positive incentive to capital formation that could benefit all industry both regulated and nonregulated.

This legislation would not impose a tax at the stockholder level when dividends are reinvested in the corporation. In this

manner, the proposal is a significant step in the direction of reducing double taxation of corporate dividends. This is a desirable goal insofar as it permits cash to be "plowed back" into the company possibly leading to additional taxable earnings at the corporate level.

III. S. 1543 Provides for More Equitable Treatment for Shareholders

As a practical matter, this dividend reinvestment program provides more equitable treatment deserved by its participants as compared to recipients of conventional stock dividends. Many stockholders would prefer stock dividends rather than cash for tax deferral reasons. However, many companies may be unable to substitute a conventional stock dividend plan in lieu of distributing cash dividends. Under the program proposed by S. 1543, such stockholders would be afforded the tax deferral benefits which are at present available only to recipients of conventional stock dividends.

IV. Dividend Reinvestment Encourages Individual Savings

Finally, stockholders would participate in the program during a period in which they do not require the cash dividends. This would in turn encourage individual savings to provide for their needs in the future in the form of supplemental retirement income. In this respect, this legislation is based on desirable national objectives analogous to those behind Keogh and IRA programs. Hence, the favorable tax treatment afforded these programs is warranted for dividend reinvestment. Such treatment is provided by S. 1543.

In conclusion, A.G.A. recognizes that S. 1543 is a desirable program for dividend reinvestment and would have the positive effect of aiding capital formation for capital intensive industries.

Stockholders of America, inc.

INVESTORS IN AMERICA

THE VOICE OF 25 MILLION

1625 EYE STREET, N.W. WASHINGTON, D. C. 20006 (202) 783-3430

SUMMARY

MY NAME IS MARGARET COX SULLIVAN AND I AM PRESIDENT OF STOCKHOLDERS OF AMERICA, INC., A SEVEN-YEAR OLD, NONPROFIT, NONPARTISAN ORGANIZATION DEDICATED TO REPRESENTING THE INTERESTS OF STOCKHOLDERS IN PUBLICLY HELD AMERICAN CORPORATIONS AND I AM HERE TODAY IN SUPPORT OF (S. 1543), FROM THE STOCKHOLDER VIEWPOINT.

THERE ARE NOW 25 MILLION OF US WHO CURRENTLY OWN STOCK IN 11,000 PUBLICLY OWNED CORPORATIONS (NYSE STATISTIC). THIS MEANS THAT ONE OUT OF EVERY SIX ADULTS IN THE UNITED STATES IS A STOCKHOLDER, OR STATED DIFFERENTLY, INDIVIDUAL STOCKHOLDERS COMPRISE 11.8% OF THE TOTAL POPULATION. THEY ARE FROM EVERY WALK OF LIFE AND THEY HAVE ONE COMMON INTEREST - THEY ARE INVESTORS IN THE EQUITY CAPITAL MARKETS.

THEY HAVE BEEN CALLED THE BACKBONE OF OUR FREE ENTERPRISE SYSTEM, A SYSTEM THAT IS NOW IN TROUBLE. SOMETHING HAS HAPPENED WHICH SHOULD BE VIEWED WITH ALARM. THERE HAS BEEN A SHARP DECLINE IN THE NUMBER OF STOCKHOLDERS. ACCORDING TO STATISTICS RELEASED BY THE NEW YORK STOCK EXCHANGE, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DECLINED BY 18% FROM 1970-75. DURING THESE YEARS, THE STOCKHOLDER POPULATION SLID FROM APPROXIMATELY 32 MILLION TO 25 MILLION AND THE AVERAGE AGE OF INVESTORS HAS MOVED FROM THE HIGH 40'S TO THE MID-50'S, THUS POINTING TO THE FACT THAT YOUNGER PEOPLE ARE SHUNNING THE MARKET. FOR THE FIRST TIME SINCE 1952, WHEN SUCH STATISTICS WERE INITIALLY RECORDED, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DID NOT SUBSTANTIALLY INCREASE AND THIS IS AT A TIME WHEN THE CAPITAL NEEDS OF THE COUNTRY HAVE NEVER BEEN GREATER. IN FACT, THE 1979 JOINT ECONOMIC COMMITTEE REPORT STATED THAT THE UNITED STATES NOW RANKS SEVENTH IN PRODUCTIVITY, CAPITAL INVESTMENT, AND ECONOMIC GROWTH,

AFTER JAPAN, WEST GERMANY, ITALY, FRANCE, CANADA, AND GREAT BRITAIN.

(S. 1543) IS CERTAINLY A STEP IN THE RIGHT DIRECTION AND PROVIDES DIRECT AND IMMEDIATE HELP IN THE FORMATION OF NEW CAPITAL SO ESSENTIAL TO INDUSTRY. COMPANIES NEED TO GENERATE EQUITY CAPITAL INTERNALLY RATHER THAN GO TO THE CAPITAL MARKETS WHERE SOME HAVE BEEN BORROWING LARGE SUMS AT HIGH INTEREST RATES - RATES THAT ARE GOING EVEN HIGHER. THIS LEGISLATION WOULD ALLOW THE COMPANIES TO DECREASE THEIR DEPENDENCE ON OUTSIDE FINANCING, AVOID ITS EXPENSE, AND STILL RAISE NEEDED EQUITY.

FURTHER, AND MOST IMPORTANTLY, FROM OUR POINT OF VIEW, IT IS ATTRACTIVE TO THE STOCKHOLDERS. DIVIDENDS REINVESTED IN ORIGINAL ISSUE STOCK UNDER A QUALIFIED DIVIDEND REINVESTMENT PLAN WOULD BE EXEMPT FROM THE STOCKHOLDERS'S INDIVIDUAL FEDERAL INCOME TAX. THIS IS AN INVESTMENT INCENTIVE FOR THE CURRENT AND THE POTENTIAL STOCKHOLDERS OR THOSE STOCKHOLDERS WHO HAVE LEFT THE MARKET. THE MARKETPLACE NEEDS THESE INDIVIDUALS AND THEY MUST BE ATTRACTED BACK.

EQUITY INVESTMENT FULFILLS AN UNIQUE PLACE IN OUR SYSTEM. IT CREATES THE CAPITAL THAT PERMITS MODERNIZATION OF PLANT FACILITIES, IMPROVES PRODUCTIVITY, ALLOWS CAPITAL FOR RESEARCH AND DEVELOPMENT FOR NEW TECHNOLOGIES, AND CREATES JOBS - ALL OF WHICH LEADS TO A SOUND AND HEALTHY NATIONAL ECONOMY.

Stockholders of America, inc.

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STATEMENT FOR

THE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE

96TH CONGRESS

ON

S. 1543

RELATING TO TAX TREATMENT OF QUALIFIED DIVIDEND REINVESTMENT PLANS

BY

MARGARET COX SULLIVAN
PRESIDENT
STOCKHOLDERS OF AMERICA, INC.
WASHINGTON DC

OCTOBER 31, 1979

A NATIONAL NON-PROFIT NON-PARTISAN ORGANIZATION
ESTABLISHED 1972

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THIS DISTINGUISHED COMMITTEE ON BEHALF OF STOCKHOLDERS OF AMERICA, INC. MY NAME IS MARGARET COX SULLIVAN AND I AM PRESIDENT OF THIS SEVEN-YEAR OLD NONPROFIT, NONPARTISAN ORGANIZATION DEDICATED TO REPRESENTING THE INTERESTS OF STOCKHOLDERS IN PUBLICLY HELD AMERICAN CORPORATIONS.

WE ARE GRATEFUL THIS COMMITTEE IS CONCERNED WITH INVESTMENT-RELATED TAX MEASURES. A CONCERN, I NEED NOT ADD, VITAL TO STOCKHOLDERS AND THEIR COMPANIES.

THERE ARE NOW 25 MILLION OF US WHO CURRENTLY OWN STOCK IN 11,000 PUBLICLY OWNED CORPORATIONS (NYSE STATISTIC). THIS MEANS THAT ONE OUT OF EVERY SIX ADULTS IN THE UNITED STATES IS A STOCKHOLDER, OR STATED DIFFERENTLY, INDIVIDUAL STOCKHOLDERS COMPRISE 11.8% OF THE TOTAL POPULATION. STOCKHOLDERS ARE A VERY DIVERSIFIED GROUP OF AMERICANS FROM EVERY STATE ACROSS THE COUNTRY AND FROM EVERY WALK OF LIFE, NOT JUST A FEW OF THE SO-CALLED RICH - AND THEY HAVE ONE COMMON INTEREST - THEY ARE INVESTORS IN THE EQUITY CAPITAL MARKETS. THEY ARE CAPITALISTS AND IT IS OUR CAPITALISTIC SYSTEM - CALLED FREE ENTERPRISE OR PEOPLE'S CAPITALISM - THAT HAS PROVIDED A MECHANISM FOR ITS PEOPLE TO BUILD OUT OF A WILDERNESS THE GREATEST INDUSTRIALIZED COUNTRY IN THE WORLD - A NATION THAT ENJOYS THE HIGHEST STANDARD OF LIVING. ANY INDIVIDUAL CAN INVEST IN AND OWN A SHARE OF MOST AMERICAN CORPORATIONS. HE OR SHE CAN BECOME A

PART OWNER WITH VOTING RIGHTS AND PARTICIPATE IN THE GROWTH OF THE ENTERPRISE AND THE COUNTRY. AN INTERESTING NEW YORK STOCK EXCHANGE STUDY REVEALED THAT 71% OF THE STOCKHOLDERS HAVE AN ANNUAL INCOME OF LESS THAN $25,000. FIFTY PERCENT OF THE STOCKHOLDERS HAVE STOCK PORTFOLIOS VALUED AT LESS THAN $10,000. MAYBE THAT IS WHY THEY ARE CALLED THE LITTLE GUYS. IT IS A GREAT SYSTEM; IT HAS MADE US A NATION OF OWNERS.

THE SUCCESS AND STRENGTH OF THAT SYSTEM COMES FROM THIS LARGE DIVERSIFIED OWNERSHIP BASE OF STOCKHOLDERS. JUST AS THE MILLIONS OF WORKERS IN THE LABOR FORCE SUPPLY LABOR SERVICES, SO CAPITAL SERVICES ARE SUPPLIED BY THE CAPITAL FORCE. THE INDIVIDUAL INVESTORS HAVE BEEN CALLED THE BACKBONE OF THIS SYSTEM; THEY ARE THE MAIN SOURCE OF EQUITY CAPITAL.

YET SOMETHING HAS HAPPENED WHICH SHOULD BE VIEWED WITH ALARM. ALTHOUGH WE STILL ARE 25 MILLION STRONG, THERE HAS BEEN A SHARP DECLINE IN THE NUMBER OF STOCKHOLDERS. ACCORDING TO STATISTICS RELEASED BY THE NEW YORK STOCK EXCHANGE, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DECLINED BY 18% FROM 1970-75. DURING THESE YEARS, THE STOCKHOLDER POPULATION SLID FROM APPROXIMATELY 32 MILLION TO 25 MILLION AND THE AVERAGE AGE OF INVESTORS HAS MOVED FROM THE HIGH 40'S TO THE MID-50'S, THUS POINTING TO THE FACT THAT YOUNGER PEOPLE ARE SHUNNING THE MARKET. FOR THE FIRST TIME SINCE 1952, WHEN SUCH STATISTICS WERE INITIALLY RECORDED, THE NUMBER OF INDIVIDUAL STOCKHOLDERS DID NOT SUBSTANTIALLY INCREASE. THIS IS ALARMING, PARTICULARLY IN THESE TIMES WHEN THE CAPITAL NEEDS OF THE COUNTRY HAVE

NEVER BEEN GREATER.

IT HAS BEEN ESTIMATED THAT OVER THE NEXT TEN YEARS AMERICAN INDUSTRY WILL NEED $5 TRILLION. WE HAVE ALLOWED OUR GREAT AMERICAN BUSINESS MACHINE TO GET RUSTY, OUR EQUIPMENT IS BECOMING OBSOLETE, AND MANY INDUSTRIES OPERATE SHORT OF CAPACITY. WE HAVE TO REALIZE THAT 67% OF ALL METAL WORKING MACHINERY IN THIS COUNTRY IS MORE THAN 13 YEARS OLD, WHEREAS IN JAPAN THE FIGURE IS ONLY 30% AND IN GERMANY 37%. THAT'S TYPICAL OF ALL OUR PLANT AND EQUIPMENT; AND IT SHOWS WHY OUR LONG-TERM PRODUCTION ADVANTAGES ARE FADING. IN FACT, THE 1979 JOINT ECONOMIC COMMITTEE REPORT STATED THAT THE UNITED STATES NOW RANKS SEVENTH IN PRODUCTIVITY, CAPITAL INVESTMENT, AND ECONOMIC GROWTH, AFTER JAPAN, WEST GERMANY, ITALY, FRANCE, CANADA, AND GREAT BRITAIN.

WE MUST REBUILD OUR INDUSTRIAL ENGINE AND EXPAND OUR ECONOMY AND THAT IS WHY WE ARE HERE TODAY IN SUPPORT OF (S. 1543). THIS LEGISLATION IS CERTAINLY A STEP IN THE RIGHT DIRECTION AND PROVIDES DIRECT AND IMMEDIATE HELP IN THE FORMATION OF NEW CAPITAL SO ESSENTIAL IN CAPITAL INTENSIVE INDUSTRIES, SUCH AS THE UTILITIES INDUSTRY, THE AUTOMOBILE INDUSTRY, STEEL, TRANSPORTATION, AND COAL MINING. FURTHER, IT PROVIDES A SIMPLE, CONVENIENT, AND TAX EXEMPT WAY TO ENCOURAGE INDIVIDUAL SAVING PLUS BUILDING THE INDIVIDUAL STOCKHOLDER'S INVESTMENT. THIS IS ATTRACTIVE - AN INVESTMENT INCENTIVE FOR THE CURRENT AND THE POTENTIAL STOCKHOLDERS OR THOSE STOCKHOLDERS WHO HAVE LEFT THE MARKET. THE MARKETPLACE NEEDS THESE INDIVIDUALS AND THEY MUST BE ATTRACTED BACK.

THE COMPANIES NEED TO GENERATE EQUITY CAPITAL INTERNALLY RATHER THAN GO TO THE CAPITAL MARKETS WHERE SOME HAVE BEEN BORROWING LARGE SUMS AT HIGH INTEREST RATES - RATES THAT ARE GOING EVEN HIGHER. THERE HAS BEEN A DANGEROUS INCREASE IN DEBT/EQUITY RATIOS IN RECENT YEARS. CLIMBING DEBT RATIOS MAKE BUSINESS HIGHLY VULNERABLE TO BUSINESS CYCLE CHANGES. THE GROWTH OF HIGH DEBT RATIOS IS A VERY UNDESIRABLE DEVELOPMENT WHICH TENDS TO CAUSE BANKRUPTCIES, GENERALLY SUPPRESSES ECONOMIC GROWTH, AND STYMIES THE ABILITY OF BUSINESS TO EXPAND AND MODERNIZE.

THIS LEGISLATION WOULD ALLOW THE COMPANIES TO DECREASE THEIR DEPENDENCE ON OUTSIDE FINANCING, AVOID ITS EXPENSE, AND STILL RAISE NEEDED EQUITY. BY KEEPING CAPITAL COSTS DOWN, THE COMPANIES MAY BE ABLE TO PASS THE SAVINGS ON TO THEIR STOCKHOLDERS - PERHAPS TO THE CONSUMERS AS WELL.

(S. 1543) PROPOSES A VERY SIMPLE TECHNIQUE. DIVIDENDS REINVESTED IN ORIGINAL ISSUE STOCK UNDER A QUALIFIED DIVIDEND REINVESTMENT PLAN WOULD BE EXEMPT FROM THE STOCKHOLDER'S INDIVIDUAL FEDERAL INCOME TAX. STOCK PURCHASED IN THIS MANNER WOULD BE TREATED SIMILARLY TO STOCK DIVIDENDS AND SUBJECT TO CAPITAL GAINS TAX WHEN SOLD. STOCK MUST BE KEPT AT LEAST A YEAR TO QUALIFY UNDER THIS LEGISLATION. THE INDIVIDUAL STOCKHOLDER WOULD BE ABLE TO EXCLUDE ONLY UP TO $1,500 PER YEAR OF HIS/HER DIVIDEND INCOME, $3,000 FOR THOSE FILING JOINTLY.

ACCORDING TO A RECENT WALL STREET JOURNAL ARTICLE, IT IS

ESTIMATED THAT SOME 20% OF THE CAPITAL RAISED LAST YEAR WAS RAISED THROUGH THE PRESENT TYPE DIVIDEND REINVESTMENT PLAN TECHNIQUE. CERTAINLY WITH THIS ADDITIONAL TAX INCENTIVE THE AMOUNTS WOULD GREATLY INCREASE - AND THE NUMBER OF COMPANIES ESTABLISHING SUCH A PLAN WOULD GROW. ACCORDING TO OUR BEST RESEARCH, THERE ARE NOW APPROXIMATELY ONE THOUSAND COMPANIES OFFERING A REINVESTMENT DIVIDEND PLAN BUT ONLY ABOUT 138 COMPANIES WITH THE ORIGINAL ISSUE APPROACH.

WHILE (S. 1543) WILL PROVIDE CONSIDERABLE DIRECT AND IMMEDIATE HELP IN THE FORMATION OF NEW CAPITAL BY LIMITING THE TAX EXEMPT STATUS TO REINVESTMENT IN ORIGINAL ISSUE STOCK AND IS A STEP IN THE REDUCTION OF THE DOUBLE TAX ON DIVIDENDS, AND THIS IS GOOD, IT MUST NOT BE OVERLOOKED THAT THE DOUBLE TAX ON ALL DIVIDENDS IS UNFAIR AND UNJUST. FURTHER LEGISLATION SHOULD BE CONSIDERED TO ELIMINATE THIS INEQUITY.

AS WE ALL KNOW, EQUITY INVESTMENT FULFILLS AN UNIQUE PLACE IN OUR SYSTEM. IT CREATES THE CAPITAL THAT PERMITS MODERNIZATION OF PLANT FACILITIES, IMPROVES PRODUCTIVITY, ALLOWS CAPITAL FOR RESEARCH AND DEVELOPMENT FOR NEW TECHNOLOGIES, AND CREATES JOBS - ALL OF WHICH LEADS TO A SOUND AND HEALTHY NATIONAL ECONOMY.

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Summary Testimony of

WILLIAM MALONE
Vice President
General Telephone & Electronics Corporation
on behalf of the
UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION

before the
Subcommittee on Taxation and Debt Management
of the
Senate Committee on Finance
October 31, 1979

The United States Independent Telephone Association*/ supports S. 1543, co-sponsored by Senators Nelson, Bentsen, Tower, and Schmitt, which would defer taxation of reinvested dividends.

The telephone industry -- being capital intensive -- requires a steady stream of equity funds to support its high level of investment in new communications facilities, year-in and year-out. Reinvested dividends are already an important

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*/ The United States Independent Telephone Association (USITA) represents the Independent (non-Bell) segment of the telephone industry in the United States. The Independent telephone industry consists of 1,500 telephone companies serving over thirty million telephones through 11,000 exchanges in over one-half of the served geographic area of the Nation. A map showing Independent-served areas of the United States and a state-by-state tabulation of Independent company statistics are attached as Exhibits A and B. These companies, together with the operating companies of the Bell System, provide exchange and inter-exchange telecommunications service through the integrated facilities of the telephone network.

The Independents' investment in plant and facilities is now $28 billion, and total plant investment is the equivalent of $156,000 per employee. About $3.5 billion was spent in 1978 for upgrading service and facilities, and the comparable figure for 1979 is estimated to be $3.8 billion.

source of equity capital for many corporations, and S. 1543 would make it more attractive for additional shareholders to reinvest their dividends.

As it is, shareholders participating in automatic reinvestment plans must pay taxes on dividends without having received any hard cash with which to pay the tax. This is particularly burdensome to small shareholders, who as a group have a much higher level of participation in existing dividend reinvestment plans. Chart 1 shows that GTE shareholders with fewer than 50 shares are ten times more likely to reinvest their dividends than are GTE shareholders with over a thousand shares. Analysis shows that 84 percent of the GTE plan's participants own one hundred shares or less.

S. 1543 would contribute significantly to tax equity or "neutrality" among investors in utility and non-utility stocks. Traditionally investors in utility stocks have sought a high dividend yield. As a result the utilities have a significantly higher dividend pay-out ratio than non-utilities. Because a substantial proportion of shareholders currently invest in utilities for dividend income rather than capital gains, the utilities do not have the same degree of flexibility to alter their dividend payout ratios as do industrial firms. The

importance of dividend payout to utility investors can be illustrated best by the traumatic experiences of Consolidated Edison when it omitted a dividend payment in 1974 and General Public Utilities when it unsuccessfully attempted to switch from cash to stock dividends.**/ Thus, while a non-utility may provide a return to investors through growth -- on which taxation of gain is deferred until sale and then taxed at capital gains rates, -- the utility as a practical matter must pay out a substantial part of earnings -- which are now taxed on a current basis at ordinary rates.

The discrimination is seen most clearly in the cases of stockholders of a high-growth company, who receive only stock dividends which are not subject to tax, and stockholders of a low-growth, high-payout company, who receive stock under an automatic dividend investment plan after paying tax up front. S. 1543 would remove this discrimination, which results in a higher cost of capital to the utilities -- a cost that is reflected in higher rates to consumers.

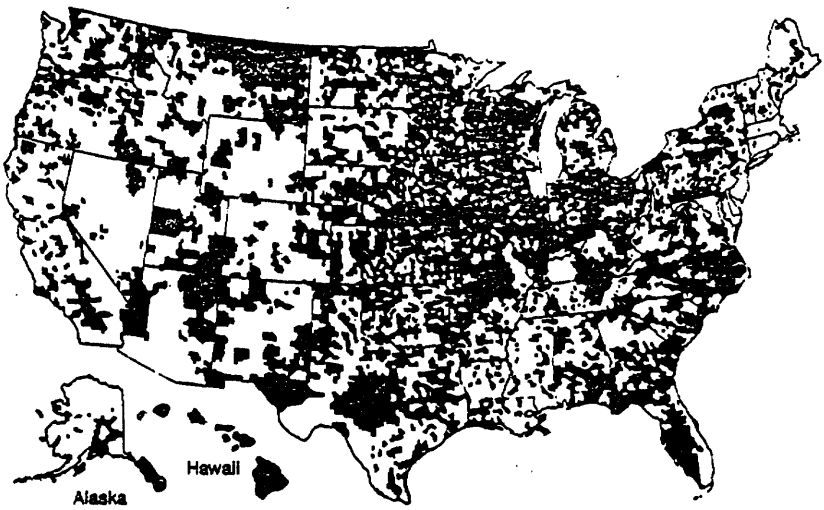
Finally, deferral of taxation on reinvested dividends would be a step toward elimination of double taxation of corporate dividends. S. 1543 would at least defer taxes on reinvested dividends.

USITA urges that S. 1543 be adopted.

**/ "A Case for Dropping Dividends," Fortune, June 15, 1968.

EXHIBIT A

UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION (USITA)



INDEPENDENT TELEPHONE COMPANIES
SERVE 51% OF THE SERVED AREA
OF THE UNITED STATES

EXHIBIT B

INDEPENDENTS BY STATE

December 31, 1978

State	Companies	Telephones
Alabama	31	406,500
Alaska	22	240,000
Arizona	6	75,000
Arkansas	31	405,600
California	23	4,224,100
Colorado	26	36,200
Connecticut	2	18,300
Florida	16	2,561,600
Georgia	34	548,500
Hawaii	1	661,300
Idaho	12	135,600
Illinois	60	1,709,100
Indiana	53	1,434,000
Iowa	158	702,000
Kansas	44	301,600
Kentucky	18	635,300
Louisiana	22	156,500
Maine	17	92,400
Maryland	1	4,300
Massachusetts	3	3,900
Michigan	50	888,100
Minnesota	95	646,000
Mississippi	21	71,700
Missouri	46	729,000
Montana	16	96,500
Nebraska	52	524,200
Nevada	4	477,700
New Hampshire	11	35,000
New Jersey	5	143,400
New Mexico	10	104,100
New York	46	1,155,400
North Carolina	28	1,824,500
North Dakota	20	138,600
Ohio	49	1,900,000
Oklahoma	36	299,700
Oregon	34	504,700
Pennsylvania	52	1,792,600
South Carolina	26	549,200
South Dakota	32	103,800
Tennessee	24	504,600
Texas	81	1,874,800
Utah	10	35,900
Vermont	8	48,100
Virginia	20	784,200
Washington	39	777,800
West Virginia	7	147,800
Wisconsin	114	1,018,800
Wyoming	11	20,500
Total:	1,527	31,548,500

CHART 1

GTE DIVIDEND REINVESTMENT PLAN
SHAREHOLDER PARTICIPATION

Shareholders		Plan Participation	
Shares Held	Registered Shareholders	Participants	Percent Participation
1-50	210,538	62,069	29.5%
51-100	107,456	17,415	16.2
101-200	67,399	9,420	14.0
201-500	52,198	4,338	8.3
501-1,000	12,850	900	7.0
1,001-over	7,376	208	2.8
Total	457,817	94,350	20.6%

Senator CHAFEE. OK, we are honored by having the very distinguished Senator from North Carolina, Senator Morgan, testifying on behalf of S. 555.

Senator MORGAN. Thank you, Mr. Chairman.

Senator CHAFEE. We are delighted to have you here, Senator.

STATEMENT OF HON. ROBERT MORGAN, A U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator MORGAN. Mr. Chairman, if it is all right with you, I will stand. After 30 years as a lawyer where you had to stand up to talk it is sort of hard for me to speak sitting down.

Senator CHAFEE. All right. I am somewhat familiar with this bill. Folks have come to speak to me about it, so why don't you go ahead.

Senator MORGAN. Well, thank you, Mr. Chairman.

I will be very brief because we had hearings on this bill last year and the record, I think, is replete with information on it.

But Mr. Chairman, I became concerned when I was Attorney General about the accumulation or concentration of the ownership of newspapers. I think as the record will show, today about 72 percent of the daily newspapers, and 76 percent of all of the Sunday circulation is now controlled by chain operations, and by that I mean those chains that operate across State lines.

Well, as Attorney General I looked at the possibility of antitrust actions, and they just aren't practical, and we had Mr. Shenefield from the U.S. Justice Department testify before our Small Business Committee, and it is just not practical.

But what has happened, as you understand, is there is such a demand now for newspapers, especially since they have gone to offset and they are now making some money for a change after all these years, that many of these chains will pay almost any price for newspapers.

The New York Times owns three in my State that I know of. A company based in London owns one of the daily papers in our State. Freedom Chain owns a number of papers. What is happening, they will come by, and they will offer these independent, generally family-owned papers such enormous amounts of money for their papers that this sets an unrealistic high rate for tax purposes, and this is what IRS is using when they value them for inheritance taxes, which is far——

Senator CHAFEE. How can the chain pay 20 or 30 times earnings and themselves make money? I have never understood that.

That is—they are doing it, but I don't suppose you want to spend too much time on that, but I am curious.

Senator MORGAN. Well, I——

Senator CHAFEE. Are there that much savings in mass, as it were? What is the code word, savings for volume, when you have got a variety of papers? I don't know how. They buy newsprint in mass ways.

Senator MORGAN. I don't know on your question, but let me say to the Chair that Mr. Morris Levin and Mr. Joseph Iannucci who are counsel for the Independent Local Newspaper Association, are with me, and in just a minute I would like for them to speak on that point.

But because of that, the taxes are just exorbitant, and family-owned papers simply have to sell. And I had some very fine testimony from a newspaperman down in my home State that we will make available to the committee.

But all this bill does is it provides some way that they can put up to half of their pretax earnings into a trust, into government securities, which would enable them to pay taxes after death.

Now, some of my newspaper friends said we don't want any special treatment. Well, I said to them, we are not giving you any special treatment. We are not doing it for the benefit of the newspaper people, we are doing it for the benefit of trying to preserve a free press, and I think that is important.

Mr. Jim Batten, the vice president of Knight-Ridder, who used to be in my State and is a very fine man, he testified. He said as long as the Knight-Ridder chain was run by the Knights, the people who were journalists, he wasn't concerned about what would happen to them in the ownership. But the trouble is they are on the big board. You don't know when Mobil Oil or Exxon or somebody else is going to take them over.

So we aren't doing this for the benefit of the newspapers. We are doing it for the benefit of the public in whose interest it is to maintain a free press.

And the urgency of this, Mr. Chairman, is that since—this is Mo Udall's bill, I wish I could claim authorship—since I have been working on this bill, we have averaged losing 1 independent newspaper per week, over 50. The gentleman from the Nashville Tennessean, John Siegenthaler, who worked with us, testified last time, lo and behold, his paper was sold since we were here last time, for something like $50 million. So there really is some urgency on it.

Now, my caution light is on, but I wonder if the chairman would allow——

Senator CHAFEE. Sure, yes, you go ahead, Senator. You have our witnesses speak.

Senator MORGAN. All right, if you will allow me, I will go back to the Senate.

Senator CHAFEE. All right, fine. Thank you very much, Senator Morgan. We appreciate your testimony.

Senator MORGAN. Mr. Chairman, I have a prepared statement and material, and I would like to submit some figures which I think might respond to those submitted by the Treasury.

Senator CHAFEE. Perfect, fine. We will submit those.

[The prepared statement and material of Senator Morgan follow. Oral testimony is continued on p. 448.]

Testimony
Senator Robert Morgan
Before the Senate Finance Subcommittee on Taxation and Debt Management
Regarding S. 555, The Independent Local Newspaper Act of 1979
October 31, 1979

Mr. Chairman, I welcome this opportunity to come before the Finance Subcommittee on Taxation and Debt Management regarding S. 555, a bill to assist in the preservation of local independent newspapers.

Background

As you may know, this legislation was introduced last year by Congressman Morris Udall in the House and by myself here in the Senate. Due to time pressure late in the 95th Congress, we were unable to have floor consideration.

Since the bill's reintroduction this year and with the growing awareness among members of the Senate about the problems facing independent newspapers, the number of sponsors for S. 555 has grown to twenty-eight.

This spring I chaired hearings before the Select Committee on Small Business to inquire into the problems facing independent ownership of newspapers. While many witnesses addressed the incentives for selling to a chain, the problems of holding onto capital under the tax code and the need for overall small business tax reform, every witness agreed that the estate taxes in this country create a special problem for independent newspapers.

S. 555

Let me briefly review the problem and discuss the solution which is contemplated in S. 555.

At present there is a total of about 1750 daily newspapers in the United States. While this number has remained constant, the ownership has changed. Only about 600 remain independent. Today, 72% of the daily and 76% of the Sunday circulation are controlled by chain operations.

One reason that independent owners have decided to sell to chains is the heavy burden their heirs will face in estate taxes. With chains paying 40 and 50 times the annual earnings of independent papers with the hope of getting a tax write-off or cashing in on inflation, the IRS has valued newspapers at a level far about what is the normal valuation for a business, routinely about 5 to 15 times annual earnings. Newspaper stocks sell at 10 to 13 times earnings, but the IRS bases valuation on what a willing seller will pay a buyer.

Faced with the enormous amount of tax, with large cash offers from chains and with little financial incentive to hold on to this important community service, the owners

have sold out. They are selling out at a rate of one a week to chains.

Mr. Chairman, since Congressman Udall introduced the companion bill to S. 555 in 1977, over 100 papers have been sold to chains and since I introduced S. 3441 in August of 1978, more than 50 papers have been sold to chains.

S. 555 is an attempt to bring some relief in this area. Under this bill, a trust could be established by an independent newspaper into which up to 50% of pretax income could be contributed for the sole purpose of paying estate taxes. Overfunding or a sale of the paper would result in stiff penalties.

There is no reduction of the estate tax under this bill. The heirs would have to pay the tax out of the trust. Extension of time for payment, as permitted in closely held corporation estates, is allowed, but a recapture clause exists which would penalize an heir who attempts to take advantage of the tax benefit and sell the paper within 15 years of the death of the owner. The bill does not provide tax exemptions, but a pre-payment device for independent newspapers.

Mr. Chairman, this is a complex bill. It is designed that way. The Senate has attempted to provide tax relief for the small farmer by passing laws on valuation. The IRS has seen fit to regulate these provisions off the books. This bill goes another route from valuation and attempts to resolve some of the regulatory issues ahead of time.

S. 555 has been endorsed by the Newspaper Guild and by the International Typographer's Union. I believe that this legislation addresses a problem recognized by all of those who are familiar with the newspaper business.

Answer to Criticism

In this vein, let me address some of the objections to this bill which have arisen during the House Ways and Means Committee hearings this summer.

Why don't we simply go the antitrust route? The answer was well put by John Shenefield, head of the Antitrust Division of the Department of Justice, in testimony before the Small Business Committee earlier this year. I will submit a copy of that hearing for the Committee's files. Mr. Shenefield indicated, as he did again in an article in the American Bar Association Journal, which I will include for the hearing record, that existing antitrust laws do not adequately deal with the newspaper problem, which is one of ownership concentration across a wide market area. Control of ideas, unlike control of commodities, is not susceptible to existing antitrust enforcement.

Why not act through special valuation? Well, as I noted earlier, this appears to be the direct approach. Yet we have seen what the Internal Revenue has done with all of the hard work of the Senate. Special valuation requires individual bookkeeping and often litigation that will discourage owners just as surely as the present estate taxes do from trying to hold on to their papers. S. 555 doesn't require much administration. And the Treasury will

lose, as the bill is currently drafted, only $10 million a year, per the budget estimate of the Joint Tax Committee. We believe the Treasury can and will make money through S. 555. Finally, the Treasury flatly opposes use of a valuation formula.

Why special legislation, why not broad small business relief? I hardly know where to begin in response to this question. First, the Congress is on record as considering independent newspapers as a special case. The Newspaper Preservation Act of 1970 sets forth the concern of the Congress with the state of newspaper ownership and with the importance of independent papers to this country.

Second, the press is the only institution specifically named in the Bill of Rights for protection.

Third, the entire tax code represents the breaking out of certain classes and groups for special attention, otherwise there would be no code, only one flat rate. Broad reform, as we all know, would take many years; years independent papers do not have.

Finally, I am introducing this legislation not for the benefit of the newspapers themselves, but for the people of this country. Competition in the newspaper industry, freedom of editorial content-- good or ill-- and an ability to dissent are guaranteed by an independent press and this is vital for our free society.

Recently speaking before the Government Affairs Committee of the American Newspaper Publishers Association, several independent newspapermen stood up to praise me for introducing this bill. They added that it was only because they were owners of independent papers that they felt they could stand up to speak; they feared a time when all members of the Association were members of chains and there would be no need for meetings. The head of the Committee spoke for the Committee and endorsed this bill.

Mr. Chairman, because of time pressure, and I want to thank you and your staff for providing me this time, I will submit several items for the hearing record. As I noted, I will submit a copy of the hearings on newspaper ownership for the files; but for the record, I would like to submit the article by Assistant Attorney General Shenefield, a copy of the prepared statements of the gentlemen accompanying me regarding the mechanics of this bill and answering other questions, a memorandum explaining the provisions of S. 555 and other items.

Thank you Mr. Chairman. I will be happy to any questions you may have.

MEMORANDUM

In Re: Independent Local Newspaper Act of 1979: Advance Estate Tax Payment Trust (Section 529) Extended Payment of Estate Tax (Section 6166B)

Current Law

Generally an estate tax return is due nine months after the decedent's death and, except in certain specified situations, payment of the estate tax is required to be made with the return.

Current law contains several provisions which permit the extended payment of the estate tax for periods of up to 10 years, and in one case of up to 15 years, from the regular due date on the tax (secs. 6166 and 6166A). To fund payment of the estate tax, capital gains treatment is afforded a corporate distribution in redemption of stock to the extent that the amount of such distribution does not exceed estate and death taxes, administration expenses, and funeral expenses (sec. 303).

However, the extended payment provisions are premised upon the existence of a pressing "liquidity" problem which would result from regular payment of the estate tax when the assets of a closely held business comprise all or a very substantial percentage of the estate. When the owner of an interest in an independent local newspaper cannot meet the percentage restrictions, he is faced with the necessity of liquidating his interest

to a chain newspaper in order to fund payment of the estate tax. Capital gains treatment for redemptions is likewise restricted by a significant percentage limitation. Neither the extended payment provisions nor the redemption provision encourages continued independent local ownership of newspapers or takes into account the vital public interest in preserving competitive local newspapers in all parts of the United States.

Estate tax extensions. Current law generally provides for deferred payment of the estate tax in the following circumstances:

(1) The Internal Revenue Service may extend payment of the tax for a period of up to 10 years for "reasonable cause", such as needed time to collect receivables or to convert assets into cash (sec. 6161(a)(2)).

(2) In addition, an executor may elect to extend payment of the estate tax over a period not to exceed 10 years where the value of the decedent's interest in a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the decedent's taxable estate (sec. 6166A). However, only that portion of the estate tax attributable to the closely held business may be extended.

(3) Alternatively, the executor may elect to extend payment of the tax for a longer period of up to 15 years if the value of the decedent's interest in a closely held business exceeds 65 percent of the decedent's adjusted gross estate (sec. 6166(a)). The tax (but not interest thereon) may be deferred for up to 5 years and then paid in equal installments over the

next 10 years. The rate of interest is 4 percent on the deferred tax attributable to the first $1 million of closely held business property, and 7 percent on the remainder.

Capital gains treatment. A distribution of property to a shareholder by a corporation in redemption of corporate stock which is included in the gross estate of a decedent is afforded capital gains treatment if certain percentage restrictions are satisfied. The redemption must be accomplished by a corporation whose stock comprises more than 50 percent of the value of the decedent's gross estate reduced by losses, debts, and administration expenses. Furthermore, this special capital gains treatment is available only as to that amount of the distribution which does not exceed estate taxes and administration and funeral expenses.

Current Law Applied to Independent Newspapers

The extension of payment provisions are intended to alleviate the liquidity problems experienced by estates in which the assets consist largely of a closely held business. The redemption provision is designed to facilitate the use of corporate assets to fund payment of the estate tax where the closely held business constitutes a substantial part of the estate of the decedent. These provisions do not reach the vital public interest in preserving independent local newspapers where the estate includes an interest in such a newspaper, but the percentage restrictions imposed by current law are not met. In such a

case, corporate assets would not be available to fund payment of the estate tax, and the executor would be faced with prompt payment of the estate tax in full. The serious liquidity problems entailed in meeting the estate tax in such circumstances is calculated to encourage disposition of the newspaper to chain publishers to raise the required cash funds.

Congress has declared that it is the public policy of this country to maintain an independent and competitive newspaper press in all parts of the United States. (15 U.S.C. § 1801 (1970)). When the executor of an estate which includes an interest in an independent local newspaper is forced to liquidate a portion or all of that interest in order to pay the estate tax, the dominant buyers are inevitably the large owners of newspaper chains. The Congressional policy of preserving independent newspapers is thereby frustrated.

For example, if the owner of an interest in a local newspaper wished to pass on to the next generation $1 million of newspaper assets, he would need at least $1.5 million in assets before estate taxes since the effective rate on $1.5 million is approximately 40%, leaving $1 million after taxes. To pass on $2.5 million of newspaper assets, he would need $4 million before estate taxes. In order to pass on $5 million of newspaper assets, the decedent would need $13.6 million in assets in order to fund $8.5 million in estate taxes incurred at an effective rate of approximately 70%. In addition, if corporate assets are to be

used to fund payment of the estate tax, applicable income taxes would further increase the funds needed to maintain local independent ownership of a newspaper. While these figures will vary depending on each local newspaper owner's personal circumstances, the ultimate conclusion is the same: the combined income and estate tax burden of current law encourages the disposition of interests in local independent newspapers to large chain publishers unless the stringent per shareholder ownership requirements of current law can be satisfied. More important, it is less likely that these ownership requirements can be met in second or third generation owned local independent newspapers.

This is borne out by the fact that the total number of daily newspapers has remained at approximately 1770 newspapers from 1954 to 1974, yet the percentage of those dailies owned by chains controlling 2 or more newspapers has increased dramatically from 27% to 55% during that period, and the trend has accelerated since 1974. W. Baer, H. Geller, J. Grundfest & K. Possner, Concentration of Mass Media Ownership 37 (September 1974) (The Rand Corporation). During a similar period, the number of U.S. cities with competitive daily newspapers fell from 117 to 55. (Id., 35). The impact of the current estate tax provisions on this trend of lessened competition cannot be doubted.

New Section 529

Section 529, Independent Local Newspaper Advance Estate Tax Payment Trust, provides for the adoption by a local independent

newspaper of a plan authorizing the creation of a trust for each individual who has an interest in the newspaper for the sole purpose of funding payment of the individual's estate tax which is attributable to his interest in the newspaper. The trust will receive contributions exclusively from the newspaper and will invest its assets solely in U.S. government obligations. Upon an individual's death, the trust assets will be used exclusively for payment of his estate tax. The net effect of the provision thus redounds to the benefit of the federal government by making monies earmarked for payment of future estate taxes immediately available. The liquidity problems faced by individuals who cannot qualify for special treatment under current law also would be alleviated. The need to raise funds for estate taxes, even with an extension for payment, would not force their executors to press for the sale of a local independent newspaper to large chain publishers. The provision, therefore, permits an independent local nespaper to arrange for the advance payment of estate taxes to the government in order to maintain its independent status.

Explanation of Provisions

In general. The provision requires an independent local newspaper to adopt a plan permitting the creation of a qualified trust for each individual who has an interest in the newspaper for the exclusive purpose of funding payment of the individual's estate tax attributable to his interest in the newspaper. To

be a qualified trust, the trust, among other things, must be created in the United States for an individual who has an interest in the newspaper, must be created pursuant to the plan adopted and must have a governing instrument providing the following: trust assets are to be invested solely in obligations of the United States; contributions are to be made exclusively by the newspaper during the individual's lifetime and, after his death, prior to payment of his estate tax; trust assets are to be devoted exclusively to payment of the individual's estate tax which is attributable to his interest in the newspaper; and any excess funding of the trust is to be distributed promptly to the individual (if living) or to his estate (if deceased). Finally, the plan adopted by the newspaper must require that the contributions to the qualified trust be made exclusively by the newspaper solely for the purpose of payment of the estate tax.

In order to limit use of the trust to its essential purpose and to curtail the potential for abuse, an individual who has an interest in more than one newspaper may be the beneficiary of a qualified trust only with respect to his interest in one independent local newspaper business, and then only if his newspaper interests do not constitute a newspaper publishing chain under the applicable definition. In addition, where a newspaper business is conducted by a partnership or corporation which is also engaged in other business activities, the contributions to the trust are limited to the value of the partnership or corporate

stock interest attributable to the newspaper business (determined as a separate going concern), and to minimize value allocation problems in such circumstances, provision is made for the spin-off of the other business operations subject to specified restrictions.

Tax treatment. The exclusive purpose of the newspaper trust is to permit advance funding of the estate tax to preclude the need for disposition of newspaper assets, and it would therefore be inappropriate to impose a tax on trust assets, contributions or distributions. A qualified trust is therefore exempt from taxation, provided the trust is administered in conformity with the requirements for qualification in its governing instrument and in accordance with applicable regulations.

An individual who is the beneficiary of a qualified trust, and his estate, will not be taxed on contributions made to the trust by the independent local newspaper business and, in the case of his estate, on distributions made by the trust in payment of the estate tax. In order to preclude questions of constructive receipt, contributions to any qualified trust are deemed to be exempt from taxation to any individual participating in the independent local newspaper's advance estate tax payment.

An independent local newspaper business can contribute an amount each year not in excess of 50 percent of its taxable income for the year from its newspaper operations and deduct such amount as an ordinary and necessary business expense. No deduction is allowed, however, to the extent that any contribution results in excess funding of the trust.

Termination of tax exempt status. Excess funding of the trust will not only cause the newspaper to lose its deduction, but it will cause the individual or his estate to realize income in the amount of the excess funding. The trust is excess funded when the fair market value of the trust assets exceeds the estate tax attributable to the decedent's interest in the newspaper. In addition, during an individual's lifetime contributions to the trust may not exceed 70 percent of the fair market value of his interest in the newspaper business. Excess funding of the trust thus occurs either when the assets exceed the highest marginal rate of estate tax that can be imposed, or when trust assets exceed the actual estate tax attributable to the decedent's interest in an independent local newspaper business.

There are a number of events which can cause a trust to become excess funded. If any part of an individual's interest in the independent local newspaper business is sold or exchanged, or if such interest is traded in an established securities market, or if the newspaper ceases publication, or is sold to a chain of newspaper publications or otherwise, excess funding will result. In such a case, the amount of any excess funding is treated as distributed to the individual and is includable in his gross income. In the case of a decedent, the amount of any excess funding is treated as distributed to the decedent's estate and is includable in the gross income of the estate as income in respect of a decedent. In addition, the amount of any excess funding is

includable in the decedent's gross estate for estate tax purposes (which may necessitate a recalculation of the estate tax).

In addition, in the case of excess funding, the independent local newspaper will recapture any tax deductions taken for prior contributions which resulted in a tax benefit to the newspaper. Specifically, the newspaper must include in gross income the lesser of the amount of such excess funding or its prior contributions to the trust as to which the tax benefit was realized.

A qualified trust will lose its tax exempt status entirely if it is not administered in conformity with the requirements for qualification specified in its governing instrument, or in accordance with the regulations prescribed by the Secretary to carry out the purposes of the trust. Upon the occurrence of an event which causes the trust to lose its tax exempt status, all of the assets of the trust are treated as distributed as described above. By these restrictions on the manner in which a qualified trust can be administered and the use to which trust assets can be put, the potential for tax avoidance is removed, and owners of interests in independent local newspapers are encouraged to make a significant economic commitment toward preserving their interests in the newspapers.

Explanation of other provisions. An independent local newspaper is limited to a newspaper publication which has all its publishing offices in a single community and is not one of a chain of newspaper publications. A chain of newspaper publications

means two or more newspaper publications published in different communities and owned, directly or indirectly, by the same person or persons.

An interest in an independent local newspaper business includes an interest in a proprietorship or an interest in a partnership or corporation which has none of its outstanding partnership or stock interests traded in an established securities market. Moreover, in the case of a partnership or corporation, the outstanding partnership or corporate stock interests will qualify as an interest in an independent local newspaper business only to the extent the value of such partnership or corporate stock interest is attributable to the newspaper business (as a separate going concern). In addition, in determining whether a newspaper is an independent local newspaper business, commonly controlled corporations are treated as a single corporation where the same parties in interest own at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all outstanding classes of stock of such corporation. This is done in order to prevent a chain of newspaper publications from reorganizing into several corporations to take advantage of this section.

The estate tax attributable to an interest in an independent local newspaper business means the excess of the amount of tax imposed by section 2001 over the tax that would have been imposed if no interest in an independent local newspaper had been included in the gross estate of the decedent.

The value of an interest in a partnership or corporation which is attributable to an independent local newspaper is determined by apportioning the net fair market value of the newspaper (determined as a separate going concern) proportionately among all outstanding partnership or corporate stock interests, with appropriate adjustment for limited equity interests such as preferred stock. This is done to minimize valuation problems and potential valuation controversies. To facilitate the allocation of values where a corporation is engaged in business activities in addition to newspaper publication, the corporation is permitted to spin-off, through means of a separate corporation, its non-newspaper operations. This spin-off must, however, satisfy the active business requirements of section 355 for both the five-year period immediately preceding and following the spin-off, a total of ten years, except for a change of business after the spin-off due to involuntary conversion, governmental order and the like. In addition, the distributee shareholders (and in the event of death and the like, their successors-in-interest) must intend to, and must in fact, retain a controlling stock interest, as defined in section 368(c), in both corporations for the five-year period following the spin-off. This is done to prevent any possible use of the spin-off for tax advantage.

Under current law, the carryover basis of property inherited from a decedent dying after 1979 is generally the

decedent's adjusted basis in the property immediately before his death. If the fair market value of the property exceeds its adjusted basis, the carryover basis in such appreciated property is increased by federal and state estate taxes. However, under this section the estate tax attributable to an interest in an independent local newspaper business will be paid out of the assets of a qualified trust, and the carryover basis in such an interest would therefore not be increased by payment of estate taxes. This increases the potential capital gains which would result from a subsequent disposition of newspaper assets, creating another incentive to maintain independent local ownership of newspaper assets.

Recapture

To encourage the continuation of independent local newspaper ownership after the death of the individual owning the interest in the newspaper, this section also provides for the recapture of estate tax benefits if the person who receives an interest in an independent local newspaper disposes of that interest. This recapture provision parallels section 2032A of the Internal Revenue Code, which provides for the recapture of estate tax benefits on the disposition of qualified farm property within 15 years after the date of death. The provision requires the recapture of such benefits if the interest in the independent local newspaper is disposed of within 15 years after the death of the individual for whom a qualifying trust was created, except

for dispositions of such interests at death. Recapture is phased out during the period between the 10th and 15th years after the date of death, just as it is under section 2032A, since there is an increased likelihood that changed circumstances might require a disposition, and heirs of owners of independent local newspapers should not be bound to the independent local newspaper business permanently.

Effective Date

This section is applicable to trusts created on or after January 1, 1979.

New Section 6166B

Section 6166B, Extension of Time For Payment of Estate Tax Where Estate Includes Interests in Independent Local Newspaper, applies the 15 year extension provision of current law to an estate comprised in part of an interest in an independent local newspaper. No percentage restrictions are imposed. By this method, estate taxes would not cause the sale of interests in local independent newspapers to large chains, and independent ownership of local newspapers would be encouraged.

Explanation of Provisions

In general. When an estate includes an interest in an independent local newspaper, the executor may elect to defer payment of part or all of that portion of the estate tax attributable to the interest in one such newspaper (but not the

interest on the tax) for up to 5 years, and then to pay the tax in equal yearly installments for up to 10 years. Interest on the amount of tax extended would be payable at the same rate as that prescribed in section 6601(j) for other extensions of the estate tax. If a deficiency has been assessed, the deficiency may be prorated to the installments.

In order to limit use of the extended payment to its essential purpose and to curtail the potential for abuse, the executor of an estate which includes an interest in more than one newspaper may elect to defer payment of the estate tax attributable to one, and only one, interest in an independent local newspaper, and then only if the decedent's interest in more than one newspaper did not constitute an interest in a chain of newspaper publications. In addition, where a newspaper business is conducted by a partnership or corporation which is also engaged in other business activities, the contributions to the trust are limited to the value of the partnership or corporate stock interest attributable to the newspaper business (determined as a separate going concern), and to minimize value allocation problems in such circumstances, provision is made for the spin-off of the other business operations subject to specified restrictions.

Acceleration of payments. If any part of the interest in an independent local newspaper is sold or exchanged, or if corporate stock is traded in an established securities market,

the extension of time for payment of the tax attributable to the interest disposed of or traded ceases to apply, and the unpaid portion of the tax attributable to such interest is payable upon notice and demand from the Secretary. This provision does not apply to transfers pursuant to a reorganization which constitutes a mere change in identity, form, or place of organization, or to a transfer by the executor to a person entitled to such property under the decedent's will or under the applicable law of descent and distribution.

If the newspaper ceases to qualify as an independent local newspaper by reason of ceasing publication, becoming part of a chain of newspaper publications, or otherwise, the unpaid portion of the tax payable in installments becomes due upon notice and demand.

Finally, if any installment is not paid on or before the date fixed for its payment, the unpaid portion of the tax payable in installments is likewise to be paid upon notice and demand.

Explanation of other provisions. The provisions relating to an independent local newspaper, a chain of newspaper publications, an interest in an independent local newspaper, and the estate tax attributable to such an interest, are essentially identical to the corresponding provisions of section 529.

Effective Date

This section is applicable to decedents who die after January 1, 1979.

Conclusion

Section 529 permits an independent local newspaper business to adopt a plan for the creation of Estate Tax Payment Trusts, the assets of which are invested solely in United States obligations, for the purpose of funding the estate tax attributable to the interest of its individual owners in the newspaper, and thus avoid any need for the sale of the paper to a large chain publisher in order to raise the funds necessary to pay applicable estate taxes. Trust assets are limited to an amount which is reasonably necessary to pay the estate tax attributable to the newspaper interest by denying any tax advantage to excess funding. Section 6166B provides for a 15 year extension of payment of the estate tax on interests in local independent newspapers, with no percentage restrictions. These two sections operate together to prevent the adverse national and local consequences caused by the disposition of independent newspapers to large chain publications in order to fund the estate tax.

The advance payment trust serves as the immediate venicle for encouraging continued local and independent ownership of newspapers, and the extension of time for payment of estate taxes from the decedent's assets serves the same purpose in circumstances where advance payment is not possible. A significant number of years is required before a trust can be adequately funded. In the meantime, an extension of payment provision is required in order to extend to executors the time to raise funds to meet the

estate tax in some way other than by selling newspaper assets. Secondly, there will be a tendency for trusts to be underfunded due to continuing inflation and in order to avoid the penalties attaching to excess funding. Therefore, a significant portion of estate tax will remain to be paid by the executor, and an extension of time for payment will be necessary to insure that a sale of the independent local newspaper is not necessary to fund such payment. Sections 524 and 6166B together provide substantial and meaningful incentives for independent local newspapers to remain local and independent.

THE NEWSPAPER GUILD 1125 FIFTEENTH STREET N.W., ROOM 835, WASHINGTON, D.C. 20005 202 [illegible]

October 24, 1979

Senator Russell B. Long, Chairman
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Long:

The Newspaper Guild, representing 40,000 employees in the newsrooms and commercial departments of newspapers, news services, magazines and related enterprises, welcomes the Taxation and Debt Management Subcommittee's hearings on S. 555, the Independent Local Newspaper Act, and hopes your committee will give the legislation early approval.

Our annual convention endorsed the original bill introduced in 1978, and in our opinion the bill has since been strengthened by the addition of provisions recapturing the bill's benefits if the independent newspaper is sold within 15 years after the death of the publisher for whom the trust was created. This appears to eliminate a weakness in the original bill and makes it more than ever worthy of support.

I am enclosing a copy of our 1978 convention resolution and request that both the resolution and this letter be entered into the hearing record.

The concentration of newspaper ownership in the hands of a few increasingly powerful chains is an alarming trend. We do not think that S. 555 is the entire answer to this threat, but there is reason to hope that it will help to stem the tide. The burden of estate taxes has been one of the prime factors inducing independent owners to sell their newspapers to chains, and a reduction of that burden cannot but help to preserve a free and diverse press.

Sincerely,

Charles A. Perlik, Jr.
President

CAP:sps
opeiu2afl-cio
Enclosure

cc: Sen. Harry F. Byrd, Jr.

LOOSENING THE CHAINS

The continuing decline in the number of independently and locally owned newspapers in the United States poses an increasingly serious threat to the diversity of news and opinion so indispensable to the role of a free press in a democracy.

The 22 largest chains now control half the nation's daily newspaper circulation; the top 10 alone account for 36 percent. The chains' appetite knows no satisfaction; they grow larger and more plentiful every year. Chains now swallow chains--Gannett's ingestion of Combined Communications is the latest and most startling example--but new ones rise to help consume what remains of the nation's independently owned newspapers. Long a major factor in the industry, chains now threaten to overwhelm it.

The nation's estate-tax laws have been pinpointed as one of the prime elements fueling this trend. Independent owners, faced with estate taxes they feel are so high as to threaten their ability to maintain their newspapers, sell out to others--and all too often to one of the major chains--in tax-free exchange for the latter's stock.

Rep. Morris K. Udall (D-Ariz.) has introduced legislation aimed at this problem. The Independent Local Newspaper Act would provide relief from estate taxes for independently owned newspapers and small chains operating within a single state. Owners who qualified under the act would be permitted to establish estate-tax-payment trusts to be funded from company profits, in advance of their deaths, to reduce the pressure for selling their papers and further diluting local ownership of the press.

The legislation may require perfecting; Udall himself has made several changes since the original bill was introduced. But there will be time for that as the bill goes through the Congressional hearing process. The measure, in its purpose and its method of achieving it, is worthy of support, and the 1978 Convention of The Newspaper Guild urges the House Ways and Means Committee to schedule early hearings and action on it.

Adopted by the 45th Annual Convention
of The Newspaper Guild meeting in
Detroit, Michigan, June 26-30, 1978.

opeiu2afl-cio
10/24/79

LAW OFFICES

VAN ARKEL, KAISER, GRESSMAN, ROSENBERG, AND DRIESEN

1828 L STREET, N.W., SUITE 701

WASHINGTON, D. C. 20036

HENRY KAISER
RONALD ROSENBERG
GEORGE B. DRIESEN
MICHAEL WOLF
JEFFREY R. FREUND

OF COUNSEL:
GERHARD P. VAN ARKEL
EUGENE GRESSMAN

TEL: (202) 466-8400

October 29, 1979

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

Re: Independent Local Newspaper Act, S. 555 and H. 2770

Dear Chairman Long:

The International Typographical Union, AFL-CIO, through its President, Joe Bingel, has taken the following position with regard to the Independent Local Newspaper Act, S. 555 and H. 2770:

> The International Typographical Union, AFL-CIO, representing more than 80,000 employees, many in the newspaper industry, is concerned about the declining number of independently owned and operated American newspapers, both because of the severe impact this decline has on employment in the newspaper industry and because of the impact this decline has on the number of fully competitive voices in the marketplace of public opinion. One of the major reasons that independent local newspapers either go out of business entirely or are sold to chains is the enormous drain the current Federal Estate Tax laws have on a paper's continued operations and, in the face of this drain, the substantial incentive to small independent newspaper owners to avoid future estate tax liability through sale of their papers. For these reasons, the International Typographical Union, AFL-CIO, supports the current efforts in the United States Congress to maintain independent local newspapers and urges Congress to pass the Independent Local Newspaper Act, S. 555 and H. 2770.

The International Typographical Union hopes its views will be of assistance to you and your Committee as you consider this important legislation.

Sincerely,

Ronald Rosenberg
General Counsel
International Typographical
Union, AFL-CIO

cc: The Honorable Morris K. Udall
U.S. House of Representatives

Can antitrust and First Amendment concerns be balanced successfully to guarantee competition in the newspaper industry?

Ownership Concentration in Newspapers

By John H. Shenefield

CONCENTRATION of ownership in the newspaper industry raises significant issues that are of concern to antitrust and First Amendment advocates alike. The preservation of competition and the dispersion of economic power are key objectives of the antitrust laws, while the preservation of a multiplicity of outlets of information and opinion is an important First Amendment goal.

The policy of the Justice Department Antitrust Division toward the media is based on two premises: first, that all elements—broadcasting, hardback and paperback publishing, movies, and magazines, as well as newspapers—are important components of the nation's economy and must be carefully scrutinized under the Sherman and Clayton acts to ensure that independent, competitive behavior is not undercut by unlawful business activities. Second, the media play a crucial role as the transmission mechanisms of political and artistic ideas from their creators to the public, as the sounding board of our political system, if you will. It is, therefore, appropriate to use the antitrust laws to promote the maintenance of numerous media "voices," even when the number of firms in a given market might be considered adequate to ensure competition in other business contexts.

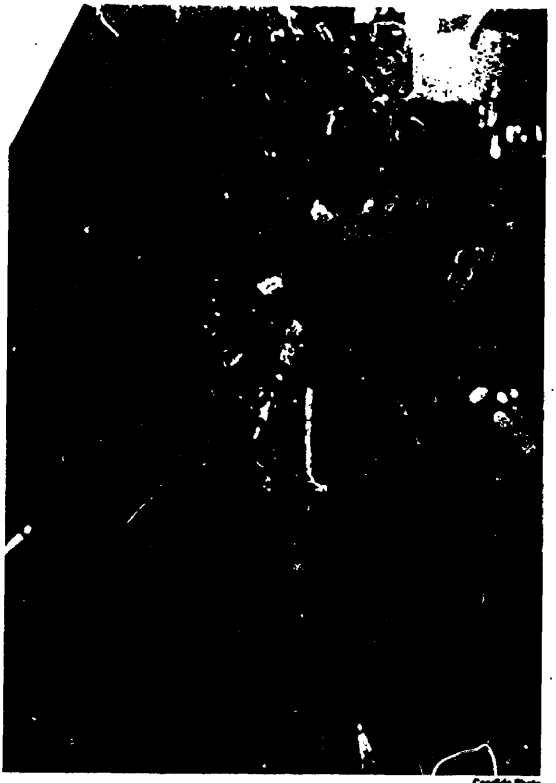
In applying these principles, we have found that many segments of the media do seem to be workably competitive and provide enough independent outlets to ensure a relatively free dissemination of ideas. In specific markets where concentration is high, however, such as mass market paperback publishing, we have not hesitated to undertake enforcement actions, particularly to challenge mergers and acquisitions that are likely to have significant anticompetitive effects. We also have been sensitive to problems of vertical integration and the use of market power in one sector to decrease competition in another.

The daily newspaper "industry" is, however, a dramatic exception to competition and diversity in the media. For most Americans, be they newspaper subscribers or newspaper advertisers, the daily newspaper business is a monopoly game: of a total of 1,526 cities with daily newspapers, only about 35 have commercially competing newspapers, a reduction from about 180 cities in 1940. In some instances, this decline can be attributed to the higher average costs imposed on a smaller paper as a result of the existence of economies of scale and the disposition of many large advertisers to place a disproportionately large portion of their advertising dollars with the newspaper having the larger circulation. In addition, the decline may be in part a result of increased competition from the broadcasting media and from weekly or free-distribution newspapers, the latter being particularly a phenomenon of suburban areas. There is, however, some reason to hope that new, more efficient printing technology will ease the economies of scale problem and, in the long run, lead to a rebirth of competing daily newspapers.

Given this environment, the Antitrust Division has proceeded on three fronts to protect and enhance competition in local markets: (1) by closely scrutinizing mergers and joint operating agreements among competing newspapers in the same market; (2) by vigorously supporting both a prospective and retroactive prohibition on the cross-ownership of a daily newspaper and broadcast properties within the same market; and (3) by monitoring actions of dominant daily newspapers that may threaten existing competition or serve to erect barriers to entry.

Acquisitions of one newspaper by another are scrutinized under Section 7 of the Clayton Act, which prohibits mergers that may tend to create a monopoly or to lessen competition in a relevant market. While daily newspapers compete with other news and advertising media, the courts have held that the daily newspaper business within a given locality is itself an appropriate market for purposes of Clayton Act analysis. Given this market analysis, the purchase of one healthy daily newspaper by another in the same locality would almost automatically have the proscribed anticompetitive effect and would be certain to do so if the acquired newspaper were the only other competitor.

In many instances, however, one of the competing newspapers will not be in sound financial condition. The courts have read into Section 7 a "failing company" defense that permits an otherwise anticompetitive merger to



Candida Photo

occur if the company being acquired will go out of business unless it is taken over and if no other less anticompetitive purchaser is available. In those instances in which a failing company defense is alleged, the Antitrust Division makes every effort to scrutinize carefully the claim in deciding whether to bring suit against the proposed transaction.

In 1970 Congress passed the Newspaper Preservation Act, which established an antitrust exemption for newspaper joint operating arrangements that combine the commercial operations of two newspapers while preserving their editorial independence. New joint operating arrangements can come into effect only with the written consent of the attorney general after a finding that one of the parties to the joint operating arrangement is a "failing newspaper."

Approximately 22 joint operating arrangements were covered by the act's grandfather clause. Requests for two new arrangements have been submitted since the act was passed. The first, involving the newspapers in Anchorage, Alaska, was approved in 1974, but the relationship was subsequently ended by the parties. The Department of Justice now is adjudicating a request for approval of a joint operating arrangement involving the Cincinnati newspapers—the *Post* and the *Enquirer*. That request was the subject of a seven-week hearing before an administrative law judge who recently made a recommendation to the attorney general favoring approval of the arrangement. The Antitrust Division supports the ultimate approval of that arrangement and participated fully in that proceeding. Our purpose was to ensure that any determination that a partner to the arrangement was a failing newspaper was based on appropriate standards after development of an adequate factual record.

The Antitrust Division also has worked strenuously for the adoption of procedures by the Federal Communications Commission that would prevent the cross-ownership of broadcast and newspaper facilities in the same locality. We argued that this ban should not be prospective only but should apply to existing broadcast-newspaper combinations as well. The F.C.C., however, while adopting a prospective ban in 1975, refused to require dissolution of existing combinations in all but a limited number of egregious cases.

When these regulations were challenged before the Court of Appeals for the District of Columbia Circuit, the division argued that the F.C.C. acted in an arbitrary and capricious manner when it failed to make the cross-ownership ban retroactive. The D.C. Circuit agreed, upholding the F.C.C.'s prospective prohibition but striking down its failure to make the rule retroactive (555 F. 2d 938). Ultimately, however, the Supreme Court reversed the latter portion of the circuit court of appeals' holding and reinstated the commission's original, prospective-only ban (436 U.S. 775).

In light of this Supreme Court action, the division will monitor license renewals in those cross-ownership situations permitted by the commission's rule making, especially where a monopoly newspaper owns a VHF television station in the same market. The division also will continue to urge that regulatory policy be designed to increase the number of local media competitors by facilitating the entry of new broadcast and cable stations.

In addition to reviewing consolidations of newspapers within a given market and to promoting diversification of newspaper and broadcast ownership, the Antitrust Division remains alert to circumstances in which the activities of dominant local newspapers can threaten the viability of alternative media. One actual and potential challenge to the predominance of existing dailies, with respect to advertising and the dissemination of local news, is the growth of suburban weeklies and other nondaily newspapers. In many instances, they are delivered free to subscribers and subsist exclusively on advertising revenue. Statistics indicate that weekly paid newspapers have an impressive circulation of about 38 mil-

lion compared to daily newspaper circulation of 62 million. Weekly newspapers, moreover, have had a more rapid circulation growth than dailies. Between 1960 and 1977, while the number of weekly newspapers declined from 8,138 to 7,465, the average circulation of a weekly increased from 2,606 to 5,075, and total circulation went from 21.3 million to 37.9 million. During this same period the number of daily newspapers remained fairly constant, but total circulation increased only slightly — from 58.9 million to 61.7 million.

Daily, city-based newspapers may find themselves subject to sharply increased competition from these other layers in the local print media pyramid. In several markets the major dailies have responded to this competition by adding zoned editions that permit advertisers to purchase, at a lower cost, only a portion of the daily newspaper's total circulation. Special editions in which the editorial content of the paper is directed to specific suburban localities also have been instituted, and some daily newspapers have either purchased or instituted their own free distribution weekly, normally with the purpose of providing advertisers "total market coverage" one day a week.

Of course, some of these practices may represent a healthy competitive response to changing market conditions and may result in improvement of the city dailies while not endangering the existence of the other publications. In some instances, however, it is alleged that major dailies have utilized their market power in a predatory fashion to exclude new competition or erect barriers to entry. The Antitrust Division is monitoring allegations that daily newspapers have subsidized free-distribution newspapers in an attempt to drive rivals out of business by charging advertising rates that do not cover costs. Our ability to conduct investigations of allegations of this kind is limited, however, given the rather small amounts of commerce that are involved in any particular instance. Where appropriate, we will refer complaints of this kind to state antitrust enforcement officials.

Our concern about newspaper concentration has not been limited to local newspaper monopolies. We also have given increasingly close attention to problems that may result from the growth of newspaper chains and the resulting increase in aggregate concentration of ownership in the hands of a decreasing number of corporations.

Photograph by Harold M. Lambert

Of the 1,753 daily newspapers in the United States in 1978, according to *Editor & Publisher*, 1,095 were owned by a publishing group controlling two or more newspapers in different cities. This group ownership is up from 552 newspapers in 1960, to 879 in 1970, and 977 in 1974. While the number of chains has increased only slightly in the last decade, from 157 in 1970 to 167 in 1978, the average number of newspapers in each chain has gone up continuously — from 5.6 in 1974 to 6.5 in 1978. Indeed, of the 53 daily newspapers that changed hands in 1978, 47 were purchased by newspaper groups.

Measuring concentration in terms of circulation, one finds that the percentage of newspaper sales held by the top four chains increased from 18 per cent in 1966 to 21.7 per cent in 1977, and the share of the top eight increased from 25.5 per cent in 1966 to 33.5 per cent in 1977. These figures represent an increase of 20.5 per cent in the share of the top four over that decade and a 31.4 per cent increase in the share of the top eight. According to the latest figures for 1978, the top 20 newspaper groups control approximately 50 per cent of the daily and 56 per cent of the Sunday circulation.

There are two observations that ought to be made about these data. First, the numbers do not represent true concentration ratios, since newspapers compete primarily in local, not national, markets. Second, while the percentage control of the top chains is not large in traditional antitrust terms—the top newspaper chain had 5.3 per cent of daily circulation in 1977—preserving a large number of independent voices, of course, is especially important because the concentration of newspaper ownership limits the diversity of opinion expressed in newspapers and diminishes the opportunity for First Amendment expression.

The Antitrust Division has attempted to explore the ability of the antitrust laws to control the increase of common ownership of newspapers not serving the same geographic market. Our review must focus on the competitive impact of a proposed transaction in a specific market. While dispersion of economic and political power is an important goal of the antitrust laws, courts have generally refused to find an antitrust violation on those grounds alone; some probable anticompetitive effect must be demonstrated.

The requirement that an acquisition of an independent newspaper by a chain be shown to have some anticompetitive impact does not mean, however, that the antitrust laws are entirely inapplicable. For example, we investigated the proposed Gannett-Combined Communications merger, in which the firms involved do not own newspapers in the same locality. We normally evaluate the effect of this type of merger on the national newspaper advertising market and on local markets in which the parties compete—whether that competition is between newspapers alone or newspapers and other media, including outdoor advertising and television or radio stations. We also are concerned with the possibility that some chain acquisitions may raise barriers to entry by potentially competing suburban or weekly papers. For example, a parent firm's large financial resources may have a chilling effect on potential entrants. Those resources may allow the introduction of zoned or other targeted editions as well as free distribution papers that will threaten the viability of existing nondaily competitors.

Given the requirement of present

merger law that identifiable potential competitive harms be demonstrated before a merger or acquisition can be prohibited, it seems likely that the Antitrust Division often will be unable to challenge successfully a chain's acquisition of an individual newspaper or group of newspapers as was the case in the Gannett transaction. Absent a change in the law, it may well be that the trend toward increasing newspaper concentration will continue relatively unabated as long as the business motivations for the transactions exist.

In testimony before the Senate Judiciary Committee earlier this year, I expressed the Antitrust Division's support for legislation that would restrict certain large conglomerate acquisitions. Our support was based to a large degree on the same concerns expressed by those who view the growth of newspaper chains with alarm — that is, that the increased concentration of economic and political resources in the hands of a few institutions may unnecessarily threaten those fundamental values of dispersed power and a multiplicity of viewpoints upon which our nation is based.

We favor a carefully crafted legislative approach restricting those transactions among large or dominant enterprises having the greatest potential for public harm and the least likelihood of countervailing benefits to society. Adoption of general conglomerate merger legislation would serve to restrict newspaper mergers that fall within its jurisdiction. These instances may occur, for example, when a newspaper chain is to be acquired by another large media conglomerate. It is likely, nevertheless, that many acquisitions of individual newspapers by chains or mergers among chains would not be directly affected by conglomerate merger legislation.

Conglomerate merger legislation is premised on a belief that large economic size, measured in terms of assets or sales, serves as a useful proxy for the economic and political power of a business enterprise. In the case of newspapers, however, it is obvious that their influence in a community is quite disproportionate to their advertising revenues or subscriber sales. Control of all daily newspapers by five chains, for example, would cause me as an American citizen far greater concern than would control of a similarly sized manufacturing industry by five business entities. Moreover, "the First Amendment goal of achieving 'the widest possible dissemination of information from diverse and antagonistic sources'" (436 U.S. 775) establishes a direct constitutional mandate for dispersion of power in the media.

Thus, an extension of the logic behind a general conglomerate merger proposal, coupled with broader considerations of First Amendment policy, might provide support for legislation specifically tailored to the problem of multiple newspaper ownership. The same considerations of economic and political power have led to restrictions on multiple ownership in other areas. For example, beginning in the 1940s, the F.C.C. began to establish restrictions on the multiple ownership of broadcast facilities, a regulatory restraint on the concentration on broadcast ownership subsequently upheld by the Supreme Court (351 U.S. 192). Today, in general, a single entity may receive not more than five television, five FM radio, and seven AM radio licenses. Similarly, many states have adopted restrictions on branch banking to prevent concentrations of power in the banking industry within a state, and Congress has respected these state decisions in the licensing process for federally chartered banks.

Balancing freedom of press and competition

Imposition of restrictions on aggregate newspaper ownership would raise the possibility of countervailing harm to the public. In some instances, for example, newspaper acquisitions may preserve a diversity of opinion—for example, when the transaction permits the continued publication of a newspaper that otherwise would fail. Most important, limitations on the ability of individuals or corporations to purchase a newspaper in a given area may conflict with another key First Amendment concern, that of ensuring that governmental restrictions do not prevent individuals from having their "voices" heard in a particular community.

Freedom of the press under the First Amendment severely restricts the power of government to impose regulations on the media and on newspapers in particular. The Supreme Court has permitted the establishment of several restrictions on the ownership and operation of broadcast facilities — restrictions that might well be impermissible on print media — because of the recognized need of the government licenses. However, while First Amendment considerations might well preclude a restriction on the ability of an individual or corporation to establish *de novo* a newspaper in any town of its choosing, those considerations might not extend to restrictions on the purchase of an existing newspaper, particularly when it is a monopoly newspaper. As the Supreme Court stated in upholding the F.C.C.'s cross-ownership rules: "We note that the regulations are in form quite similar to the prohibitions imposed by the antitrust laws. This court has held that application of the antitrust laws to newspapers is not only consistent with, but is actually supportive of the values underlying the First Amendment."

Legislation restricting the growth of newspaper chains should be enacted only after weighing potential harm against carefully articulated need. If legislation is necessary, it must be carefully drafted to take into consideration the competing public policies.

The Antitrust Division remains concerned about increasing concentration in the newspaper industry. The emergence of the one-newspaper town as the national norm and the assembling of newspaper monopolies into increasingly large organizations must give pause to anyone concerned about the concentration of economic and political power. We shall continue our efforts to use the antitrust laws to enhance the opportunities for new competition and to prevent acquisitions that threaten competition as they increase concentration. We are sensitive, however, to the possibility that well-intentioned restrictions on acquisitions in the newspaper industry may actually limit the expression of diverse views in some instances.

We are not yet prepared to conclude that legislation should be enacted in this extremely sensitive area. The matter is of enormous consequence, however, and merits serious attention from the legislative and executive branches. We expect to work with Congress in surveying the complex issues in order to determine whether it is necessary to supplement the antitrust laws as they pertain to media concentration. ▲

(John H. Shenefield is assistant attorney general in charge of the Antitrust Division of the United States Justice Department. This article is adapted from testimony before the Senate Select Committee on Small Business.)

Letters

MERGER CONCERN

I'm getting more than just a little weary of reading news articles and slick magazine ads telling us what a great thing it is now that the Gannett conglomerate has gobbled up 80 daily newspapers, 7 television and 12 radio stations.

And that doesn't include outdoor advertising interests, weekly newspapers, Canadian newsprint interests, marketing, research and news service subsidiaries stretching from the U.S. Virgin Islands in the Atlantic to the U.S. Territory of Guam in the Pacific and including 33 states in between.

The merger of the Gannett Co. and Combined Communications Corporation was one of the worst things that has happened in America in recent years. The danger of Three Mile Island was mild by comparison. The merger should not have been allowed and the government's anti-trust division should break it up.

I am completely unimpressed by the high-sounding boast that Gannett is a "world of different voices" and how much better group ownership is for local communities. Hogwash.

Everybody knows who signs the checks, who gives the orders and who has the final authority. Make no mistake about that.

How stupid does Allen Neuharth think the people are?

If conglomerate ownership is such a great thing, why does Gannett feel it necessary to spend $1.5 million to polish and improve its image? Why does Allen Neuharth think it necessary for him to spend so much of his company's money flying around the country making speeches trying to allay the fears?

Let's face it. Gannett is a huge conglomerate interested primarily in the bottom profit line. Let anybody—be it the President of the United States or the lowliest citizen, threaten Gannett's bottom line and you'll quickly see how much authority its local editors have!

I understand Mr. Neuharth is a very fine, capable, personable gentleman and I have no quarrel with him personally. His company, Gannett, also has a fine reputation up to this point.

But what happens when Mobil Oil or the Arabs buy out Gannett? Who gets control then? What will the man be like who succeeds Mr. Neuharth on his retirement?

His successor could be money-hungry and power-mad. Why give him or anybody else possession of such power?

I understand American Financial owns seven per cent of Gannett already, which is a pretty sizeable hunk of a big corporation. What if American Financial keeps on until it gains control? (It reportedly is trying to do this.) American Financial has no interest in any of Gannett's newspapers, tv, radio or other operations except financial.

Out tax structure is partly to blame, if not almost wholly, for enabling Gannett to attain control of such a vast segment of our communications media.

Because of depreciation, deductions for interest payments and other loopholes, the big chains can grab off these newspapers at almost no cost. And if they're unprofitable, they can write it off their taxes.

U.S. Senator Robert Morgan, a resident of my own county and a neighbor of mine, and Congressman Morris Udall have introduced legislation to ease the estate tax burden on heirs when the owner of an independent family newspaper dies. The whole nation owes Sen. Morgan a debt of gratitude.

This legislation of Senator Morgan would prevent the growth of these conglomerates and keep them from continuing to buy up public opinion and from creating monopolistic financial empires at the expense of the public.

Cartoon by Wallmeyer, *Long Beach (Calif.) Independent Press-Telegram*

Mr. Neuharth should read the testimony given by James Hurley III of the *Salisbury Post*, reprinted in the May 24 issue of the *Congressional Record*. Jim Hurley tells what happens to local newspapers when the chain moves in.

In a speech in New York June 12 Mr. Neuharth said nobody is looking over the shoulders of his local editors and publishers—he should have said: No one looks until they violate corporate policy. Chain newspapers are like the government—they simply don't hand out checks without controls.

Just for example, what if a member of Mr. Neuharth's family should run for public office. How long would the local editor keep his job after opposing him?

We must accept the fact that Gannett now controls an empire. But we don't need Mr. Neuharth or its advertising agency, Young & Rubicam, to rub salt in the wound it has inflicted on the First Amendment and press freedom in America. Please, Gannett, don't talk to us about Freedom!

HOOVER ADAMS

(Adams is editor and publisher of *Dunn (N.C.) Daily Record.*)

EDITOR'S COMMENT

Dan Hayes
Managing Editor
The Quad-City Times
Davenport, Iowa

"The features supplied by your wire service are particularly useful. We—and our readers—find them consistently interesting, well written and reliable. The fact that they're not always 'predictable' is another important advantage..."

The New York Times NEWS SERVICE

Another reason why the Gannett mergers should be stopped.

The Austin Citizen

Phone:
(512) 453-6633

821 West St. Johns Avenue
P.O. Box 19467
Austin, Texas 78760

Sept.20,1979

Mr.Hoover Adams,Publ.
Dunn Daily Record
Dunn,N.C.

Dear Mr.Dunn.

I was interested in your remarks on the Gannett Co. that appeared in [redacted] week before last.

Being a former Gannett employee I agree with most of what you said.However,I could give you a few stories that you wouldn't believe, I've known Allen Neuharth too,for a number of years. I think they make too much of the 'local autonomy' issue and I have some scars to prove it. Most folks don't aware of what goes on when Gannett moves in a Publisher from out of town.He is given local autonomy alright, but he's not local,doesn't understand the local scene,and cares less for the local people (including the employees).

Briefly,I was General Manager at Rockford when those papers were sold to Gannett in 1967. No finer guy in the world is Paul Miller.And Allen is a neat intelligent guy and to a point I admire him. We were all promised a lot of things. Business ran fairly well since the Publisher stayed after the sale for four years. Then,a new Publisher from the East arrived and stated that there would be some changes. He was right, The product did NOT get better.It got worse. He irritated the customers,both advertisers and readers. Circulation went down. And,the people who were the most loyal,executives and department heads were treated the worst. Seventeen of them(from an executive staff of twenty two,including dept.heads) either were harassed into resigning or were fired in less than two years. This is the part of the chain operation I think is little known. I resigned and took "early retirement" after working for the guy only about 10 months. I was 55 years old and been with the newspapers for 31 years. The last four as Gen.Mgr. My Gannett pension is less than a hundred dollars a month.

The Austin Citizen

one:
(512) 453-6833

821 West St. Johns Avenue
P.O. Box 15467
Austin, Texas 78761

The Rockford Newspapers (The Morning Star and the evening Register-Republic)at one time had a combined circulation of 103,000 ABC.

Gannett took them to an all day paper two years ago and on Oct.1,1979 they are dropping the evening edition completely. Today's circulation is about 76,000 and after Oct.1 will probably be in the neighborhood of 65,000

Now is that a better newspaper ? I don't think a chain can make a newspaper better in any sense of the word.

I'm not so much worried about them controlling the news, as I am about what they do to their help, their new found city readers and to the product generally.

It's just a personal observation....one that I sat in on. Thought you'd like to hear that angle.

After being out of work a year I moved here and started a new daily The Austin Citizen five afternoons a week and it's now rolling upward at 17,000 paid home delivery.

I recently resigned (again) but the Publisher(and owner) asked me to stay on. After having been publisher, I'm now Asst. to the Publisher and working every day and having fun. I'm now 62 years old and in good health. Incidentally they've had 5 Publishers in seven years in Rockford. They don't stay long enough to learn the temperature of the city,nor long enough to find their way to the Press room.

Again,I did appreciate reading your remarks.

Stay in there !

Most Sincerely,

William H.Klusmeier

MANCHESTER UNION LEADER

NEW HAMPSHIRE SUNDAY NEWS

"There Is Nothing So Powerful As Truth"

UNION LEADER CORPORATION
Manchester, N. H. 03105
(603) 668-4321

WILLIAM LOEB
PRESIDENT AND PUBLISHER

Sept. 13, 1979
(dict. Sept. 12)

Mr. Hoover Adams
DUNN RECORD
E. Canary St.
Dunn, NC 28834

Dear Mr. Adams:

Bill Long tells me that you are a friend of his.

Of course I agree with your position as recently stated in various publications. I think I am the only publisher besides yourself who has testified before Congressional Committess against chain ownership of newspapers. It is so much better for the nation.

America was based on the concept of diversity of opinion, and obviously there would not be diversity of opinion under these circumstances.

Of course the present owners of newspapers run them as if they were running a grocery store. There is no interest in the content of their papers, all they care about is making money. In the days of my wife's grandfather E. W. Scripps, founder of Scripps-Howard newspaper empire and United Press, editors were interested in making money, but they had some integrity as well. They cared about the editorial policy of their papers. The present crop are nothing but leftists.

I will stand ready to help you in any action you may take to break the expansion of newspaper chains.

Very sincerely,

William Loeb
President

W.L.-B. Alonzo

56-071 565

The Grafton Record

RILIE R. MORGAN
Publisher Emeritus
1922-1958
JOHN D MORGAN
Publisher

Phone 701-352-0640
Box 471
GRAFTON, NORTH DAKOTA
58237

Hoover Adams
Duran Daily Record
DUNN, N. C.

Dear Mr. Adams—

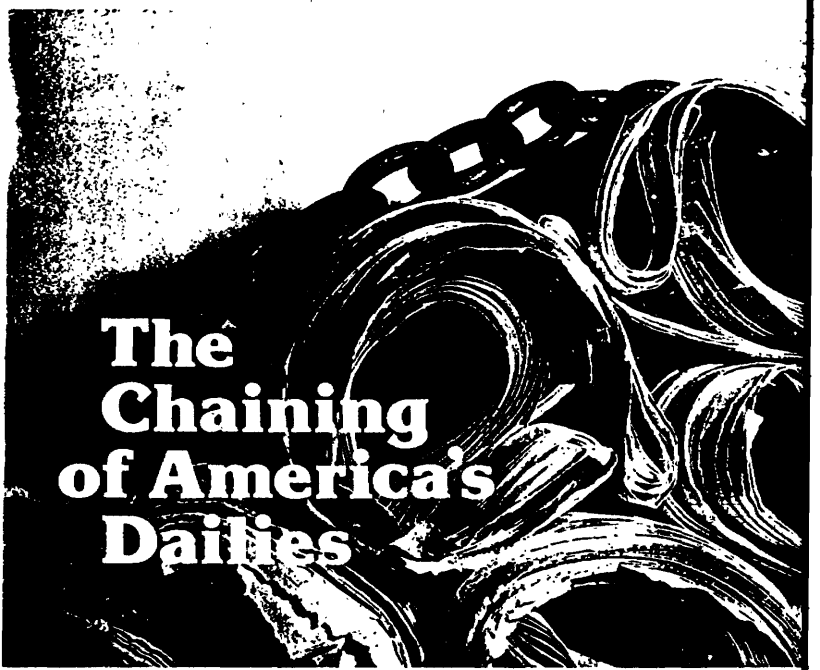
What an excellent letter to Publishers Auxiliary!! Just be carefull not to get swallowed up by an offer you can't refuse from the biggies.

Many Thanks for expressing a lot of our feelings, too.

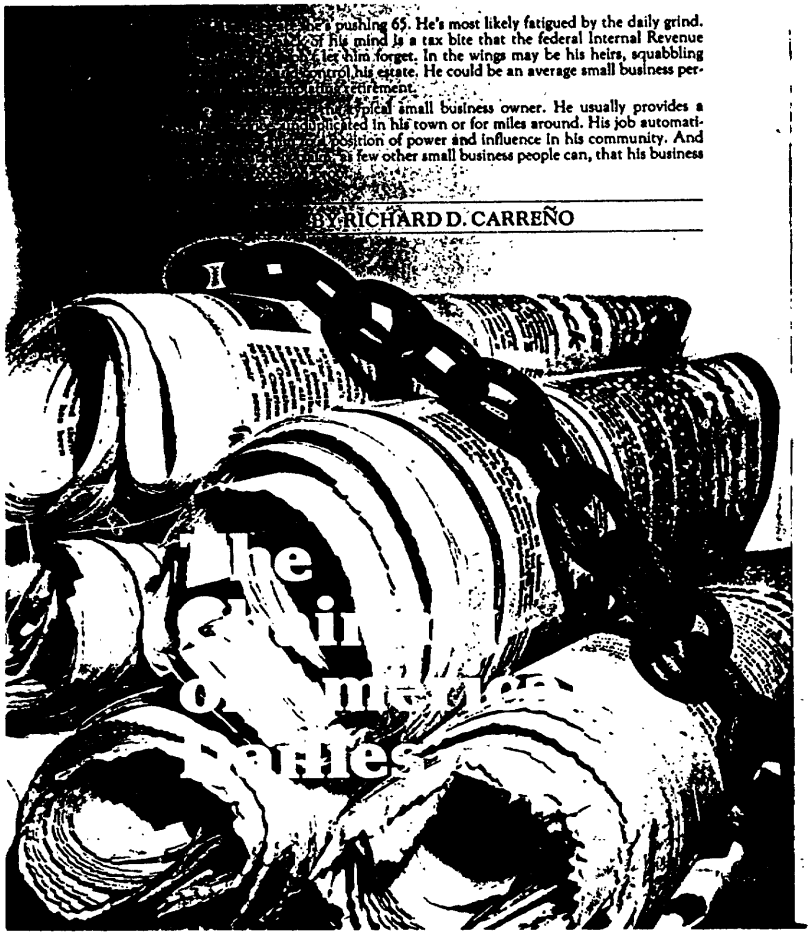
Ray Morgan

56-071 566

JUNE/JULY 1979
Small Business
A Small Business Service Bureau, Inc. Publication



How far does it go?



...e's pushing 65. He's most likely fatigued by the daily grind. ...of his mind is a tax bite that the federal Internal Revenue ...ler him forget. In the wings may be his heirs, squabbling ...control his estate. He could be an average small business per- ...retirement.

...he typical small business owner. He usually provides a ...unmatched in his town or for miles around. His job automati- ...position of power and influence in his community. And ...as few other small business people can, that his business

BY RICHARD D. CARREÑO

He is the owner-publisher of the small daily newspaper. You may criticize him for being too liberal or too conservative. You may praise him for courage and foresight, or condemn him for weakness and narrow mindedness. But when all is said and done, you probably also read his paper and advertise in it. For reader and advertiser alike, it is your local newspaper and in most cases there is no other.

The consumer's lack of an alternative contributes significantly to the power and wealth of the local publisher. He also holds what those concerned with journalistic diversity and freedom of the press consider a special trust. This is particularly true, they say, as more and more small communities, like many large cities before them, are becoming one-newspaper towns.

But if any one factor truly sets the publisher apart from his small business colleagues, industry observers are quick to point out, it is the press's First Amendment constitutional guarantee. As other small business people fret about truth in advertising, truth in lending and truth in packaging, all under a watchful government eye, the publisher just worries about the truth—or his particular version of it. The publisher might have all the advantages of the non-competing local utility. But in addition he has one more: Unlike the utility, his business is unregulated.

But if the independent publisher's status puts him in a unique position as a small business person, he is, in at least one respect, remarkably similar to many of his colleagues. Like other small entrepreneurs—from the owners of the corner pharmacy to the local butcher—the small independent newspaper publisher is part of what many people think is a dying breed.

"Within two decades, virtually all daily newspapers in America will be owned by perhaps fewer than two dozen major communications conglomerates."

Chains Court Last of Independents.

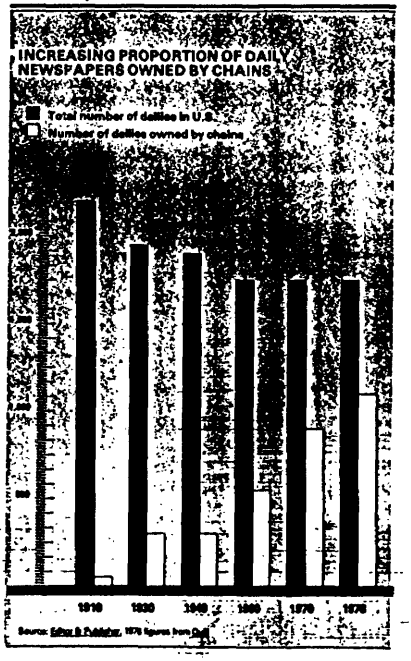
There are fewer and fewer publishers like Keith Prescott Low of *The Patriot Ledger* in Quincy, Massachusetts, whose forebears were part of the family business since the 1860s. "It's a philosophical thing with me," Low says. "I think it's important to have roots in the community."

Last year, Low had the opportunity to back that philosophy with action, according to *Fortune* magazine. *Fortune* reported that Low turned down a $20 million bid for his paper, saying, "We're not interested. Period." More recently, the paper's editor, William B. Ketter, was unwilling to confirm the $20 million figure, but conceded that Low had received offers for the paper and that Low's philosophy was accurately portrayed by the *Fortune* article. He also stressed that Low is not "anti-group" and feels that there is a place for both chains and independent newspapers within the industry.

Low's refusal to sell is not typical, however. Many publishers *are* interested—very interested.

The same concentration that has resulted from the merger and acquisition activity in other independent industries and services is now emerging as the trend in the newspaper industry. Media conglomerates and newspaper chains are swallowing the independents—small, medium-sized, and large papers alike—like so many minnows.

John Morton, respected newspaper securities analyst, likens the trend to the concentration of supermarket ownership. A series of articles in *The Washington Post* two years ago made the trend sound more ominous. "Within two



decades, virtually all daily newspapers in America will be owned by perhaps fewer than two dozen major communications conglomerates," said *The Post*, which itself owns a piece of the action.

Larger chains like Ottaway Newspapers Inc., itself a subsidiary of the giant Dow Jones & Co., (publishers of *The Wall Street Journal*), buy yet smaller chains. Such was the case last year when Ottaway purchased Essex County Newspapers Inc., publishers of four small Massachusetts dailies, *The Beverly Times*, *The Gloucester Daily Times*, *The Newburyport Daily News*, and *The Peabody Times*.

Gannett Newspapers of Rochester, New York, the largest of the chains, only enhanced its stable of papers last year when it bought the medium-sized *News* and *Journal* of Wilmington, Delaware, papers that were formerly owned by the E.I. DuPont de Nemours & Co., the chemical company. (Because of its aggressive purchasing efforts, Gannett is considered to be among the most predatory chains. Gannett executives use private jets to move swiftly into small communities when there's a possibility that a paper might be up for sale.)

Also last year, Time Inc. broadened its daily newspaper holdings by buying the independent *Washington Star*, one of the country's most respected papers and, with a daily circulation of about 350,000, one of the largest.

In all, 53 dailies were sold in 1978. Forty-six wound up in the hands of group (owners of two or more papers). By the beginning of this year more than 1,100 of the country's 1,762 dailies were owned by groups.

The nation's 170 newspaper chains now own enough newspapers to control over 70 percent of all daily circulation in the country. The 10 largest chains own 279 daily papers and control a combined circulation of about 22 million.

Knight-Ridder Company is the largest chain in circulation. Its 32 daily papers have a total daily circulation of about 3.5 million. Gannett Company, with the largest number of papers (78) controls a circulation of nearly three million. The top-ten chain with the smallest circulation is Thomson, whose 63 [U.S.] papers have a combined circulation of about 1.1 million. The Times-Mirror Company, with the fewest number of papers (six), still has a combined daily circulation of around 1.8 million.

The quickening pace at which groups are acquiring papers is also evident. In 1910, 62 papers were owned by 13 groups. In 1940, 319 papers were owned by groups. By 1970, 879 papers were owned by 157 groups. *[See chart on page 7.]*

So fast is the tide of acquisitions (multiple newspaper ownership) that figures have to be adjusted almost monthly. David Shaw, the media reporter for the *Los Angeles Times*, was forced to make last-minute revisions in an article on newspaper acquisition that first appeared in the *Times* and was later reprinted in *The Quill*, a magazine published by a professional journalists' organization. In the original piece, published last September, Shaw noted that Gannett was the owner of 77 papers. In the revised *Quill* article, published last December, the figure was amended to 78.

High Profit Potential Prompts Acquisitions.

At the root of the trend to group ownership is the potential for high profit returns. Despite the well-publicized shutdowns of some major newspapers (notably the *Chicago Daily News* last year), the newspaper

FACTS AND FIGURES

• Chain-owned papers control about 22 percent of all daily newspaper circulation in the United States today. The top 20 chains control more than 30 percent of all daily circulation. Four chains control more than 20 percent of all daily circulation.

• In 1920, 700 American cities had competing newspapers under separate ownership. Today fewer than 40 do.

• Independent papers are being bought by chains at the rate of 50 to 60 per year. Of the 53 dailies that were sold in 1978, 46 are now group-owned.

• Today there are fewer than 700 independently-owned daily newspapers in the United States.

FEELINGS

• [illegible] could a newcomer tell by reading a few [illegible] whether the local newspaper was owned locally or by the Gannett or Knight-Ridder chains? Anyone [illegible] understand why most local journalism is [illegible] native, and trivial must admit that the encroachment of chains, groups and conglomerates is not the [illegible]

— [illegible]

• Ultimately we [illegible] small newspapers because we believe in small communities and [illegible] social and political institutions. Each new publication adds to our collective independence by resisting the appalling homogenization of culture and information brought on by a centralized news establishment.

— THE EDITORS OF THE HARVARD (MASSACHUSETTS) [illegible] AND AUTHORS OF "[illegible]"

• I don't want to pretend that all independently owned papers were great paragons of journalism because obviously they weren't. But the publisher whose [illegible] and ego are involved in the community is more apt to take the coverage of the community more seriously and enhance the property than someone who [illegible] that property as a source of capital for investment elsewhere.

— BEN H. BAGDIKIAN, JOURNALIST, EDITOR AND MEDIA [illegible]

• Everything in the newspaper business starts with the reader product, and unless you're on target in terms of what you're giving the reader, then you can't make it. If you are on target with that, everything else—advertising, circulation—will follow.

— ALLEN H. NEUHARTH, GANNETT NEWSPAPERS

industry is exceedingly prosperous. Based on data supplied by analyst Morton, *The Washington Post* reports that the after-tax profit margins of the 13 major publicly-owned newspaper companies were last year about 10 percent of sales. That figure compares to a 5.4 percent profit margin for all companies on *Fortune* magazine's 500 list and a 6.9 percent margin for all printing and publishing companies. Privately-held newspaper companies reportedly enjoy about the same profit margins as those held publicly.

In late April, the American Newspaper Publishers Association reported even more good news. Advertising revenues for dailies increased to a record $12.7 billion in 1978, a 14 percent increase over 1977. Employment in the industry also reached a record high, increasing by 11,000 to 406,200 workers.

The high profitability of newspapers is linked to another more visible trend in the industry—the development of single-paper markets. The result has been monopoly ownerships that make newspaper ownership literally distinct from many other forms of business, particularly small business. Nowhere in the arena of small business are clients such a captive audience as are the readers and advertisers of a local newspaper. Without competing media, a newspaper constituency has no alternative to its local publication—regardless of its quality, its cost and its profits to its owners.

Like other small entrepreneurs—from the owners of the corner pharmacy to the local butcher—the small independent newspaper publisher is part of what many people think is a dying breed.

The investment potential in small papers in monopoly markets has, as a consequence, skyrocketed.

Contributing to the climate for acquisition by chains are other factors. Among the most significant are federal inheritance taxes that weigh heavily against the independent publisher whose assets are almost exclusively invested in his newspaper.

Other Factors Encourage Selling.

The Columbia Journalism Review came up with some other conclusions when it reviewed the tax dilemma in an article last year:

"Income taxes stimulate newspaper-owning companies to use their profits to buy other newspapers. If they pay out profits as dividends, the money is taxed twice—first through the corporation income tax of roughly 50 percent and second through the normal income tax on stockholders. Individual newspapers usually don't lend themselves to indefinite expansion. So the easiest way to plow back earnings is to buy other newspapers."

The magazine also noted that, "The typical newspaper is worth much more to the new buyer than to the old because of tax regulations governing plant depreciation. The present owner has probably used up all his depreciation allowance on the newspaper's building and much of the depreciation allowance on equipment. The new purchaser can have the property reappraised on the basis of current market value (and replacement cost) and start the depreciation process over again, with huge tax savings."

The acquisition scenario is usually played out in one of two forms. In one, the publisher is often elderly and bereft of suitable heirs, the second and third generations that would normally become beneficiaries of the newspaper. Without sufficient capital to offset inheritance taxation, and sometimes even without the interest of heirs in continuing the family's publishing tradition, the publisher is confronted with sale—either before his death (the preferable choice) or after, when the paper is liquidated by the estate. In this scenario, the publisher may also lack the will to continue publishing, his initiative sapped by advancing age.

The second scenario is less complex. In this case the publisher is eager to consider sale to a chain because profits are uppermost in his mind.

This monetary factor can't be ignored. Chains are willing to pay prices that individual investors can't easily marshal. While some years ago, newspapers sold for 10 to 25 times net earnings, chains are now bidding as high as 30 to 40 times earnings and as high as four times gross revenues.

It is no small fact that Gannett paid $60 million for the *News* and *Journal* of Wilmington, $40 million more than Time Inc. paid for *The Washington Star*. The combined circulation of the Delaware papers is about a third of *The Star's* circulation. Again, the explanation is economic. The Wilmington papers, which blanket the state with their circulation, are considered an excellent long-term investment. *The Star's* growth potential is said to be marginal.

PERCENTAGE OF CHAIN-OWNED DAILIES

YEAR	NO. OF DAILIES	NO. OF DAILIES OWNED BY CHAINS	% OF TOTAL
1910	2,202	62	2.8%
1930	1,942	311	16 %
1940	1,878	319	17 %
1960	1,763	560	31.8%
1970	1,748	879	50.3%
1978	1,753	1,096	62.5%

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Proposals for Tax Revision and "Competitive Review."

Revision of the tax codes has become a legislative priority of Congressman Morris Udall, the liberal Democrat from Arizona. Udall, who has become a champion of diversity in journalism, filed two bills last year which would relate directly to the newspaper industry. One, the Local Independent Newspaper Act, would offer tax relief to the independent publisher. The other, the Competition Review Act, would establish a federal commission to oversee competition within certain industries, including book and newspaper publishing.

Because of the specialized nature of the Newspaper Act in targeting a segment of the small business community, the measure is of particular interest to small business people. What the proposed law would do, according to Robert A. Neuman, an aide to Udall, is establish a mechanism that would permit an independent publisher to set aside some earnings in an income tax-exempt trust. The sheltered money could be used to pay inheritance taxes. The law would protect many independent publishers from the need to sell, Neuman explains. But the law would also protect a concept that Udall feels is embodied in the independent press: its diversity of ideas. "If we can help someone hold onto his property, we think we will have done the public some good," Neuman said.

Ironically, Udall's proposal has become the subject of its own controversy. Many within the press, including prominent independent publishers like Malcolm Borg of *The Record* in Bergen County, New Jersey, have complained that the Newspaper Act represents the kind of special interest legislation that newspapers should avoid seeking. (Many publishers, as well as editors and reporters, fear that specific legislation aimed at newspapers, because it's subject to interpretation and court rulings, may erode First Amendment rights.)

The American Newspaper Publishers Association and the National Newspaper Association suggest that tax law revisions be applied to all closely-held companies. "If the bill [the Local Independent Newspaper Act] is confined to newspapers it will soon be labeled 'special privilege' and never get anywhere," said a March editorial in *Editor & Publisher*, a trade journal. "The principle of tax revision is a good one if applied to all small, privately-owned businesses."

Chains Leave Little Space for New Blood.

Will the rate of sales to groups level off or even abate? No, says John Morton, the Washington-based newspaper analyst and probably the most respected trend watcher in his field. Morton does note, however, that the pace of acqusition will vary from region to region and that some small community papers will be among the last to fall to the pack. Morton includes among these papers those in old industrial communities in the northern Midwest and in New England. Generally, he says, they're mill town papers and not "vigorously sought after" by chains because mill town markets are "somewhat static" and "prospects for growth are not that strong. What companies want to buy is earning growth," he explains.

The kind of earning growth the chains are looking for, Morton

GETTING NEW BLOOD INTO THE FIELD

Just as the current newspaper market makes it difficult for locally-owned newspapers to resist sale to chains, it severely restricts the possibilities for "new blood" to enter the publishing field. There are still some young publishers, however, who have been enterprising enough to find a spot for themselves. Loren Ghiglione is one.

notes, is the potential for doubling or tripling of earnings. Chains also hope to increase profits by introducing new technology and improving management. Finally, Morton notes they almost always court newspapers with circulations above 250,000.

Still, even the mill town papers that Morton describes as not "particularly desirable," have received offers. The mill town papers just don't fetch the highest prices. Instead of selling prices of 30 to 40 times net earnings, these papers might sell for 20 times earnings. Instead of four times revenues, the selling price for high-priced papers, Morton says that mill town papers might sell for two times revenues.

Morton stresses another aspect of the sales market: It has no room for new independent blood. A small independent publisher, Morton says, risks "great peril" if he thinks he can start a paper in an already established market. Even chains, he notes, with the financial resources that few indivi-

Frank McNitt, former owner of The News, felt that "community and paper [are] better served by someone actively involved in the community." In selling his paper to Ghiglione, McNitt showed his willingness to back up this belief by accepting less ...

Loren Ghiglione, publisher of *The Evening News* in Southbridge, Massachusetts, is new blood. In fact, Ghiglione contends that he is among a handful of independent publishers of no great financial means to buy a daily newspaper within the past 10 years. Ghiglione's motivation in buying a paper was rooted in his social activism. He decided that he would make a newspaper the outlet for that activism.

Ghiglione, who is also *The News*' editor, is introspective about the industry. His press criticism has appeared in national publications and a review of the New England press which he edited has attracted national attention and an award from Sigma Delta Chi, a prominent society of professional journalists.

The 38-year old Ghiglione is a founding member of the National News Council, president of the New England Society of Newspaper Editors and a New England advisory board member for United Press International. He holds a master's degree and a law degree from Yale University and a doctorate from George Washington University.

Like others who are critical of newspaper concentration, Ghiglione shares concerns about editorial quality under group ownership, the standardization of news content and the "almost outrageous" prices that groups pay for papers. And after his own experiences trying to buy a paper, it's not surprising that one of Ghiglione's primary worries is that the industry is now so structured that no new publishers are entering the field.

If they are not sold to groups, press critics point out, many newspapers are guided by the royal tenets of succession. From generation to generation, the paper remains in one family's hands. And as is the case with royalty, even the idiot son may become king—or publisher.

For someone like Ghiglione, who did not come from a newspaper family, it is more difficult to become a publisher. He explains that his purchase of *The News* (circulation: 6,200) was almost a fluke. Part of his buying strategy was a national search that took him from California and Minnesota to South Carolina and New England. In all, he visited about a dozen states and spoke with newspaper brokers and publishers in all of them. "It was an education for me," Ghiglione said in a recent interview. "Not having a family in the business, it was a way of learning about the business in a short time."

One of the things that Ghiglione learned, he said, was that many independent publishers would express "sympathy" with his goal of joining their ranks but that "very few would sell without getting the most they could." That meant, of course, that they would eventually sell to groups.

Ghiglione admits that he started his own search for a newspaper fortified by a "romantic image" of the role of the independent publisher. But he was also convinced then—and remains so today—that "the need is just as great if not greater" for talented people to work at small papers as it is for them to work at large metropolitan dailies.

Ghiglione explains that he was finally able to buy *The News* only because its former owner, Frank McNitt, was—he searches for the right word—"unusual." For one thing, Ghiglione says, McNitt felt that "community and paper would be better served by someone who was actively involved in the community." Moreover, Ghiglione added, McNitt was prepared to back up that belief, unlike other publishers Ghiglione encountered, by accepting less money than he would otherwise have received from a group.

There was another "unusual circumstance" in the purchase. McNitt permitted Ghiglione to learn about the paper first hand by letting the new publisher work as his assistant before the sale was final.

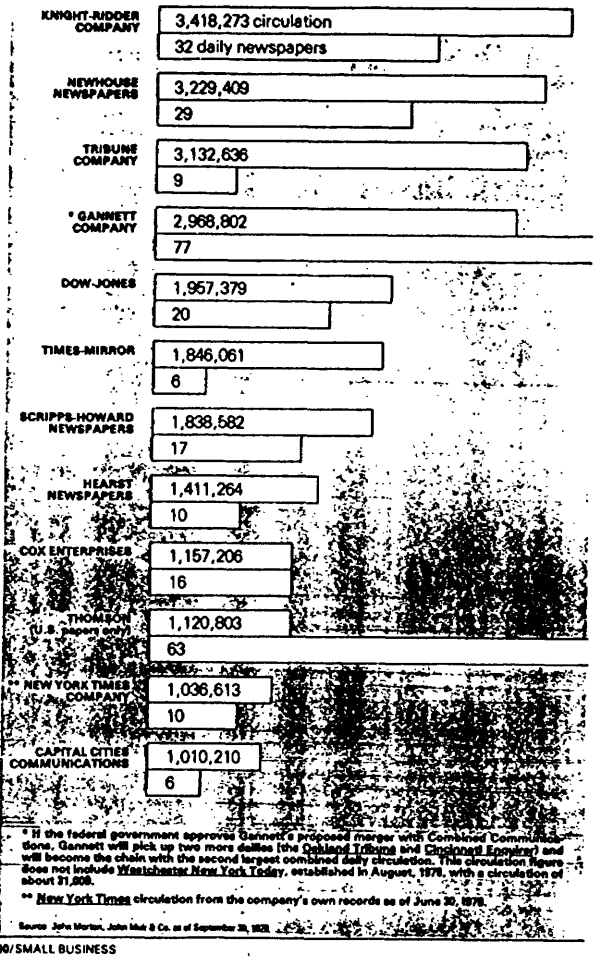
"I don't think I'd be able to do today [buy the paper] what I did then," Ghiglione says. He worries about the costs that prevent newcomers from breaking into publishing. He worries about interest rates that have climbed from 6½ percent when he bought *The News* 10 years ago to 12 to 13 percent today. "That eliminates most individuals if they're not multi-millionaires," Ghiglione says.

Still, Ghiglione doesn't counsel defeat, although he does believe that "dailies are out" as potential acquisitions for new owners. "You have to go to a weekly," he says. Ghiglione also suggests that the newcomer should avoid brokers, who are primarily interested in groups and increased commissions. The individual buyer has to "hope for a long-term payout" to the former owner, Ghiglione says.

Finally, he contends, getting into business is also a matter of attitude. "You have to be ready to mortgage yourself to the hilt to show that you are committed and that buying a newspaper is the most important thing in your life at that moment." For Ghiglione, at least, it was important enough that he managed to locate an owner who admired his determination enough to sell him his newspaper. ■

TWELVE LARGEST NEWSPAPER CHAINS

Ranked in order of each chain's combined circulation (top bar) and showing total daily newspapers in each chain (bottom bar).



* If the federal government approves Gannett's proposed merger with Combined Communications, Gannett will pick up two more dailies (the Oakland Tribune and Cincinnati Enquirer) and will become the chain with the second largest combined daily circulation. This circulation figure does not include Westchester New York Today, established in August, 1978, with a circulation of about 31,000.

** New York Times circulation from the company's own records as of June 30, 1978.

Source: John Morton, John Mack & Co. as of September 30, 1978.

duals can match, don't do that.

These concerns—the tax implications of ownership, the infusion of independent capital in the industry and the relationship between diversity of ownership and press freedom—are part of a growing inquiry into the changing status of the press. The National News Council, an independent organization that reviews journalistic issues, is now studying the concentration trend. Brickbats from critics and reassurances from spokesmen for the chains are lobbed from one camp to the other.

Press critic Ben H. Bagdikian, a former reader ombudsman for *The Washington Post*, sees concentration as a means by which groups can "influence public opinion and government policy" to serve their own economic and corporate interests. "The potential threat of centralized, remote control of concentrated economic and editorial power is always there," warns John B. Oakes, a former senior editor of *The New York Times*. Says Congressman Udall: "I dread the day when all American newspapers look alike and read alike and when

FOOTNOTES TO CHART

* If the federal government approves Gannett's proposed merger with Combined Communications, Gannett will pick up two more dailies (the Oakland Tribune and Cincinnati Enquirer) and will become the chain with the second largest combined daily circulation. This circulation figure does not include Westchester New York Today, established in August, 1978, with a circulation of about 31,000.

** New York Times circulation from the company's own records as of June 30, 1978.

there won't be much more difference in the daily newspapers in Topeka and New York than there is in—a Big Mac."

Many people have been wondering aloud what happens to a free press and a free people if newspaper groups order their affiliates to manage the news to promote or downgrade an issue. Allen H. Neuharth, Gannett's president, contends that such dictated policy would never come to pass. "The public is too sophisticated to accept that now," Neuharth explains. "It would be bad journalism and bad business. We believe completely in the concept of local autonomy—letting our individual editors and publishers decide their own news play and endorsements and everything else."

But a case involving the Michigan-based Panax Corporation chain raises the spectre. Last year, the chain was accused of ordering its papers to print front-page articles critical of President Jimmy Carter. Two editors refused. One was fired and the other reportedly resigned under pressure. Panax has denied the allegations.

"Good Guys" vs. "Bad Guys." Because of Gannett's size and prestige, Neuharth has become something of a symbol in the debate over newspaper concentration. He is flamboyant in personal style, an outspoken exponent of group newspaper ownership and no apologist for the keen business acumen that has placed his chain in its eminent position. As a result, Neuharth is also frequently portrayed as the personification of the evils of concentration—the technocrat as journalist.

"I dread the day when all American newspapers look alike and read alike and when there won't be much more difference in the daily newspapers in Topeka and New York than there is in—a Big Mac."

But symbolism isn't reserved for Neuharth alone. In fact, the debate over concentration often conjures up a mythical romantic past to do battle with the present. In one corner is the independent publisher, whom critics of concentration almost invariably depict in the mold of William Allen White, the crusading publisher of the Emporia, Kansas, *Gazette*. In the other corner are the groups, which their critics identify with some of the more blatant excesses of such press lords as William Randolph Hearst and Colonel Robert McCormick, the original owner of the *Chicago Tribune*. Lamentably, the case—even as endorsed by Congressman Udall—is frequently presented as the "good guys versus the bad guys." Nothing could be further from the truth.

There are prize-winning chains—Knight-Ridder—and those which are less aggressive in reporting the news—Scripps Howard Newspapers. There are good independent newspapers and there are bad independent newspapers. Critics often forget that William Loeb of the Manchester [New Hampshire] *Union Leader*, probably one of the most irresponsible and most viciously vituperative publishers in the country, is an independent, too.

Moreover, the good-guy-versus-bad-guy debate fails specifically to address at least one problem that astute press observers maintain is among the most critical issues within the industry today: the almost insurmountable problem of getting new blood into the newspaper publishing field. *[See sidebar, page 8.]*

The proposed Udall law, for instance, would in no way stimulate acquisitions of papers by persons who now have no business interests in the industry. In fact, the law would perpetuate at least one failing of local ownership—the retention of papers by heirs who, as John Morton notes, may have little commitment to journalistic excellence. "Whether independent or group-owned," says Morton, newspapers "operate as monopolies. Independent, locally-owned newspapers have seemed, if anything, less willing than their group-owned brethren to tilt against the local establishment of which they and their owners are inevitably members in large standing."

"To some degree, Congressman Udall is remembering good old days that never were," says Alvan H. Chapman, Knight-Ridder's president and chief executive officer. "To be sure, a fair number of American communities a generation or two ago were blessed with the sort of independent publishers he's talking about—fearless men and women, rooted in their communities, who told the truth as they saw it and fought for the best interests of their areas. But unfortunately, it's also true that this was simply not the dominant pattern. Many, many newspapers across the country were pervasively mediocre, unprofessional and timid. They often lacked the economic strength—or will—to resist the special interests which called the shots in their communities."

As Chapman described the past, he also describes the present. ■

Richard D. Carvello is a freelance writer living in Connecticut. He is news critic and ombudsman for The Evening News *of Southbridge, Massachusetts.*

Senator CHAFEE. All right, who is next?

Mr. LEVIN. I am Morris Levin, and Mr. Iannucci who is——

Senator CHAFEE. OK, Mr. Levin, go ahead.

STATEMENT OF MORRIS J. LEVIN, COUNSEL, INDEPENDENT LOCAL NEWSPAPER ASSOCIATION, ACCOMPANIED BY JOSEPH S. IANNUCCI AND RAYMOND J. WIACEK

Mr. LEVIN. I have a statement which I have also requested be in the record. I think Mr. Iannucci would request the same.

Just in response to your question, Senator, there are many ways that the chains can save money. Often they pay with paper, stock dividends, stock switches. That is tax free to both the buyer and the seller. If there is a total stock exchange, or up to 80 percent, as I understand it under the tax laws, they don't pay cash. They also have a tremendous cash flow which an independent paper cannot have. They have the accumulated earnings of a dozen or more papers. They have the benefit, also, of a Washington bureau which can cover more and more national or international news.

There are many ways through equipment, machinery, ability to set aside funds under section 531, that they can put away money and make a greater profit. And I would like to correct the statement I think that Senator Morgan made. It isn't 20 and 30 times earning.

Senator CHAFEE. I said that.

Mr. LEVIN. Excuse me, then, sir.

Senator CHAFEE. What is it?

Mr. LEVIN. Up to 60, and last year in a purchase in the State of Louisiana, Shreveport and Monroe, the estimated price was 83.3 times earnings, by the Gannett Co.

Now, Senator, if I can speak as a Rhode Islander for 1 second——

Senator CHAFEE. Yes.

Mr. LEVIN. We are blessed. We have almost all locally owned newspapers.

Some of the publishers, for example, in Rhode Island, have gotten quite old. It is not possible for them to guarantee succession. It just cannot be done today.

Senator CHAFEE. Let me ask you a question. Isn't a solution to this—first of all, we run into a problem immediately of why treat the press separately? Now, yes, you have got the argument that the free press and so forth, although I don't think there is significant evidence that the Knight-Ridder or the Gannett or whoever they are, the chains, have stifled the free press, but maybe you can argue that. I don't know.

Mr. LEVIN. No argument there, sir, none.

Senator CHAFEE. But here we are, we are treating—what about the family farm? What about the family machine tool business? All of these things, aren't they all going to come in and say, take care of us, too? I attended an affair in Chicago of the Family Business Association of America, which they are asking the same thing, the small family business is going down the drain, they say.

Now, how do we answer that?

Mr. LEVIN. First of all, 2 years ago in the Tax Reform Act of 1976, this was done for the family farm, or I should say, it was

attempted to be done by a change in the valuation of the farm, so there is precedent for doing what we are talking about.

Second, our bill provides what can be used as a test. Since there are a finite number of independent newspaper owners, approximately 600 dailies, you could run this as a test for 2 or 3 years. We say it will make money for Treasury, not cost them money. The Joint Committee on Taxation says that they foresee a possible revenue loss of $10 million a year, but we think that under our figures and with today's inflation rates, that the Treasury would actually make money.

If what we are proposing works—and it can be forecast within 3 to 4 years—absolutely, make it available to other small businesses as well. We are giving you a——

Senator CHAFEE. Well, thank you, and isn't—well, I won't—it seems to me one solution would be for the father who owns the business to every year distribute some of the stock to his heirs so that when he dies there isn't this massive estate tax.

Mr. LEVIN. $3,000.

Senator CHAFEE. But he has got a lifetime limitation——

Mr. WIACEK. But the lifetime exemption is $60,000, and we are talking about $50 million moreover under the unified system put in in 1976, all those gifts will be taxable; they will form part of the estate.

And one of the other big differences——

Senator CHAFEE. Well, now, wait a minute, no, they wouldn't be part of his estate unless he died within——

Mr. IANNUCCI. It is calculated in his estate tax rate. The rate is calculated in such a way that it is a unified schedule, so all the gifts, the taxable gifts you make in your lifetime, determine your beginning bracket for your estate tax. If you give away $25 million in your life, your starting bracket for your estate is $25 million.

Mr. WIACEK. They are in your estate. You just get a credit for the gift tax paid earlier.

Mr. IANNUCCI. In reponse to your question of why start with newspapers in preference to other businesses, you are dealing with a situation where the multiple paid for the newspaper is so high and the valuation is so high that if you want to retain the newspaper and pay your tax, that you can't get a cash flow out of the newspaper as it is run independently to pay your tax and pay the interest on it.

The paper as run as an independent just doesn't generate enough after-tax dollars to allow you to pay the tax that is due.

Senator CHAFEE. Senator Dole?

Senator DOLE. I am sympathetic with what the bill proposes to do. I am not totally certain. We have a lot of problems in our small States, particularly with acquisitions of daily newspapers.

Mr. LEVIN. Senator, may we respond in writing to some of the points you have made?

Senator CHAFEE. Don't misunderstand me. I am not against the proposal. I am just troubled by what kind of a path we are going down.

Suppose it is a family-owned television station; a family-owned television station was just sold in Sacramento the other day to a

Rhode Island outfit for $63 million. Now, that I suppose that man was doing it in connection with settling his estate, potentially.

Mr. WIACEK. I do some work in the broadcasting field, and again, I think the point about multiples is relevant here. The FCC keeps data on the purchase price, because of the regulated nature of the industry, of all broadcast assets, and for the last 2 years, the average multiple is in the range of 10 to 16, and we are talking 40 to 60 to 80. So the artificiality of the price upon which the estate tax is based is just fundamentally different in the independent newspaper field.

Senator CHAFEE. Maybe that could be taken into account just somehow, but that also gets us down a dangerous path.

Mr. LEVIN. Mr. Gutman said that they might be better off exempting them from taxation. We didn't ask him for that, but if he really pushes it, we will take it.

Senator CHAFEE. Well, that really would go down a different—OK, anything else?

Mr. LEVIN. Thank you, sir.

Senator CHAFEE. Thank you.

[The prepared statements of Messrs. Levin and Iannucci follow. Oral testimony is continued on p. 459.]

STATEMENT OF MORRIS J. LEVIN, INDEPENDENT LOCAL NEWSPAPER ASSOCIATION

Mr. Chairman. I am Morris J. Levin, of Levin & Toomey, a law firm in Washington, D.C. I appear today as counsel for the Independent Local Newspaper Association, and am accompanied by Joseph S. Iannucci and Raymond J. Wiacek, of the law firm of Jones, Day, Reavis & Pogue.

The Independent Local Newspaper Association (ILNA) is a trade group, whose membership is composed of newspapers which would benefit from the legislation proposed in S. 555. That is, newspapers which are not part of interstate newspaper chains or publicly traded.

Members of the ILNA are also members of the two major newspaper trade associations, the American Newspaper Publishers Association (ANPA)—which basically represents the nation's daily newspapers, and the National Newspaper Association (NNA)—which represents some smaller daily and most weekly newspapers. These two organizations are, I believe, represented here today. Last year, they took a position which was neither in support of nor opposed to predecessor legislation in the 95th Congress, but offered other proposals. They have this year joined in a set of legislative recommendations regarding estate taxes, but remain officially neutral on S. 555. Their legislative recommendations are not designed solely for the independent publisher, as is S. 555. Their recommendations are for broad based legislation, and would provide benefits to most of the newspaper chains—those which are family owned or are closely controlled corporations. If these recommendations were enacted, there would be no inhibitions against further purchases of independents by these chains. Thus, their proposals do not go to the heart of the problem raised by S. 555—the preservation of independent newspapers.

Today, the nation's newspapers are dominated by chains—two-third, of the dailies are owned by chains, and they have over 72 percent of daily and 75 percent of Sunday circulation.

The interests of the chains are not necessarily devoted to the protection of independent newspapers. The chains are buying such independents at a rate of better than one daily and three to four weeklies every seven days. The number and strength of the chains waxes stronger as the list of independents decreases. Simply stated, there can be no true consensus within the newspaper industry as to how, or even whether, to provide some legislative relief for independent newspapers threatened by the estate tax laws. I mention this because last year, in commenting on this legislation, Daniel L. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy, suggested that there should be an "industry consensus".

It is worth noting that Allen H. Neuharth, the Chairman and President of the ANPA, who is also the Chief Executive Officer of Gannett Co., Inc., has stated on several occasions that neither he nor ANPA takes a position on S. 555.

While some within the newspaper industry now decry special legislation as proposed in S. 555, it would appear that they have forgotten the full support given by

the ANPA less than ten years ago to the Newspaper Preservation Act, an amendment to the antitrust laws which benefitted only 44 newspapers in 22 cities. They also seem to brush aside other special legislation benefitting the newspaper industry in the postal laws, in the tariff laws covering newsprint, and in many other areas. (See the lists under "newspapers" and "newsprint" in the index section of the United States Code.)

With regard to the criticism which has been leveled at S. 555, that it is special interest legislation limited to independent newspapers, I must point out that the sponsors of this legislation apparently have little or no interest in protecting and forstering the growth of family-owned or other closely controlled chains. S. 555 can, however, easily be expanded to cover and include other similarly situated businesses. Since there are a finite and known number of independent newspapers, the efficacy of the approach taken by S. 555 can be determined within a few years after enactment. Thus, S. 555 can be used as a test and model for other family-owned independent businesses.

The fact is, no other industry is now beset by such highly inflated purchase prices as now are prevalent with independent newspapers. As already stated, they are being gobbled up at an increasing rate, and it now appears that there is not too great a supply left, and all may soon be gone unless remedial action is taken immediately.

Mr. Chairman, there is a real and immediate need for S. 555. This is a pragmatic solution to the problem described by other witnesses, at little, if any, real cost to the Treasury. The Treasury apparently agrues that there is a problem, but denies responsibility as to the causal factor, and flatly refuses to come up with any means of relief. The answer is not in the antitrust laws, as has been recognized by Assistant Attorney General Shenefield in testimony on this subject.

It is the effect of estate taxes on the swollen values placed on newspapers that causes the sales to newspaper chains. The Congress cannot lower the prices paid for newspapers, but it can adjust the estate tax laws. This was done for the family farm in the Tax Reform Act of 1976. Relief should also be provided for independent newspapers.

Mr. Chairman, we have met with Treasury officials last year and again in 1979 in an attempt to work something out that Treasury could support. They flatly oppose S. 555. They flatly oppose providing a modificaton to the valuation formula for newspapers, as had been done for family farms. They offered no suggestions as to means whereby Treasury could alleviate the problem, other than stating that they sympathized with our situation.

It is not enough to recognize that independent newspapers are an endangered species. Something must be done, and done soon, to relieve the pressure on the independents, so that they are not forced to sell their newspapers. Without being facetious, I must state that independent newspapers are at least as important to our nation as the snail darter and the furbish lousewort.

Treasury stated during hearings on companion legislation before the House: "Complications caused by special interest bills must be weighed against the equity in the claim for relief. Unless the equitable argument is extremely strong, the claim should be rejected."

Mr. Chairman, this bill, S. 555, seeks to preserve for the public an independent press at little if any real cost to the Treasury. There is great equity in our claim for relief. We urge the Committee to give its favorable consideration to S. 555.

TESTIMONY OF JOSEPH S. IANNUCCI

I am Joseph S. Iannucci, a partner in the law firm of Jones, Day, Reavis & Pogue, 1100 Connecticut Avenue, N.W., Washington, D.C. I appear today as counsel for the Independent Local Newspaper Association, in support of S. 555. My comments are basically explanatory of the tax consequences of this legislation, and a response to the statement offered by the Department of the Treasury at hearings on H.R. 2770, bill identical to S. 555.

This bill is intended to address the basic cause of the continuing diminution in the number of independently owned newspaper—and that is the effect of the Federal estate tax upon such properties.

Because local independent newspapers are selling at artificially inflated prices frequently thirty to sixty times earnings, heirs of the owners of such newspapers are finding it impossible to pay estate taxes, and the owners are finding it impossible to find an acceptable method to save for the payment of estate taxes, short of selling the newspaper to those willing to pay thirty to sixty times earnings; invariably, this means a sale to a newspaper chain.

Because small newspapers sell for at least thirty times after-tax earnings, one's interest in such a newspaper is valued, for estate tax purposes, at thirty times earnings. Under current law, this situation makes it impossible, even under the most liberal deferral provisions, to fund the estate tax burden from the earnings of the newspaper. As a result, the deceased's interest must be liquidated to pay the tax.

For example, assume a person has a $5 million interest in an independent newspaper (conservatively valued at thirty times earnings) and assume that that interest constitutes the bulk of his estate. At current rates, the estate tax due on the $5 million interest would be $2,550,880 (assuming the unified credit under Section 2010 is applied to reduce estate tax owed on other assets). Under current law, the executor of the estate may elect to extend payment of the estate tax for up to 15 years if the value of decedent's interest in a closely held business exceeds 65 percent of the decedent's adjusted gross estate (Section 6166(a)). The tax in our example (but not interest thereon), therefore, may be deferred for up to five years and then paid in equal installments over the next ten years. Interest accrues (and must be paid annually) at four percent per annum on the first $345,800 of deferred tax (assuming the unified credit is applied to reduce estate tax owned on non-newspaper assets of the estate) and at nine percent per annum for the remainder (Sections 6601 and 6621).

Thus, in our example above, the estate would owe $222,656 per year in simple interest payments for the first five years following the demise of the newspaper owner, and level tax payments of $255,080 *plus* interest payments decreasing each year (as the balance due is decreased) but starting at $222,656, in each year thereafter. For year six, then, a total of $477,736 would be due the Treasury.

Given that the newspaper can only expect to earn $166,666 per year ($5 million = $166,666 after tax earning × 30), it is clear that the heirs will not even come close to meeting the interest payments, let alone the installment tax payments plus interest, from the newspaper's earnings. Nor will they be able to borrow the sum necessary to pay the tax given that the tax and interest will significantly exceed earning for 15 years. The only solution left is to liquidate the estate's interest in the closely held newspaper. Invaribly in recent years, this has meant sale of a once independent and local newspaper to a controlled, national chain.

The purpose of this bill before this committee is not to reduce the ultimate tax burden on the estate of independent newspaper owners. If that were our object, we would propose that an alternative method for valuing an interest in an independent newspaper be used. Such a proposal, however, would except newspapers from the nearly universal "willing buyer, willing seller" valuation rule, perhaps for not althogether persuasive reasons.

That is not the object of the bill. All the bill under consideration will do is alleviate the problem I outlined above by permitting the prepayment of estate tax. The monies slated for later payment of the estate tax burden attributed to an interest in an independent newspaper may, under the bill, be placed in a turst, to be monitored by Treasury and to be invested only in U.S. Government obligations. These U.S. Government obligations may be interest-bearing or non-interest-bearing as the Secretary of the Treasury is empowered under the bill, to decide. It is contemplated that the Secretary will set the interest rate for the oligations purchased with the trust funds at well below market or even at no interest. If this is the case, the trusts will act solely as devices for the prepayment of estate taxes and the deductions for the trust contributions will result in no revenue loss to the Treasury.

In its testimony on H.R. 2770, the Treasury contended that the deduction allowed for trust contributions (up to 50 percent of annual earnings) would result in a significant revenue loss due to the loss of the tax on the sum deducted. Treasury indicated that, at the corporate rate, this would amount to a loss of 46 cents on every dollar used to fund the trust.

However, that objection completely ignores the fact that the Treasury will stand to gain significantly because it has the use of the money placed in trust at low or no-interest rates for significant periods of time. While the Treasury is losing the direct payment of 46 cents on every dollar placed in a trust, it gains the use of 54 cents at most favorable terms. If we assume that the average dollar is in trust and invested in Government obligations for 15 years (based upon an assumption that prepayment of estate tax begins some 30 years prior to the time estate tax is due and continues at level annual amounts) and that those Government obligations bear interest (or no interest, as the case may be) at nine percent below market, the Treasury can earn $1.25 on each such dollar by investing elsewhere that excess 54

cents that it would not have collected.[1] The so-called "lost" 46 cents is more than triply recouped before the trust's dollar is used for payment of estate tax. Clearly, all the bill intends is a financing method for the payment of estate tax; not a reduction in revenue.

While it is also true that the trust corpus is free from estate tax itself, and there is no estate tax on the amount that is placed in the trust and used to pay estate tax, this still does not alter the validity of this legislative proposal. First, the result is identical to that achievable had the newspaper owner given his interest in the newspaper to his future heirs during his lifetime and paid a gift tax on such annual dispositions out of the remaining newspaper assets. The amount used to pay the gift tax (substantially equivalent, under the unified estate and gift tax system, to the amount that would be due for estate tax had the gifts not been made) would not be subject to inclusion in the gross estate and thus would not be subject to the estate tax.

Second, if the Treasury benefits by $1.25 on the use of the 54 cents per dollar it ordinarily would not be entitled to, it still comes out ahead even when that 54 cents is not includable in the gross estate and subject to estate taxation. The estate tax on 54 cents at a 70 percent rate would be approximately 38 cents. The total benefit to the taxpayer of both the income tax deduction ($.46) and the estate tax exclusion ($.38), amounting to 84 cents, is still far less than the $1.25 earned by the Treasury on its use of the newspaper owner's trust funds at a below market rate of interest.

Not until the Secretary chooses an interest rate of less than four percent below market for the Government obligations purchased by the funds placed in trust under the bill (assuming an average 15 year prepaid dollar) will the Treasury even approach a revenue loss. Since the bill permits the Treasury absolute discretion in setting the interest rate on these obligations, unless the market rate of money falls below four percent, we assume that the Treasury will not suffer any revenue loss. Again, all the bill provides for is an estate tax financing mechanism.

The Treasury has also objected that the funds transferred to the estate tax prepayment trust will not be includable in taxable income by the owner, and not treated as a taxable dividend. But, as pointed out in the example above, if the Government obligations purchased by the trust bear interest at a rate 9 percent below market, the Government gains $1.25 on every dollar invested for 15 years. Subtracting the tax that would have been payable as corporate income tax ($.46) excluded by the proposed deduction and the estate tax that would have been due on the remaining $.54 ($.38) but for the bill, the Government will still realize a $.41 gain on every dollar. This sum more than covers the $.38 per dollar tax on an alleged corporated dividend distributions ($1.00 minus $.46 corporate tax = $.54; $.54 × 70% = $.38). The Government still is ahead by $.03 per dollar.

In any event, it is inequitable, given the policy explicit in Section 303 of the Code, to assess a dividend rate of tax on corporate distributions used for the payment of estate taxes. Assuming a capital gains rate for such distributions, as provided in Section 303, the Government's "profit margin" under the bill remains well in excess of $.03 per dollar.

Treasury has further objected to the bill on the grounds that the exemption of trust earnings from income is contrary to existing law which treats the beneficiary as the owner of a trust and therefore taxable on its income. In response, let me note that, first, there is no assurance that the trust will earn any income. The Government obligations which the trust funds must be invested in could, as I have described, bear no interest at all. Second, the exemption of trust earnings from income is wholly consistent with current tax law. The exemption of qualified pension or profit sharing plan earnings from income, for example, provides the same benefit for a similar policy rationale as this bill. The exemption of the earnings of a qualified trust from income is not unprecedented in U.S. tax law.

Questions have been raised as to why it is necessary to provide such an extended period for the prepayment of the estate tax, and why should the trust last for so long a period of time. The Government should applaud the fact that the bill provides for a lengthy prepayment period. The longer the Government has the use of the prepaid tax funds at a below-market interest rate, the more it stands to benefit. Further, it is highly unlikely that any independent newspaper owner, particularly those already approaching retirement age, will be able to fully fund a trust adequate to satisfy his entire estate tax bill attributale to his newspaper interest.

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[1] At an interest rate of 9 percent, compounded annually, the $0.54 invested in year 1 will grow to $1.79 by year 15 when the estate tax is due. After subtracting the principal amount of $0.54 used to pay estate tax, the Government is left with earnings of over $1.25.

Even if full or excess funding were possible, the bill provides for extraordinary disincentives for overfunding. Any amount placed in trust in excess of that amount necessary for paying estate tax on an interest in an independent newspaper is severely penalized. The deductions taken on such amounts are recaptured, so that Government regains the $.46 it previously lost. In addition, the sum would be treated as a dividend to the decedent's estate and could be taxed under the income tax at rates as high as the 70 percent bracket. The sum remaining will also be includable in gross estate and could be taxed under the estate tax at rates as high as 70 percent. And, in addition to those substantial penalties, the Government still would have had the use of the $.54 at below-market rates for a substantial period that it otherwise would not have had.

In sum, the bill only intends to provide a mechanism for financing the payment of estate tax out of current earnings, rather than by liquidation of the newspaper at or prior to the newspaper owner's demise. There is no revenue loss, and, in effect, no tax reduction contemplated by the bill.

I have appended to this statement some examples of how the estate tax would affect a newspaper owner under the present law and also under the provisions of S. 555.

S. 555 - The Independent Local Newspaper Act of 1979

Because independent local newspapers are presently selling at multiples exceeding 30, 40 and even 60 times earnings, owners of such newspapers (and their heirs) are finding it impossible to meet the estate tax burden without selling the newspapers to "chain operations." Example 1 demonstrates that, even under the most liberal estate tax deferred payment provisions of present law, a $5 million newspaper (valued at 30 times earnings) can at best be able to fund only the interest due on the deferred estate tax from newspaper earnings, and will be unable to pay the applicable estate tax from newspaper earnings even on the most liberal deferred payment basis. The newspaper also would be unable to borrow sums to pay the shortfall, since there are no newspaper earnings available to cover the interest expense for the sums required to be borrowed. Thus, the sale of the newspaper is, in most instances, the only practical solution to the estate tax payment problems created by present law.

S. 555 offers another solution: prepayment of the estate tax to the U.S. Treasury. S. 555 allows 50% of newspaper earnings to be paid annually into the Treasury by means of the purchase of Government obligations bearing little or no interest. By this method, the owner of the newspaper pays his estate tax prior to his demise. While the owner's estate tax liability is finally determined at his death, the Treasury has had the use of the prepaid estate tax payments throughout the life of the owner. It is this use of the prepaid estate tax that vitiates the potential revenue loss to the Treasury.

Examples 2 and 3 demonstrate that the potential revenue loss to the Treasury under S. 555 is compensated by the Treasury's use of the prepaid estate taxes -- funds it otherwise would not have received. The examples deal with a $5 million newspaper on which approximately $2.5 million in estate tax would be owed. The examples assume different prepayment periods, no interest paid by the Treasury on the sums prepaid, and the use of money benefits by the Treasury. The examples calculate the economic benefits realized by the Treasury through the use of the prepaid taxes it would not have otherwise received. The examples do not attribute any economic benefit to 46% of the prepaid estate tax which the Treasury would have collected in any event in the form of corporate income taxes.

To demonstrate that there is no revenue loss to the Treasury, the economic benefits enjoyed by the Treasury from the estate tax prepayments are subjected to the 46% corporate tax (the Bill provides for a corporate deduction), then the remaining balance is taxed as if distributed as a dividend to the owner at the highest (70%) rate (the Bill provides for no inclusion in income) and the remaining balance is taxed at the highest (70%) estate tax rate (the Bill provides for an exclusion from the gross estate). In essence, the $2.5 million in estate tax prepayments are taxed as under current law. These taxes are, at each step, subtracted from the benefit gained by U.S. Treasury on the use of the estate tax prepayment. In each example, the U.S. Treasury suffers no loss. The Treasury has, in addition to a large positive cash flow, a revenue gain.

S. 555 simply provides a financing vehicle for the payment of estate taxes in order to preserve independent local newspapers.

EXAMPLE 1 - Present Law

Pre-tax earnings of independent newspaper:	$ 307,000
Annual corporate income tax:	-141,000
Annual after tax earnings:	= 166,666
	x 30 1/
Value for estate tax purposes:	$5,000,000
Estate tax due (Section 2001(c)):	$2,550,800 2/

Current Law:

Most favorable payment method:

1. Defer entire tax due for five years, but pay interest annually thereon (4% on first $345,800 of deferred tax, 6% on remainder) = $146,132 each year

2. For years 6 to 15, pay interest plus a 10% installment payment of tax, each year. Year six payment = $146,132 + $255,080 = $401,212

Result:

Years 1 to 5	$ 166,666	earnings
	-146,132	interest on deferred tax
	$ 20,534	amount left after paying interest on estate tax alone
Year 6	$ 166,666	earnings
	-401,212	interest plus installment payment of tax (see above)
	$ 234,546	shortfall in funds to pay estate tax
Years 7 to 15	There would be a large shortfall in each year since the earnings will not cover the 10% of the estate tax due, without even considering the interest charges.	

1/ Chains are paying 30 to 60 times earnings, or more, for independent newspapers. While the chains have not explained how or why they can do this there are a variety of "economies" they can institute. First, a chain can vastly reduce overhead through simple economies of scale; a chain's foreign or Washington correspondents, for example, will serve many papers rather than just one. Further, newspaper chains frequently reduce or eliminate local reporting staff. Second, a newspaper chain can markedly increase both the prices charged and market available to advertisers, since they can offer both regional and national market coverage. Third, capital-rich newspaper chains can often afford ultra-high technology cost-saving equipment. Not only does the purchase of such equipment frequently reduce labor costs, but sometimes the labor displacement is so great as to effectively "break" a newspaper's local union, to the detriment of the remaining employees, to say nothing of those who are fired. Fourth, the chains already have a tremendous cash flow from their other newspapers, which can cover any temporary imbalance in earnings from the new purchase. There are just a relatively few independents left, and the chains are competing to buy them.

2/ N.B. For a newspaper valued at more than $5,000,000 the value in excess of $5,000,000 would be taxed at a 70 percent rate.

EXAMPLE 2: Prepayment of Estate Taxes under S. 555

Current Law:

Estate tax due on $5 million newspaper = approximately $2,551,000 1/

Independent Local Newspaper Act of 1979:

1. Assume an average 27 year period for prepayment of estate tax to Treasury.

2. Annual prepayment of estate tax is $2,551,000 divided by 27 = approx. $95,000.

Annual payment of corporate income tax:

$ 307,000	(before tax earnings)
- 95,000	(deduction for estate tax prepayment)
$ 212,000	(taxable income)
x .46	(corporate rate)
$ 98,000	(corporate tax paid)

3. 27 annual prepayments of $95,000 each invested in Government obligations bearing no interest:

a.
$ 95,000	
-44,000	(at 46% corporate rate: annual tax Government entitled to under current law)
$ 51,000	(amount Government not entitled to until payment of estate tax at death at year 27)

b. $ 51,000 invested at beginning of each year for 27 years at 9% (Treasury's advantage by paying 9% below market on obligations) yields: $5,239,000 at conclusion of 27-year period.

c.
$ 5,239,000	(earned by Treasury)
-2,551,000	(estate tax due on $5 million)
$ 2,688,000	(benefit to Treasury of use of $95,000 per year)

4. Subtracting each alleged revenue loss from the benefit Treasury has received (as described in 3, above):

$ 2,688,000	(benefit to Treasury of use of total payment sum)
-1,173,000	(alleged loss to Treasury due to deduction of trust fund contributions for corporate income tax or put another way, the loss to Treasury of permitting the use of $ to pay estate tax that under current law would go to pay corporate income tax) [.46 x $2,551,000]
$ 1,495,000	
- 965,000	(alleged loss to Treasury by not including funds transferred to estate tax payment trust (after corporate tax paid) in income of owner; assuming the highest rate (70%)) [(2,551,000 - 1,173,000) x .70] 2/
$ 530,000	
- 289,000	(alleged loss to Treasury due to exclusion of corpus of trust after corporate and individual (dividend) income taxes paid from taxable estate) [(2,551,000 - 1,173,000 - 965,000) x .70] 2/
=$ 251,000	Net tax benefit to Treasury (use of the 54% of trust that it would not have otherwise obtained, less taxes that would have been collected on the $2,511,000 trust principal amount).

1/ All numbers rounded to nearest thousand.

2/ Using the highest possible tax rate.

EXAMPLE 3: Prepayment of Estate Taxes under S. 555

Current Law:

Estate tax due on $5 million newspaper = approximately $2,551,000 1/

Independent Local Newspaper Act of 1979:

1. Assume an average 30 year period for prepayment of estate tax to Treasury.

2. Annual prepayment of estate tax is $2,551,000 divided by 30 = approx. $85,000.

Annual payment of corporate income tax:

$ 307,000	(before tax earnings)
- 85,000	(deduction for estate tax prepayment)
$ 222,000	(taxable income)
x .46	(corporate rate)
$ 102,000	(corporate tax paid)

3. 30 annual prepayments of $85,000 each invested in Goverment obligations bearing no interest:

a.
$ 85,000	
-39,000	(at 46% corporate rate: annual tax Government entitled to under current law)
$ 46,000	(amount Government not entitled to until payment of estate tax at death at year 30)

b. $ 46,000 invested at beginning of each year for 30 years at 8% (Treasury's advantage by paying 8% below market on obligations) yields: $5,211,000 at conclusion of 30-year period.

c.
$ 5,211,000	(earned by Treasury)
-2,551,000	(estate tax due on $5 million)
$ 2,660,000	(benefit to Treasury of use of $85,000 per year)

4. Subtracting each alleged revenue loss from the benefit Treasury has received (as described in 3, above):

$ 2,660,000	(benefit to Treasury of use of total payment sum)
-1,173,000	(alleged loss to Treasury due to deduction of trust fund contributions for corporate income tax or, put another way, the loss to Treasury of permitting the use of $ to pay estate tax that under current law would go to pay corporate income tax) [.46 x $2,551,000]
$ 1,487,000	
- 965,000	(alleged loss to Treasury by not including funds transferred to estate tax payment trust (after corporate tax paid) in income of owner; assuming the highest rate (70%)) [(2,551,000 - 1,173,000) x .70] 2/
$ 522,000	
- 289,000	(alleged loss to Treasury due to exclusion of corpus of trust after corporate and individual (dividend) income taxes paid from taxable estate) [(2,551,000 - 1,173,000 - 965,000) x .79] 2/
=$ 233,000	Net tax benefit to Treasury (use of the 54% of trust that it would not have otherwise obtained, less taxes that would have been collected on the $2,551,000 trust principal amount).

1/ All numbers rounded to nearest thousand.

2/ Using the highest possible tax rate.

Senator CHAFEE. Mr. Seidman.

STATEMENT OF P. K. SEIDMAN, C.P.A. AND ATTORNEY, MEMPHIS, TENN., ACCOMPANIED BY SHELDON COHEN, ESQ.

Mr. SEIDMAN. Senator, my name is P. K. Seidman. I am a certified public accountant and attorney, resident of Memphis, Tenn., and I am accompanied here today by counsel, the Honorable Sheldon Cohen.

Senator CHAFEE. Well, gentlemen, glad to see you here.

Go to it.

Mr. SEIDMAN. Thank you, sir.

I want to talk about the existing tax rules as they pertain to estate tax, and what S. 541 might do.

As you know, the present law allows a choice of evaluation date of the property of the decedent, either the value as of the date of death or the value as of 6 months after the date of death.

Now, this choice attempts to avoid a harsh and unfair result for the protection of the heirs of the estate when property declines sharply and abruptly in value shortly after the date of death.

However, if the estate tax return is unavoidably and without design filed just 1 day later, the exiting law disallows the alternate valuation date election and requires that property be valued as of the date of death.

Now, this loss of the election is automatic and applies even if there is unavoidable, reasonable cause for the late filing of the return.

There are adequate penalties for late filing. Moreover, these other penalties may be excused if the Commission finds there is in fact reasonable cause for the late filing.

Now, we have found that there is general agreement that the existing law regarding the alternate valuation date election provides an unfair and unintended result and that it should be changed. The proposed new rule in S. 541 would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if the estate tax return is not filed on time. It would not change the property valuation dates of the present law or have any effect on the determination of the estate tax liability.

Senator DOLE. How do you answer the Treasury's objections that if you did this they wouldn't be able to reach all the other people who might be in the same class who might be adversely affected?

Mr. SEIDMAN. Well, as you know, Senator, with any remedial and corrective legislation, unfortunately it often finds some taxpayers who become a casualty to the statute of limitations, and S. 541 is no exception. Yet, if S. 541 is adopted, it surely restores equity and accords relief provided unwarrantedly against a penalty which is imposed.

Senator DOLE. Now, I assume this legislation addresses one particular estate.

Mr. SEIDMAN. Yes, sir.

Senator DOLE. In the State of Tennessee.

Mr. SEIDMAN. Yes, sir.

Mr. COHEN. There are several others that we know about in other States, sir, that are similarly situated.

Senator DOLE. Where they are unavoidably prevented from filing?

Mr. COHEN. In Mr. Seidman's situation, the executor was in the hospital recovering from open heart surgery on the date that was required.

Mr. SEIDMAN. Let me cover that, if you will, Senator.

Senator DOLE. Well, that doesn't bother me. I assume it must be targeted in some way.

Mr. SEIDMAN. Yes, yes.

The whole thing came to light in an estate in Tennessee, in Memphis, Tenn., where the executor 6 weeks prior to the filing date, the due date of the estate tax return suddenly found himself in emergency heart surgery. There was no way of anyone else then or thereafter until his recovery in possession of all the information that was needed for this, which happended to be a complicated estate tax return of 50 schedule pages, and so——

Senator DOLE. What final impact did it have, dollarwise?

Mr. SEIDMAN. It finally eliminated 90 percent of the heirs' distributable estate. When the IRS, when the Treasury Department proposed a deficiency by disallowing the alternate valuation date, the stock from the date of death to the date of the report and the proposed deficiency had dropped from $42 a share to $5 and less a share, and so the sizable lot of listed stock that was held in this estate immediately cut the legs out from under the estate, and the estate was doubled in the taxable amount, the estate had paid a tax of approximately $413,000 and the Treasury suggested a deficiency of approximately $605,000 additional, so that the estate then, the distributable estate as it was determined after the RAR was $1,851,000. When the proposed deficiency was submitted November 20, 1975, the distributable estate was narrowed down to $136,000 together with further market declines.

Now, it is obvious that this resulted from the one asset which controlled the entire value of the estate, and when the quoted value dropped from $41 plus down to about $5, you can see that the estate was practically wiped out as far as protecting the heirs and any distributable amount.

And so, it seems that the rule of equity was completely violated in such a harsh exaction of the penalty, particularly when there were other penalties for late filing where there was reasonable cause, and those penalties were far less than that which the Treasury proposed in this deficiency notice.

Senator DOLE. Well, we have to run over and vote. I don't have any other questions. I am again sympathetic with what you propose to do, but we need to address the questions that have been raised today—maybe we can do it with Mr. Cohen later.

Mr. COHEN. We would be glad to work with the staff on any language that would ameliorate the appropriate kind of cases. We just feel that this is a deserving case. There are other deserving cases, and those should be ameliorated.

Senator DOLE. Let's leave it on that basis then, and we will be right back for one other panel.

Mr. SEIDMAN. There is a complete statement for the record which has been submitted.

Senator DOLE. That will be made a part of the record.

Mr. SEIDMAN. Thank you.

[The prepared statement of Mr. Seidman follows:]

TESTIMONY OF P. K. SEIDMAN

SUMMARY OF PRINCIPAL POINTS

1. Existing estate tax rules permit a choice for the valuation date of the property of a decedent: (a) value as of the date of death, or (b) value as of six months after the date of death.

2. This choice avoids a harsh and unfair result when property declines severely in value shortly after death.

3. However, if the estate tax return is filed just one day late, existing law disallows the alternate valuation date election, and requires property to be valued as of the date of death.

4. This loss of the election is automatic, and applies even if there is unavoidable reasonable cause for the late filing of the return.

5. There are other adequate penalties for late filing. Moreover, these other penalties may be excused if there is "reasonable cause" for the late filing.

6. We have found there is general agreement that the existing rule regarding the alternate valuation date election provides an unfair and unintended result, and that it should be changed.

7. The proposed new rule would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if it is not filed on time. It would not change the property valuation dates of the present law, or have any other effect on the determination of the estate tax liability.

8. The proposed new rule would be applicable to all estates which have not yet filed returns and to estates which have filed returns but which are still open under the statute of limitations.

9. This bill and its effective date provisions would not result in any unwarranted relief to any estate. It would merely provide the intended result to estates which would otherwise be unfairly penalized.

S. 541

My name is P. K. Seidman, a certified public accountant from Memphis, Tennessee. My testimony today relates to the provisions of S. 541. Enactment of this legislation would remove an inequity in the Internal Revenue Code relating to the valuation of property for estate tax purposes. I would like to explain the effect of this Bill and give the reasons that I urge its passage.

Generally, under the estate tax rules, the estate tax is based upon the value of the decedent's property at the date of death. For many years, however, the law has allowed an estate to use an alternate valuation date. Thus, under current law, an estate may pay the estate tax based upon (a) the value of all of the property in the estate on the date of death or, (b) the value of the property on the day exactly six months after the date of death. This choice of dates for the valuation of the property avoids a harsh result in a case in which there is an abrupt decline in the value of the property shortly after the date of death.

S. 541 would remedy a serious problem with the existing law. For some reason which we have been unable to ascertain, present law provides that the alternate valuation date may be used only if the estate elects such method on a timely filed estate tax return. Thus, if the estate tax return is only one day late, and even if the delay is due to reasonable cause, the estate may not use the alternate valuation date.

This result is incongruous and inequitable. There is a specific penalty provided by law for the late filing of an estate tax return. This specific penalty does not apply, however, if there is "reasonable cause" for the late filing. If the specified late filing penalty may be excused for reasonable cause, there certainly is no reason to impose what may be a much harsher "penalty"—the loss of the alternate valuation date—and make that penalty applicable regardless of the existence of reasonable cause.

To my knowledge, there is general agreement on the part of the Treasury and the Congressional Staff that the provisions of existing law provide an unintended result and should be corrected. Thus, everyone agrees that existing law is unfair, and that the alternate valuation date election should be available even if, for some reason, an estate tax return is filed late. The only remaining question relates to the proposed effective date for this change in law.

As it is proposed, S. 541 would remove the inequitable effect of present law in those cases in which estate tax returns have not yet been filed, as well as those cases where estate tax returns have been filed late, but where the tax liability of the estate has not been finally determined. Thus, the adoption of S. 541 would eliminate the harsh penalty otherwise imposed by existing law in the circumstances involved in the Estate of Sylvia Buring, with which I am personally familiar.

Sylvia Buring died November 24, 1972. At the time of her death, Mrs. Buring owned a substantial amount of stock of a New York Stock Exchange Company, and this was the most significant asset of the estate. The value of this stock declined almost 50 percent during the six months after the date of death. This is exactly the situation to which the alternate valuation date is intended to apply.

Unfortunately, the estate tax return was filed late due to the sudden illness of one of the co-executor, and the resulting inability of the other co-executor to file a tax return within the prescribed time. There is no dispute that the failure to file the return on time was due to reasonable cause, and the Internal Revenue Service agreed that no late filing penalty was appropriate. If the alternate valuation date election cannot be made by the Estate of Sylvia Buring, there would be a substantial unwarranted increase in its estate tax liability.

The alternate valuation date is intended to and should apply if a decedent's property has severely decreased in value, even if, for some reason, the return is filed late. This is particularly true in cases like the Estate of Sylvia Buring which would otherwise be penalized solely as a result of the unfortunate physical incapacity of one of the executors.

S. 541 would benefit all those in circumstances similar to the Estate of Sylvia Buring. It would eliminate an unintended penalty in circumstances where no penalty is appropriate, and where the statute of limitations has not yet expired.

I know that your Committee will consider carefully the substance as well as the effective date of S. 541. In urging that you extend the effect of this ameliorative change in the law to situations like those of the Estate of Sylvia Buring, I believe that I am consistent with the general policy adopted by this Committee--changes in existing law which remove unintended inequity are made applicable to all cases which are open under the applicable statute of limitations. I believe that this policy should be applicable in the case of S. 541.

It is important to bear in mind that the result of S. 541 is merely to extend relief to a limited number of cases which would otherwise be subjected to an unwarranted penalty. This legislation does not open any loophole or provide relief in cases in which relief is unwarranted. The value of property in an estate is fixed on the date of death and on the date six months later. No planning is involved and no new elections of the alternate valuation date or other administrative problems would result.

In summary, I believe this legislation is good legislation and good tax policy. It would have the salutary effect of providing the originally intended tax result to the estates which would otherwise be penalized improperly.

Thank you very much.

Senator DOLE. And we will be back, right?

Senator CHAFEE. Right.

Thank you.

Why doesn't the next panel come up and get in place and we will be ready to go.

[A brief recess was taken.]

Senator DOLE [presiding]. I think we may proceed in any order you wish. You are all speaking on S. 1703, and we find ourselves caught between votes, so anything you can do to expedite matters would be appreciated.

How would you like to start, as you are listed?

Mr. SAMIA. As we are listed, Mr. Chairman.

Senator DOLE. We have a total of a 20-minute time limit, divided any way you wish.

STATEMENT OF LOUIS SAMIA, EXECUTIVE DIRECTOR, CARE, ON BEHALF OF THE AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE

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

I would like to be brief on this. I am Louis Samia, the executive director of CARE, and I am appearing on behalf of the American Council of Voluntary Agencies, which is an association representing 44 major agencies such as the Catholic Relief Service, Baptist World Alliance, the Jewish agencies, Church World Service, CARE, Save the Children, Foster Parents Plan, and many more.

We have all made previous statements which we believe will be made part of the record, sir.

I have with me today Dr. J. Winston Crawley, director of overseas divisions, of the Foreign Mission Board, Southern Baptist Convention; Rev. Msgr. Andrew P. Landy, assistant executive director of Catholic Relief Services, U.S. Catholic Conference; Dr. Vernon Larson, president of the Association of U.S. Directors of International Agricultural Programs; Dr. A. Colin McClung, executive officer of International Agricultural Development Service.

Before we proceed, I believe on behalf of my colleagues and a number of other agencies, we would like to thank Senator Chafee for his lead in presenting Senate bill 1703 and in his foresight in trying to help the private voluntary organizations.

We say this because we believe it was not the intent of Congress to penalize the private voluntary organizations in the Tax Reform Act of 1978; also the fact that Congress in the Foreign Assistance Act has declared that U.S. cooperation in development should be carried out to the maximum extent possible through the private sector, including those institutions which already have ties in the developing areas, such as educational institutions, cooperatives, credit unions, and voluntary agencies.

Only last week a large number of voluntary agencies, both religious and private organizations, met with the President to discuss the advent of the Kampuchea situation and the fact that the President had asked these particular voluntary agencies to do their utmost in relieving the suffering of that particular country. And naturally the answer was yes, which was significant in the way that the private voluntary agencies work and is also significant in the fact that they are needed in their work overseas.

I think the record shows a tremendous response by the private voluntary and religious sector to the desires of Congress and the administration. That was one instance. For example, in recent months my own organization has been very deeply involved in the situation in Uganda, Nicaragua, Dominican Republic and Thailand. These are areas where suffering has occurred. There has been manmade and natural disasters and the private voluntary sector has been there to meet these particular demands.

If Senate bill 1703 is not adopted, the private voluntary organizations will have to curtail some of their work overseas. Money that is now going to vital developmental and nutritional programs will have to be transferred to salaries. This means diverting from programs an amount of funds that will not be able to be met by other resources as such.

We feel that the loss to the Treasury created by passage of S. 1703 is minimal. The effect on the charitable agencies, if it is not passed, could be very devastating. The cutback in vital programs of development, disaster assistance, and refugee relief is clearly, to us, not worth the few dollars gained by the Treasury.

With this, Mr. Chairman, with your permission, I would like to call on Dr. Crawley to add his comments.

STATEMENT OF DR. WINSTON CRAWLEY, DIRECTOR OF OVERSEAS DIVISION, FOREIGN MISSION BOARD, SOUTHERN BAPTIST CONVENTION

Mr. CRAWLEY. As a representative of Southern Baptists, I want to support fully what has been said by Mr. Samia. Southern Baptists number 13 million, spread throughout the country. Many of our people are deeply concerned about this matter because of the effect it can have on the programs of our work across the world. We have 3,000 missionaries serving in 95 countries and territories, which would make our organization one of the largest involved in overseas programs.

We are involved in a wide variety of benevolent programs, medical, educational, agricultural, community centers, literacy, all kinds of programs. We are deeply involved in the world hunger concern with agricultural missionaries in many lands. We are deeply involved in relief and reconstruction efforts. We were calculating just the other day that in Cambodia, and the matter of the Cambodian refugees in Thailand, we have spent about $750,000 in the last 3 or 4 years, well before this became a matter of common concern to the American media, and this type of operation will be crippled if we do not have the action taken on the bill as recommended, S. 1703.

Already the impact of inflation and of dollar decline is a real hindrance to our programs across the world, and to have added to it the impact of having to pick up what for us will probably be an annual load of $1 million does curtail our efforts rather considerably.

We feel that this bill as proposed will be a very simple and appropriate way to resolve the problem. It is not anything new. It is a plan that has worked for many years. It would simply restore an exclusion which is available at present to some other overseas workers, and to restore it to the employees of religious and charitable organizations would avoid the crippling effect on our involvement across the world.

We feel that there is an element of urgency in this because of the 1979 tax burden itself, with 1979 coming toward a close, and we certainly hope that this subcommittee and the entire Congress will approve speedily this amendment to the tax law.

Mr. SAMIA. Thank you.

Monsignor Landi.

STATEMENT OF MSGR. ANDREW P. LANDI, ASSISTANT EXECUTIVE DIRECTOR, CATHOLIC RELIEF SERVICES, U.S. CATHOLIC CONFERENCE

Monsignor LANDI. First of all, I would like to express my gratitude for the opportunity of being present at this hearing. I am

Andrew Landi, assistant executive director of Catholic Relief Services of the U.S. Catholic Conference, and I am here in place of Bishop Edwin Broderick who is attending meetings in Europe at the present time that have to do with welfare matters in Third World countries, and particularly, emergency matters in Cambodia and Thailand.

I have a written statement of Bishop Broderick which I would like to submit for the record, and if I may I would like to take 2 or 3 minutes to express the highlights in this statement.

Catholic Relief Services is the overseas welfare arm of the Catholic bishops in the United States, over 200 of them. We are present in about 80 countries, all Third World countries, carrying on activities in the form of emergency relief, self-help development, refugee assistance, and welfare aid. We reach about 14 million people in the course of a year, and although we are a Catholic organization, we are not missionary. Our principal purpose is welfare work, and this welfare work is carried out regardless of race, color, or creed. As a matter of fact, of the 14 million persons that we give assistance to, most of whom are children, I would say about two-thirds of them are non-Christian—they would be mostly Moslems and Hindus.

The passage of S. 1703 is very important to us for our structure. Without its passage it would be very difficult for us to continue our personnel structure in carrying out the present activities. We are not thinking of expanding our activities, but in carrying out our present activities. Unless we get some relief from S. 1703, we would have difficulty in retaining some of the present personnel we have, and we would also have difficulty in recruiting other personnel.

And I might mention I have in mind not religious personnel. We only have about a dozen religious personnel, priests, and sisters in our structure overseas. We have 113 lay persons, and they would be the ones who would be principally affected.

So I endorse what has been said by my colleagues in favor of S. 1703, and we ask your very serious consideration and approval of S. 1703.

Thank you very much, Mr. Chairman.

Mr. SAMIA. Dr. McClung.

STATEMENT OF DR. A. COLIN McCLUNG, EXECUTIVE DIRECTOR, INTERNATIONAL AGRICULTURAL DEVELOPMENT SERVICE, INC.

Mr. MCCLUNG. Thank you.

My name is A. Colin McClung. I am executive officer of the International Agricultural Development Service. We are a U.S.-based charitable corporation which works in agricultural projects in the developing countries.

I speak for my own organization and also for the worldwide network of international agricultural research centers, sponsored by an international consortium. These are the centers that developed the miracle rice and wheat of the green revolution.

The Foreign Earned Income Act of last year has had a very serious effect on the Americans employed in these organizations, in the international centers, and in our organization. At the international centers, there are about 132 Americans on the senior staff

which totals 530 people; 53 nationalities are represented on the staffs of the international centers. Six of these have reported confidential surveys of all of their American staff, and the tax costs for the Americans went up from $1,372 to $7,225 as a result of the act in 1978.

Because of the international funding of these centers, it is very difficult for them to make any salary adjustments of any substantial kind. Funding comes from 28 different donor agencies, most of them from government agencies. These organizations take a very dim view of paying additional salaries to Americans to help them pay the tax levied on them by their own government.

The numbers of people involved here is very small. There is a great deal of leverage in agricultural research in the developing countries. I would remind you that when the miracle rice was developed, there were no more than 25 senior scientists. This small group, however, created a new technology which revolutionized rice growing throughout the world.

Finally I would like to comment on the fact that the United States has been the leader over the last 30 years in international agricultural research. The U.S. Congress has repeatedly, over the past 30 years, taken action which has supported this line of endeavor, and have made a great contribution. As recently as October 3, President Carter wrote a letter to his colleagues in Canada, the heads of government in Canada, France, Germany, Italy, Japan, and the United Kingdom, urging them to increase support to the international agricultural research centers over the coming 5 years at the rate of 10 percent annual increase in real terms.

With all of this history of support to this line of endeavor, we would hope that the Congress would take favorable action on S. 1703.

Thank you very much, Mr. Chairman.

Mr. SAMIA. Dr. Larson.

STATEMENT OF DR. VERNON LARSON, PRESIDENT, ASSOCIATION OF UNITED STATES UNIVERSITY DIRECTORS OF INTERNATIONAL AGRICULTURAL PROGRAMS, AND DIRECTOR OF INTERNATIONAL AGRICULTURAL PROGRAMS, KANSAS STATE UNIVERSITY

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

I am Vernon Larson from Kansas State University, and today I also represent the association of my colleagues throughout the entire land grant system in the United States. I know you want to slip on to vote, and I want to get back to Kansas tonight before the snow in Russell moves into Manhattan.

I support this bill very much, Senator, and appreciate the chance to be here. Rather than read my script, I would merely like to say that if the Congress wants the land grant schools and the other institutions in the United States to help support foreign aid, which has been a credit to this Congress over the past two decades, we need to change this bill. This is making it impossible to get our top quality people to serve abroad. We can do a lot with a 90-day specialist, but to build institutions we need the person that will move with his family into these different areas.

I have lived overseas 9 years, equally divided between India, Nigeria, and Lebanon, and unless we have a tax incentive, you can't get that person to work abroad.

So I support the bill, and again, I think the money saved is going to be minimal, but the program altered will be drastic.

I think that this is one of the greatest steps forward to help foster what we are trying to do, and I commend you for this.

Thank you.

Senator CHAFEE. Thank you very much.

Bob?

Senator DOLE. I appreciate the testimony and obviously the remarks of Dr. Larson.

I did not hear Mr. Rosenbloom when he testified, but I understand the Treasury's opposition to the bill is based on a number of reasons. One is that the bill is not limited to employees of organizations engaged in relief activities or, for that matter, to employees of U.S. organizations.

Is that a major problem? If we took care of that objection, by limiting coverage to employees of organizations engaged in relief activities for the United States, or of the United States, would the Treasury change its position?

Mr. SAMIA. I believe, Senator, that our suggestion has been in the bill that this be relegated to those individual organizations that are registered under 501(c)(3) and accepted by the IRS as such.

Mr. MCCLUNG. To clarify a little further, the international agricultural research centers which I mentioned are financed substantially by the U.S. Government so that they are organized in other countries, chartered in other countries. It is important that all 501(c)(3) organizations be covered by this legislation regardless where organized.

Mr. CRAWLEY. I believe we are thinking in terms of programs of benevolence broader than relief in the strictest sense of the word, development programs are included, agricultural development, community development, medical and health care development, and many other things that technically may not be relief but are benevolent and humanitarian efforts.

Senator DOLE. These organizations also suggest, and I am certain you have read their views—that if there are, as you indicate, problems in getting people to serve without certain incentives—they suggest that we consider the direct grant rather than use the tax system indirectly for that purpose. I wonder how you respond to that.

Mr. CRAWLEY. For our organization, for the Southern Baptist Foreign Mission Board, that would not do the job because of the question of church and state relationships.

Senator DOLE. Right.

Mr. CRAWLEY. And I think there would be serious question whether the courts would support it in a case like ours.

Mr. SAMIA. I believe also, Senator, that this is also indicative that the Treasury also feels that the private, voluntary organizations do need some help. I believe talking for my organization the grant mechanism that the Treasury is talking about would be one administrative system that would be out of, really out of reach, as such, and would create much, much more of a problem to the

agencies than if the tax incentive of $20,000 was included, which is much simpler.

Mr. LARSON. Senator, I feel the amount saved would be very minimal on this. I realize our friends from the Treasury indicated that it was substantial when we think of revenues at Kansas State University, but it is minimal when we look at the world picture and what has been accomplished and what we are hoping to continue.

All of us have seen these schools develop in the poorer countries of the world. We have got a real hunger problem over there. We are investing considerable money, and this really is a drop in the bucket when we look at the total picture of trying to get the job done.

Senator DOLE. Well, I don't quarrel with that, but I know we met this morning in this same room for 2 hours to consider reducing benefits for disabled Americans. I suppose it is a matter of priority. We are trying to save money. Maybe there are some ways this bill could be restricted without doing violence to the purpose of the legislation.

The cost, as I understand it, is about $30 million the first year?

Mr. CRAWLEY. $25 million was the estimate.

Mr. SAMIA. $25 million, which we questioned.

Mr. CRAWLEY. But I really have doubts.

Senator DOLE. You don't think it would be that much?

Mr. CRAWLEY. Just projecting from our experience, it is hard for me to see how it would be that much.

Senator DOLE. Thank you.

Senator CHAFEE. One of the suggestions is that it be restricted to certain nations, in other words, that you wouldn't qualify for, for instance, if you were in Western Europe.

What is your reaction to that?

Mr. SAMIA. Senator, if I may, I believe you will find that the voluntary agencies would look upon that one and would possibly discuss it among themselves and look upon it with a positive look.

Senator CHAFEE. With a what?

Mr. SAMIA. With a positive look.

However, at the present time most of the agencies have representatives that are either stationed in Geneva or Vienna, two of the highest priced cities in the world, and the factor of the listing as the five listings or the five deductions that you can take under the current bill will total that $20,000 if not more.

Senator DOLE. Could I just interrupt here?

Senator CHAFEE. Sure.

Senator DOLE. As I understand it, does this bill cover teachers in State Department supported schools?

Senator CHAFEE. I don't think so, but this is just the 501(c)(3) people.

Senator DOLE. I think it does.

Senator CHAFEE. Does it?

Senator DOLE. As I understand, there are about 15,000 employees that would be affected; 4,000 would be teachers. The Southern Baptist Conference has about 2,900 missionaries abroad, and other charities have about 2,500. I don't know why we would want to include teachers. I mean, I can understand why they would want to

be included, but if we are looking for a way to reduce the cost of the proposal, that might be a place. It would reduce cost by about 20 percent.

Senator CHAFEE. Well, thank you very much, gentlemen.

I have met with the representatives of your group and the suggestion Senator Dole made is a good one. I haven't looked into that, but the Western Europe thing seems a possibility. But as you pointed out, your folks are in Vienna and in Geneva, and just from my brief experience in Geneva, they need every dime they have got to survive there.

Now, if we didn't do this, in other words, if the bill were not enacted, then what would happen? You would either reduce your personnel or you would reduce the services, that is, the wheat or the supplies or whatever it is. Is that right? Is that right, Monsignor Landi?

Monsignor LANDI. Yes. This would be true, and also we would not be able to call upon other resources outside of the United States. For example, our agency today receives close to $10 million in goods and cash from the European Economic Committee. We also receive funds from two United Nations organizations, namely, UNICEF and the United Nations High Commissioner for Refugees, and there are voluntary agencies in Europe, Canada, and Australia that finance some of our projects, and a good deal of these resources would not be open to us if we didn't have the structure to be able to handle these resources that come to us from these areas.

Senator CHAFEE. Then I think the point was also made that the European nations that might be contributing are a little bit resentful that they are contributing in order to help pay U.S. taxes.

All right, we have got to wind this up.

Did you have a comment that you wanted to make?

Mr. MCCLUNG. I wanted to comment on your inquiry as to what would happen if we did not get this relief. In the organizations that I am speaking for, there are multinational, international staffs, and what we have already seen is a tendency for Americans to find a position back in the United States, and in return, that post to be filled by a non-American. Over a period of time, I believe that would be the tendency we would see for the adjustments to be made, even though those projects are substantially financed by U.S. sources.

Senator CHAFEE. And that is the same experience?

Mr. LARSON. That is the same experience. The Eastern European would come in and fill some of the vacancies.

Senator CHAFEE. All right, fine.

Well, you have spoken very well, and have been excellent witnesses, and we appreciate your coming. Thank you.

[The prepared statements of the preceding panel follow:]

SUMMARY OF TESTIMONY BY MR. LOUIS SAMIA, EXECUTIVE DIRECTOR OF CARE, INC.

S. 1703 is strongly endorsed by the American Council of Voluntary Agencies for Foreign Service, Inc. ("ACVS"), an association of 44 major charitable organizations, including Catholic Relief Services, Baptist World Alliance, Christian Children's Fund, Save the Children Federation, Foster Parents Plan and CARE, whose members provide vital charitable services in less developed countries throughout the world.

The bill is necessary in order to correct certain unintended impacts of the Foreign Earned Income Act of 1978, which has caused a sudden and severe increase in the tax on overseas charitable workers.

If S. 1703 is not enacted, many overseas charities will have to immediately curtail essential services, in order to compensate their modestly paid employees for this new tax.

The overseas charities perform a vital function. Congress repeatedly has declared a policy of relying on such organizations to the maximum extent feasible in providing overseas aid and assistance. Overseas charities have played a critical role most recently in Cambodia, in the Carribbean in providing emergency relief after recent hurricanes, and in Uganda and Nicaragua, where charitable workers were the first on the scene to help victims of war.

We do not believe that Congress intended to force charitable organizations to curtail their programs at the time the 1978 act was passed. Passage of S. 1703 will correct this unintended result of the 1978 Act.

Good afternoon. My name is Louis Samia. I am Executive Director of the cooperative for American Relief Everywhere, Inc., the worldwide relief agency known as CARE.

My testimony this afternoon is being presented on behalf of the American Council of Voluntary Agencies for Foreign Service, Inc. ("ACVS"), an association of major charitable organizations whose members provide charitable services in less developed countries throughout the world. The members of ACVS include Catholic Relief Services, Baptist World Alliance, Christian Children's Fund, Save the Children Federation, Foster Parents Plan, CARE and 38 other major charities,[1] all of whom are non-profit organizations, dependent upon voluntary contributions for much of their funding. ACVS members provide disaster relief, emergency feeding and self-help programs, and countless other essential charitable services in dozens of poor countries around the world.

The purpose of my testimony this afternoon is to strongly endorse S. 1703, which has been introduced by Senator Chafee, and co-sponsored by a broad bi-partisan coalition of Senators on the Committee. (In addition, an identical bill is being introduced in the House this week.)

As I will explain in my testimony, S. 1703 is an essential relief measure, which is necessary to correct unintended impacts on charitable workers from the Foreign Earned Income Act of 1978. Unless S. 1703 is enacted immediately, charitable organizations which perform work overseas, including CARE and other ACVS members, will be forced to cut back sharply on their charitable services in order to compensate their modestly paid employees for the sudden and severe increase in the tax brought about by the new law. From a humanitarian point of view, and in terms of continued good will for the United States, the impacts of these curtailments in charitable services could be devastating.

We do not believe that Congress intended these results at the time it adopted the 1978 Act. As applied to charitable workers, the effect of S. 1703 essentially is to restore the status quo prior to the 1978 law, by allowing charitable workers the option of continuing to be taxed under a revised version of § 911 of the Code. (This is the same option which currently is allowed for highly paid workers in camps). The bill would *not* affect the taxation of those persons employed by for-profit corporations overseas, and would have a *de minimus* impact on revenues. From the standpoint of the charities and those they serve, however, S. 1703 is essential legislation, which is needed to ensure that the ability of the charities to perform their historical mission is not seriously impaired, in violation of repeated expressions of Congressional intent to support the role of the charities in performing overseas work.

ACVS members provide vital charitable services in less developed countries around the world. For example, my organization—CARE—is responsible for feeding over 25 million people each day, including approximately 18 million children. In addition, CARE provides emergency disaster relief, including food, clothing, housing materials, and other relief to victims of war and natural disaster around the world, and has extensive programs for medical aid and self-help development. The vital work of many other ACVS members is equally well known.

ACVS members, along with other charitable organizations, play a particularly important role in providing aid and assistance when immediate relief is required, or when official government involvement is limited by political constraints. For example, CARE and other overseas charities played a key role in providing disaster relief to victims of hurricanes David and Frederick in the Dominican Republic and elsewhere in the Caribbean. In addition, CARE was first on the scene in Nicaragua, and in providing emergency relief to victims of war in Uganda, after Idi Amin was

[1] A complete list of ACVS members has been attached to this testimony.

overthrown. In many cases, CARE is able to begin providing relief before American officials are allowed even to enter the country. Finally, just last week, CARE and other overseas charities met with President Carter, to discuss ways of expanding the charities ongoing relief to refugees in Cambodia and elsewhere in Southeast Asia, underscoring once again the unique contribution our agencies are able to provide.

Unless modified by S. 1703, however, the 1978 Act will directly and severely undercut the ability of the overseas charities to perform this important work, by causing a sudden increase in employee taxes, which ultimately will have to be paid for by reducing program funds. This result will be directly inconsistent with the Foreign Assistance Act, and with other declarations of Congressional policy, which reportedly have emphasized Congress' intent to rely on the charitable sector "to the maximum extent possible" in providing overseas assistance and relief (see 22 U.S.C. § 2152(b)).

The success of overseas charitable programs is dependent upon the dedicated, career oriented employees CARE and other overseas charities are able to attract. These individuals undertake their charitable service at an enormous personal sacrifice. Living conditions at many of CARE's foreign posts are among the most uncomfortable and unattractive of any in the world, and are qualitatively different from and more severe than conditions for charitable workers here in the U.S. In addition, in order to hold down overhead expenses, and to devote as much funding as possible to charitable programs, salaries are kept at modest levels. For example, the salary of the average CARE worker is just over $12,000 per year (plus certain limited allowances for special expenses), even though many of our overseas workers are highly skilled professionals, who have been working overseas for as long as 20 to 30 years, and could earn much higher salaries in corporate positions in the U.S. These amounts do not begin to compensate our employees for the hardships they endure. Sometimes, even I am amazed by CARE's ability to continue to attract and retain such dedicated employees under the circumstances.

The tax structure which existed prior to the 1978 Act played an essential role in allowing our employees to remain overseas under these conditions. Since the exclusion from income provided for by prior law was more than total compensation for most employees, virtually all of our employees were exempt from paying federal tax. In addition, it should be noted that, at the time of 1976 revisions of § 911, Congress explicitly recognized that charitable workers deserved special treatment and, for that reason, retained a $20,000 per exclusion for employees of qualified § 501(c)(3) organizations, at the same time that the exclusion for all other workers was reduced to $15,000 per year. The 1976 revision of § 911 thus provides direct precedent for the distinction between charitable and non-charitable workers drawn by S. 1703.

The 1978 Act substantially modified prior law, by replacing the § 911 exclusion with a package of five special deductions. In general, the purpose of this new law was to reform and modernize the taxation of overseas workers, in part to avoid losing overseas jobs for Americans. For many overseas workers, especially those living in Western Europe and Japan, or earning high salaries, the effect of the new law was to substantially reduce the amount of tax which was due.

For charitable workers, however, the impact of the 1978 Act was just the reverse. For virtually all charitable employees, the 1978 Act causes a sudden and severe increase in tax. In CARE's case, for example, the 1978 Act tax liability will be increased for all but 6 out of 178 overseas employees. The amount of this tax increase will be as much as $6,000 per year, in the most extreme cases. Fifty of CARE's workers will experience a tax increase of over $2,000 per year and well over half will experience increases of over a $1,000 per year even though, as mentioned previously, the average CARE salary is just over $12,000 per year.

At current salary levels, our workers simply can't tolerate tax increases of this magnitude. As a result, in order to avoid losing many of our most skilled and experienced employees, CARE and other overseas charities will have no choice other than to increase employee salaries to compensate for the amount of the tax.

The effects of this salary increase will be severe. Unlike corporate employers, charities do not have the option of passing on salary increases to "customers" in the form of higher prices. Instead, each dollar in increased salary necessarily will be obtained by cutting scarce funding for programming. The magnitude of these cuts will be substantial. In CARE's case, for example, in order to fully compensate our employees for the new tax, taking into account the additional tax which will apply to any salary increase (the so-called "tax on the tax"), it will be necessary to divert from programming an amount of funds equal to one dollar in every seven which currently is spent for employee salaries.

Because overseas charities generally are quite efficient in their operations, and can conduct very large charitable programs on relatively modest budgets, the impact of these program cuts often will be dramatic. In CARE's case, for example, the amount which would have to be diverted from the program funds would equal or exceed CARE's entire budget for its participation in *each* of the following projects:

Feeding 475,000 individuals in Haiti
Essential irrigation projects to increase farm land in Bangladesh
Feeding 250,000 children and mothers per year in Tunisia
Constructing 180 classrooms and teachers quarters for earthquake victims in Guatemala
Promoting better nutritional practices during pregnancy and early childrearing for 70,000 mothers in Egypt

Unless S. 1703 is enacted, one or more of these programs, or our work in Cambodia, or some other equally vital project will have to be curtailed.

We do not believe that Congress intended these results at the time it passed the 1978 Act. The 1978 law was not finalized until the hectic closing days of the 95th Congress, and there was no opportunity at the time for Congress to assess the potential impacts of the new law on the charities. Indeed, quite frankly, we were rather stunned when the version of the new law agreed upon in conference finally was published and we had the opportunity to calculate the impact of § 913 on our employees. If there had been any opportunity for Congress to focus on the impact of the 1978 Act on charities, it is inconceivable to us that it would have concluded that the meager revenue gain to be obtained by applying § 913 to charities, justified the devastating cut-backs in charitable services which § 913 would bring about.

In summary, we believe that the case for approving S. 1703 is compelling. The revenue impacts proposed for the bill would be *de minimus*. For example, for all 44 ACVS member charities, we have estimated that the gross decrease in revenue would be less than $2.5 million per year. Further, there is good reason to assume that *net* revenues actually might increase since, if S. 1703 is not enacted, it may be necessary for AID or other federal agencies to expand their programs to make up for cutbacks in charitable services, at a much greater total cost to the Treasury.

If S. 1703 is not enacted, the ability of the overseas charities to continue to perform their historical mission will be seriously impaired. Essential charitable services will have to be eliminated, and a unique opportunity for good will for America will be lost.

Thank you for this opportunity to present my remarks.

AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC.

MEMBERSHIP LIST

American Council for Judaism Philanthropic Fund, Inc.
American Council for Nationalities Service
American Friends Service Committee, Inc.
American Fund for Czechoslovak Refugees, Inc.
American Jewish Joint Distribution Committee, Inc.
American Mizrachi Women
American ORT Federation, Inc.
Assemblies of God, Foreign Service Committee
Baptist World Alliance
CARE, Inc. (Cooperative for American Relief Everywhere)
Catholic Relief Services, United States Catholic Conference
Christian Children's Fund
Church World Service
CODEL, Inc. (Cooperative in Development)
Community Development Foundation, Inc.
Foster Parents Plan, Inc.
Foundation for the Peoples of the South Pacific, Inc.
Hadassah, The Women's Zionist Organization of America, Inc.
Heifer Project International, Inc.
Helen Keller International, Inc.
HIAS
Holt International Children's Services, Inc.
Interchurch Medical Assistance, Inc.
International Rescue Committee, Inc.
Lutheran Immigration and Refugee Service

Lutheran World Relief, Inc.
MAP International (Medical Assistance Programs)
Mennonite Central Committee
Migration and Refugee Service, United States Catholic Conference
Near East Foundation
PACT, Inc. (Private Agencies Collaborating Together, Inc.)
Polish American Immigration and Relief Committee
Project Concern, Inc.
Salvation Army
Save the Children Federation, Inc.
Seventh-Day Adventist World Service, Inc.
Tolstoy Foundation, Inc.
United Israel Appeal, Inc.
United Lithuanian Relief Fund of America, Inc.
United Ukrainian American Relief Committee, Inc.
Young Men's Christian Association, International Division
Young Women's Christian Association of the U.S.A.

TESTIMONY BY WINSTON CRAWLEY, DIRECTOR OF OVERSEAS DIVISION, FOREIGN MISSION BOARD, SOUTHERN BAPTIST CONVENTION

The Foreign Mission Board of the Southern Baptist Convention is the international service agency for more than 13 million members of Southern Baptist churches. At present the Foreign Mission Board maintains approximately 3,000 missionaries in 95 countries and territories around the world. Those missionaries serve also as facilitators for several thousand other persons annually who participate overseas in a variety of special projects on a shorter range basis.

Southern Baptist missionaries are engaged in a wide variety of benevolent programs, including sanitation and public health, medical ministries (21 hospitals and 94 clinics and dispensaries), schools (482 schools at various academic levels), literacy courses, community development centers, children's homes, agricultural centers, etc. Major efforts are focused on combating world hunger. Vigorous response is made to natural disaster (such as those involving hurricanes David and Frederic recently in the Caribbean) and to the needs of refugees (such as currently in major involvement with the Cambodian refugee situation in Thailand).

Across the years, missionaries have served with a level of financial support considerably lower than the usual salary level for comparable employment in the United States. As Americans residing overseas in connection with their work, they have had an exemption of income up to $20,000 annually from United States income tax. Because of that tax exclusion, the Foreign Mission Board (like other charitable and religious organizations) has not had to divert additional amounts of money from its programs of work to enable employees who are on a minimal support level to carry an income tax burden.

Already in recent years there have been serious pressures on funds available for oveseas programs of voluntary agencies, in part from taxes payable to other countries, but even more from the escalating inflation in the United States and more drastically in other lands, and from the decline in value of the American dollar.

To encounter at this time the loss of the income exclusion under the Foreign Earned Income Act of 1978 places a new and severe burden on the programs of work mentioned earlier. Even though the new tax arrangement does involve some allowable deductions for special expenses related to living and working abroad, our careful estimates are that Southern Baptist missionaries will have additional tax bills for 1979 amounting in total to approximately a million dollars. Persons who are already on a minimal support arrangement cannot appropriately be expected to pick up this additional tax burden without major help. Therefore the Southern Baptist Foreign Mission Board faces the probability of having to shift approximately a million dollars from its service programs around the world to provide the help needed just for 1979 for the carrying of this additional tax burden.

With the foreseeable effects of inflation, the impact of the tax situation on funds available for work programs in 1980 and future years will surely grow far beyond the figure of one million dollars per year.

We are convinced that this result was not intended by Congress in the passing of the Foreign Earned Income act of 1978, since it will have a crippling effect on worldwide programs for human welfare being carried on by charitable and religious organizations.

We support fully the amending of Section 911 of the Internal Revenue Code as proposed in S. 1703. This seems to be the simplest way to resolve what constitutes a

major problem for charitable operations overseas. It does not involve a new departure in taxation, but will simply retain a plan that has served satisfactorily for many years and is already available under present law for camp residents. Therefore to extend the provision also to persons performing charitable services in the employ or organizations meeting the requirements of Section 501 (c)(3) of the Internal Revenue Code would seem to be highly appropriate. It would prevent a serious drain on the resources of voluntary agencies and make possible the use of millions of dollars more of such resources in significant contributions to human welfare.

There is an element of urgency in the passage of this proposed amendment, to avoid the immediate impact of the current law on 1979 taxes, with the resulting diversion from overseas programs of approximately one million dollars in the case of the Foreign Mission Board of the Southern Baptist Convention—in addition to the similar large drain on the resources of other charitable organizations. We urge the Finance Committee and the Senate to take favorable action on S. 1703 as early as possible.

STATEMENT BY THE MOST REVEREND EDWIN B. BRODERICK, EXECUTIVE DIRECTOR, CATHOLIC RELIEF SERVICES-UNITED STATES CATHOLIC CONFERENCE

Catholic Relief Services-United States Catholic Conference (CRS) is the official agency of the Catholic Church of the United States rendering emergency relief, self-help development, refugee assistance and welfare aid in over 80 countries overseas.

During 1978, its 35th Anniversary Year, CRS had a program value of $291 million. CRS improved the quality of life for over 14 million of the poor and underprivileged, without distinction of race, color or creed by its operations in 17 countries in South Europe, North Africa, the Middle and Near East; 15 countries in Asia and the Pacific area; 29 countries in Sub-Sahara Africa; 13 countries in Central America and the Caribbean area and 11 countries in South Africa. The agency sustained a full-time program director and staff in 58 of these countries to implement programs, utilize available monetary and technical resources and evaluate such services through management systems. The cumulative value of programs implemented by CRS since inception exceeds $3.5 billion.

CRS is primarily a service agency. Consequently, a high percentage of its operating budget must be expanded on salaries. In 1978 CRS employed 1097 people on its world-wide staff. Of this number, 113 were United States citizens on overseas assignment who were directly effected by the Foreign Earned Income Act of 1978.

These staff members are professionals with either administrative, management or technical skills in the fields of Health, Education and Welfare i.e. Nutritionists, Doctors, Nurses and specialists in Child Welfare, Development, etc. Their average compensation in 1978 was $13,024 which, by today's standards, is extremely low and exemplifies their spirit for service from a humanitarian motivation.

Prior to the enactment of the Foreign Earned Income Act of 1978, virtually all of the United States citizens on overseas assignment were exempt from Federal Income Tax on their modest earnings from CRS.

When the Act went into effect and its provisions were applied to our staff, it was evident from their declarations that less than 4 percent would benefit from the deductions allowed under Section 913. On the other hand, 57 percent estimated that they would become subject to taxes ranging up to $3,100 per annum.

A practical application of the allowable deductions indicates that in 38 percent of the countries, the cost-of-living differential would not apply at all and, in over 50 percent of the countries, it would be insignificant.

While the hardship area deduction applies to most countries in Sub-Sahara Africa, there are instances, primarily in other areas of the world, where employees are precluded from taking this deduction because CRS must maintain its office and staff in the capital city. This is indeed unfortunate as many of the programs, projects and services rendered by CRS employees are in the qualified hardship areas whereas the employees's tax home is not. Therefore, they cannot claim the deduction.

For the Tax Year 1979 the average deduction claimed under Section 913 by the CRS overseas staff is $9,000 which is less than half the amount excludable as income by qualified taxpayers prior to enactment of the 1978 Act.

Any attempt by CRS to alleviate the plight of its overseas staff by absorbing the additional taxes involved would pyramid since such increased earnings would generate added tax liability for both the employee and CRS. This approach would also increase the agency's pension contributions, insurance costs and other fringe benefits which are based upon a salary formula.

If no legislative relief is obtained and it should become necessary to adjust salaries in order to retain the overseas staff, we estimate that the annual cost to CRS would approximate $200,000. This outlay would add more than 10 percent to the cost of sustaining the staff at the identical income level which existed prior to enactment of the 1978 Act.

CRS is already hard pressed to meet rising payroll costs due to inflation and, in the case of overseas staff, the declining value of the United States dollar abroad. Therefore, were the agency to assume this tax levy with its related expenses we would have no alternative but to curtail our overseas program services at a time when there is an ever increasing need for them.

Catholic Relief Services endorses and supports the statement on behalf of the member agencies of the American Council of Voluntary Agencies for Foreign Services, Inc. with respect to the proposed amendment to section 911 of the Internal Revenue Code, as incorporated in S. 1703, which would permit eligible American employees of charitable organizations the option of using the $20,000 income tax exclusion now available only to eligible corporate employees working in camps.

Summary Statement of A. Colin McClung, Executive Director, International Agricultural Development Service, Inc.

Mr. Chairman, my name is A. Colin McClung. I am Executive Officer of the International Agricultural Development Service. It is a U.S. based charitable corporation directing a variety of agricultural programs in the less developed countries.

Many of these activities are undertaken in cooperation with a number of international agricultural development centers. Many of the scientists and production specialists serving directly in these centers are Americans. Because of last year's Foreign Earned Income Act, their tax burdens have soared. For example, figures have been obtained from six of our centers which indicate that the average taxes paid by American employees have risen from 1977 to projected 1979 from $1,372 to $7,225.

Our budgets are relatively inelastic. The unique international character of the centers further complicates this problem. The staff is drawn from 53 different nations. A uniform salary scale prevails in order to ensure equal pay for equal work and equal talent regardless of nationality. Thus, there is no way in which we can remedy this situation simply by raising the salaries of Americans to compensate for the new taxes. Some of the other sponsoring countries have already vigorously protested the idea. They said we would be, in effect, using their tax dollars to subsidize American employees and our Treasury Department.

Mr. Chairman, we are but one small part of a large undertaking by this country through a variety of agencies to expand foreign trade, increase stability and improve the prospects for peaceful relations with the Third World. It is clear from our perspective, however, that unless this government provides the minimal support necessary to enable us to maintain the personnel we need to do the job assigned us, all our interests will suffer irrevocably. Thank you for your consideration.

Statement of A. Colin McClung, Executive Officer, International Agricultural Development Service, Inc.

Mr. Chairman, my name is A. Colin McClung. I am Executive Officer of the International Agricultural Development Service. It is a U.S. based charitable corporation directing a variety of agricultural programs in the less developed countries with funding provided by U.S. AID, the World Bank, the Interamerican Development Bank and others. In order to carry out these projects it is essential that our organization post scientific specialists in the host countries. The greatest source of expertise to meet this need is found within the United States scientific community.

Many of these activities are undertaken in cooperation with a number of international agricultural development certers. Many of the scientists and production specialists serving directly in these centers are Americans also. Last year, the Foreign Earned Income Act eliminated their option, as employees of nonprofit research organizations, of choosing a $20,000 exclusion in calculating their income tax obligations. They were left only with a series of deductions for such specified items as housing and educational allowances which, unfortunately, did not prove nearly as efficacious as the earlier alternative of the exclusion. As a result, their tax burdens have soared. For example, figures have been obtained from six or our centers which indicate that the U.S. income taxes for American employees have risen from 1977 to projected 1979 by approximately 526.26 percent. Income rose 21.06 percent during

the same period. The average taxes paid by these U.S. scientists went from $1,372 to $7,225.

Naturally, these increases are devastating for the individual, but, more importantly, they have a severe adverse impact on their sponsoring organizations. With limited resources, labor cost increases of this magnitude simply cannot be easily absorbed. Staff elsewhere has to be reduced or program monies diverted. If not, there is an inevitable increase in attrition among the Americans involved. In fact, just such a phenomenon is now becoming apparent as is its corollary of increased difficulty in recruiting new scientists to serve in these posts. The situation will only worsen as time goes on unless some relief is provided.

Our budgets, like many of those of non-profit organizations, are relatively inelastic. In our case, they are not based on government treaties and there is no assessment of funds. It is truly a unique example of international cooperation. It is this unique international character of the centers, however, which further complicates our problems. The staff is drawn from 53 different nations. A uniform salary scale prevails in order to ensure equal pay for equal work and equal talent regardless of nationality. Of these 53 nations, only three tax their scientists when they work at the centers. Thus, Americans are already at a considerable disadvantage. Given the impact of the changes last year, they are now faced with an enormous reduction in their take home pay vis-a-vis their colleagues. Their disadvantage is rapidly becoming exploitive.

There is no way in which we can remedy this situation simply by raising their salaries a like amount, even if we could afford it. The other scientists would certainly object. In fact, some of the other sponsoring countries already have vigorously protested the idea. They said we would be, in effect, using their tax dollars to subsidize American employees and indirectly funnel money into our own Treasury. Thus, the only workable solution we can find is to ask for relief through the Congress.

The number of taxpayers involved is not great. There are 530 senior staff at all centers of whom 132 are Americans. Thus, their importance to the United States Treasury is quite limited, but their role in the management and progress of these centers and in the field of agricultural development in general is inestimable.

I would remind you the total senior scientific staff of the International Rice Institute never exceeded 25 scientists during the period when the new "miracle" rice was being evolved. Americans have historically proven to be the most experienced and richest source of manpower in the agricultural development field. Our ability to make a significant contribution to the economies of the developing countries will be severely limited if these U.S. tax laws continue to restrict our ability to employ the best qualified American scientists. The leverage of these dedicated professionals on the process is far out of proportion to their numbers and their absence would be sorely felt. This is not simply an American view, but also an opinion that has been expressed to me in growing alarm by the other participating countries who see our scientists as a prime source of talent in the development of their own resources.

Such a diminution of effort is contrary to American interests in my view and in the view of the Congress as expressed through the Foreign Assistance Act, in particular Title XII. President Carter has also expressed his concern over the work of the centers. As recently as October 3, 1979, he sent a letter to the heads of the governments of Canada, France, Germany, Italy, Japan, and the United Kingdom reminding them of their pledge at the Tokyo Summit to increase bilateral and multilateral aid to agricultural research. He referenced the five year plan for expanding the scope and intensifying the efforts of the centers and pledged enlarged support from the U.S. and urged the other governments to do the same.

Given the increasing instability of the world economy due to energy problems and the threat to the developing world posed by the population explosion, the work of these centers is of vital importance. Unless we succeed in helping the world increase its food supply at a much greater rate, we face disastrous famines and enormous political upheavals. Bangladesh, for example, must increase its food supply by 50 percent in just the next 11 years if it is to maintain its present level of purely marginal nutrition. Countries such as Bangladesh will not be able to purchase increased food supplies in those amounts. They must increase their food supplies themselves. Nor is it possible for these densely populated countries to open up new farming lands. They simply do not have the space. They must maximize production on their present land. The only way in which they can do this successfully is through research. And, as mentioned before, the United States is in a unique position to provide the leadership required. Without our full participation, the effort runs a much greater risk of a failure.

Mr. Chairman, we are but one small part of a large undertaking by this country through a variety of agencies to expand foreign trade, increase stability and improve the prospects for peaceful relations with the Third World. It is clear from our perspective, however, that unless this government provides the minimal support necessary to enable us to maintain the personnel we need to do the job assigned us, all our interests will suffer irrevocably. Thank you for your consideration.

STATEMENT OF DR. VERNON LARSON, PRESIDENT, ASSOCIATION OF UNITED STATES UNIVERSITY DIRECTORS OF INTERNATIONAL AGRICULTURAL PROGRAMS

Mr. Chairman, I am Vernon Larson, Director of International Agricultural Programs at Kansas State University in Manhattan, Kansas. Today I also speak as the President of the Association of United States University Directors of International Agricultural Programs. This association was formed in 1965 to bring together those persons from the United States Agricultural Colleges, who were charged with implementing the international dimension of the universities. Today, this association has a membership of 137 persons representing almost all of the land-grant colleges and many other institutions involved in agricultural development in the less developed and poorer countries of the world.

I deeply appreciate the opportunity to speak before you in support of Senate bill 1703, since if the wishes of Congress as expressed in the Foreign Assistance legislatin are to be implemented, the present act must be amended.

Because of the foresight of Congress through Foreign Assistance Assistance legislation there are on every continent today agricultural universities patterned after our American colleges that are functioning as problem solving institutions focusing on the most pressing needs of their respective societies. These programs have succeeded because American professors and their families were willing to move abroad for two years or more and become immersed in the foreign culture. The short term, 90 day specialist can serve a vital role, but that person cannot build a viable institution on foreign soil.

The present legislation saves very little money, but greatly alters a program. One cannot obtain the services of the top rate U.S. professors today, but instead must look for the unemployed on the world market. Is the intent to save a few dollars or is it to alter a program that has been extremely successful?

Thank you again, Mr. Chairman, for this opportunity to speak on such a major concern of the American agricultural development community.

Senator CHAFEE. We will conclude the hearings.

[Whereupon, at 5:40 p.m., the subcommittee recessed subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TESTIMONY BY SENATOR THAD COCHRAN

Mr. Chairman, I would like to take this opportunity to speak in support of the partial reinstatement of a tax exemption for charitable, religious and nonprofit workers employed overseas. This exemption was rescinded by the Foreign Earned Income Act of 1978.

I introduced legislation along those lines early this summer, S. 1372, and I am cosponsoring S. 1703, Mr. Chafee's bill.

Basically, the legislation would reinstate a tax exemption for the first $20,000 earned by an employee of a charitable, religious or nonprofit organization meeting the requirements of Sections 501(c) of the Internal Revenue Code.

Originally, the tax exemption was for any employee working overseas. The Foreign Earned Income Act of 1978 eliminated any exclusion of income for both nonprofit organization employees and corporate employees, with no distinction being made between the two.

In the 1976 amendments to Section 911 of the Internal Revenue Code, however, a difference was recognized and a distinction was made between nonprofit organization employees and corporate employees. We should recognize that difference and reinstate that distinction once again.

One of the major differences between nonprofit organizations and corporations is that, unlike corporations and businesses, a nonprofit organization that must pick up the tab for an increase in taxes or salaries to compensate for the tax cannot pass its costs along to the consumer. It must either lay off personnel or cut back in services.

This is not the time we should begin shortening or limiting our services—services that are of a varied nature and affect many persons.

One of the affected types of service that we immediately think of is missionary work, The people in Mississippi who were concerned about the plight of the Southern Baptist missionary and the Southern Baptist Foreign Mission Board brought this unfortunate situation to my attention.

I am sure that the Southern Baptist Foreign Mission Board is typical of many foreign mission boards in that its missionaries are provided a minimum support basis. In order to offset inflation and dollar devaluation, it has been necessary to add cost-of-living supplements to protect even that minimum support level from erosion. Because these minimum support levels cannot bear an increase in taxes, the Southern Baptist Foreign Mission Board plans to increase the supplement to compensate for the expense of the additional taxes for its missionaries. The mission board has found in preliminary calculations that the act will impose close to a million dollars in additional taxes. To a foreign mission board, or any nonprofit organization, this jeopardizes desperately needed services.

Not only are missionaries affected, but so are many other nonprofit organizations such as CARE, the Salavation Army, the YMCA and the YWCA. Nonprofit organizations are active in the fields of education, health and development.

Of particular interest to me, being a member of the Agriculture, Nutrition and Forestry Committee, is the work of land-grant colleges overseas. Because of their work with Agricultural Ministers of foreign countries and with organizations such as the International Agricultural Research Centers, countries have been able to increase their crops and better feed their people. The persons sent overseas are employees of the land-grant colleges but are paid by the Agency for International Development. Since A.I.D. restricts more than a 10 percent increase in pay, the only economic incentive a person had for uprooting a family and leaving a secure life was the $20,000 exemption. Land-grant college officials fear they will not be able to attract the quality personnel needed to meet the challenges overseas.

One may question the effect on revenue if we reinstate this exemption. Expected revenue from the elimination is nominal in comparison to the detrimental effect the tax increase will have on charitable services. Revenue gains have only been calculated for nonprofit and corporate organizations combined, but only a limited percentage of this revenue gain will come from employees of charitable, religious and nonprofit organizations.

I am sure the committee will obtain more accurate data on the revenue effect of this bill. From reviewing the available figures, however, I do not think there will be a significant enough increase in revenue from nonprofit organizations to warrant the great loss in services. Services deleted by these organizations will in many cases be picked up by the federal government. It is a shared opinion that this is directly contrary to federal policy established by Congress in the Foreign Assistance Act declaring a policy of reliance on the charitable sector "to the maximum extent possible" in providing overseas assistance and relief.

We must also look at the noneconomic effects of having charitable, religious and nonprofit organizations working abroad. In the House Ways and Means Committee Report on the Foreign Earned Income Act of 1978 it was stated that "the presence of U.S. citizens working abroad provides considerable noneconomic benefits, such as enhanced international good-will and mutual understanding."

What about the deductions which were included in the act supposedly to compensate for the loss of the exclusion? From all reports, these five deductions will do very little in offsetting the expensive effect of the increase in taxes.

For example, an analysis prepared on behalf of the American Council of Voluntary Agencies for Foreign Service, Inc., shows that for CARE's overseas workers, the great majority will receive a deduction of significantly less than $10,000 from the Section 913 subsections—or less than one-half the exclusion allowed under pre-1978 law.

It is my belief that the Congress did not intend to handicap our charitable and religious organizations by eliminating this exemption. It is my hope that this committee will take action to eliminate this handicap and to provide the needed tax relief for the dedicated citizens working abroad.

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., October 31, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Finance Subcommittee on Taxation and Debt Management.

DEAR MR. CHAIRMAN: We commend you for calling these hearings to examine the possibility of providing additional incentives to Americans to save. As you are well aware, each dollar saved by Americans now shrinks over time. In these inflationary times, saving has become a losing proposition. As you also know, the savings rate in the United States is now the lowest in the industrialized world and this has chilling implications for U.S. economic growth, standard of living and job opportunities.

Our goal, then, must be to provide a tax break for small savers that will allow Americans to set aside savings for future needs and at the same time increase the U.S. savings rate to provide additional investment funds for capital formation.

We believe that the best way to meet these twin goals is the enactment of the Savings Act of 1979 (S. 18, H.R. 169). The bill provides a 50 percent tax credit for additions to all types of bank and savings accounts, stock and taxable bond holdings, insurance and assets of small businesses. Only savings over a threshold amount—the average saving rate by income bracket—is eligible for the credit, ensuring that only *additional* saving is rewarded.

This approach differs significantly from the more commonly mentioned proposal, which normally provides a tax deduction for interest earned up to a certain dollar limit—say, $100. Most tax returns, even in low income brackets, show that much interest income. That means a windfall for the taxpayer without any incentive to do additional saving. The corresoponding revenue loss to the government would increase the federal deficit and contribute to inflation.

By rewarding only saving done over a threshold amount, the Savings Act of 1979 avoids rewarding saving that is being done anyway, without the credit. For example, if people earning $20,000 a year normally save four percent of their income, they would only get the credit on saving in excess of $800.

Of course, some people save more than the average rates now, so some credit would be given out before behavior changed. But the thresholds have been set high enough that about 80 percent of current saving is not eligible. So the initial revenue loss would be held to the $5 to $10 billion range.

This would increase the deficit, but it would not be inflationary. Here's why: Professor Michael Boskin of Stanford estimates that savings increases three to four percent for every 10 percent increase in the rate of return on savings. Since the Saving Act of 1979 would *double* the rate of return on savings (a 100 percent rise), we can expect saving to increase 30 to 40 percent. Current personal saving is nearly $100 billion per year, so there would be $30 to $40 billion in additional saving.

The revenue loss to the government from the tax credit therefore would be half of that (it's a 50 percent tax credit) plus the initial revenue loss of $5 to $10 billion. Since the total is less than the amount of additional saving, any resulting deficit would be self-financing and not inflationary. The deficit would be funded by private saving, not by money creation. And there would be additional saving left over to finance creation. And there would be additional saving left over to finance private investment, leading to economic growth, more jobs, and additional government revenue.

Another big advantage of the approach taken by the Savings Act of 1979 is that it provides more help for low income families than the bills giving a tax deduction for interest earned. A $100 deduction is worth $50 to someone in the 50 percent tax bracket. But the same $100 deduction is worth just $15 for the family in the 15 percent bracket.

A 50 percent tax credit, on the other hand, is worth the same 50 cents for every dollar saved over the threshold amount for both low and high income taxpayers. As a percent of income, the incentive is actually higher for low income families. And the threshold amount is low for low income families; it's zero for those under $10,000. Such a family gets 50 cents off it tax bill for every dollar saved.

Finally, interest deduction bills limit their impact to savings in banks, savings and loans and credit unions. The Savings Act of 1979, because it provides a credit for actual saving, not a deduction for interest earned, also applies to saving in stock and taxable bond holdings, insurance and assets of small businesses. By treating all forms of saving equally, the Savings Act of 1979 will not favor one type of savings at the expense of the others.

In short, the Savings Act of 1979 offers more than a small tax break to people with small savings accounts. It provides a powerful incentive for additional saving and investment in all sectors of the American economy, as well as the opportunity

for all Americans at all income levels to receive a significant reward for saving and investing their money wisely. Mr. Chairman, we respectfully urge that S. 18, the Savings Act of 1979, be given full consideration by the Subcommittee as you proceed with your hearings.

Sincerely,

CLARENCE J. BROWN,
Member of Congress.
JAMES A. MCCLURE,
U.S. Senator.

THE SAVINGS ACT OF 1979 (S. 18, H.R. 169)

H.R. 169 is designed to encourage and to assist Americans to save and invest—activities which many of our citizens find next to impossible in an inflationary period.

The bill allows a tax credit of 50 percent for additions to all types of bank and savings accounts, stock and taxable bond holdings, insurance, and assets of small businesses. It will sharply increase the reward to saving, and will, for the first time in years, allow many of our citizens to have a real return after taxes and inflation on their savings. It will enable many people to set aside sufficient funds for the purchase of a home, payment of tuition or medical expenses, a secure retirement, and the many other goals our citizens have worked so hard to reach, only to be cheated out of them by taxes and inflation.

While helping savers to reach these goals, this bill will help the country reach its goals of full employment and no inflation. By adding to the supply of saving, the bill makes possible the funding of far more investment in plant and equipment, the modernization of thousands more factories, and the creation of hundreds of thousands of additional jobs each year. By increasing productivity and the demand for labor, this will make American industry more competitive with foreign firms even while providing real wage increases for American workers. By funding the investment out of saving, instead of through money creation by the Federal Reserve, and by increasing efficiency and the supply of goods, the bill will reduce inflation.

The United States has long had the lowest rate of saving and investment in the Western world. As a consequence, every other major Western nation has a better employment record, and a faster rate of growth of real wages and fringe benefits than the U.S.

WAGE INCREASES, INVESTMENT, AND SAVING

	1965–75 percent change in real wages and fringe benefits[1]	Investment as percent of GNP—Averages, 1956–73		Household savings ratios, 1976 estimate (percent)
		Total	Total minus homebuilding	
United States	15.7	17.5	13.6	6.8
Canada	48.5	21.8	17.4	10.12
Japan	138.9	35.0	29.0	24.26
France	77.4	24.5	18.2	16.18
Germany	78.1	25.8	20.0	14.16
Italy	116.4	20.5	14.4	22.24
United Kingdom	53.9	18.5	15.2	12.14

[1] Includes pension programs and other fringe benefits.

Sources: Bureau of Labor Statistics, OECD.

Last year, before the Joint Economic Committee, a panel of experts on growth and capital formation zeroed in on the bias in the tax code against saving. Income is taxed when earned. If it is consumed, it purchases a service or a product with little added tax. If it is saved, the service (interest or dividends) is taxed a second time at higher tax rates. The experts recommended removing saving from taxable income as the best way to return the tax code to neutrality between consumption and saving. Taxes would remain on the earnings of saving, but we would no longer be double-taxing both saving and its earnings. This bill is a major step in that direction.

The bill recognizes the difficulty lower income taxpayers have in saving by providing a tax credit rather than an exemption. Low income taxpayers would receive a credit on all eligible savings.

Middle and upper bracket taxpayers have historically saved higher percentages of their incomes than lower bracket taxpayers. To sharply reduce the cost of the bill, these taxpayers would receive a credit only on eligible savings done in excess of the normal percent of income saved by people in their income brackets. Thus, if people earning $20,000 usually save 4 percent of their income, or $800, they would only get the credit on saving in excess of $800.

If we have estimated the average savings rates exactly for each income level, and if everyone at a given income level saves at the average rate for that level, the initial expense of the bill is zero. Only as saving rose in response to the bill would any credit be given. Thus, the bill avoids rewarding saving that is being done anyway, without the credit.

Of course, some people save more than the average rates now, so some credit would be given out before any behavior changed. The thresholds have been set high enough so that perhaps 80 percent of current saving is not eligible. This would put the initial cost in the $5-10 billion range, on the "inframarginal" current saving that would be eligible.

This initial cost would not be inflationary. A 50 percent credit doubles the effective yield on saving, and would generate more saving than the rise in the deficit. Professor Michael Boskin of Stanford estimates a savings elasticity of 0.3 to 0.4 with respect to yield. A 100 percent rise in yield would produce a 30 to 40 percent rise in saving. Personal saving is nearly $100 billion a year. The increase would be $30 to $40 billion. In that sense, the credit is self-financing. Any deficit would be funded by private saving, not by Federal Reserve purchases of Treasury bills (money creation). For most credit recipients, they would have to save double the amount of the credit they receive.

This saving credit will restore the attractiveness of straight-forward saving in basic U.S. industry, small business, and homebuilding, as compared to inefficient but tax-sheltered projects. A 50 percent credit doubles the reward to such taxable investment and saving for any given interest rate or dividend. Thus, this credit will produce a reallocation of saving into projects of the greatest value in terms of economic growth and modernization of American plant and equipment.

Savings is the key to noninflationary economic growth. Growth is the key to full employment, rising living standards, and a sound social security system. Attached are a more detailed description of the bill and a Wall Street Journal article which documents the poor performance of the U.S. in saving and growth.

The first part of the bill creates a nonrefundable credit against the personal income tax equal to 50 percent of Eligible Net Saving (defined below), insofar as the saving exceeds certain required levels.

The required levels, called Thrushold Saving Amounts, are based on the taxpayer's adjusted gross income less personal exemptions. The thresholds (see Table) rise with income to reflect the fact that as a family's income rises, its saving, as a percent of its income, also rises. Only saving in excess of the threshold level is eligible for the credit.

Income less exemptions which saving must exceed to qualify

Adjusted gross income less exemptions:	*Percent*
Not Over $10,000	0
Over $10,000 but not over $12,000	1
Over $12,000 but not over $15,000	2
Over $15,000 but not over $20,000	3
Over $20,000 but not over $25,000	4
Over $25,000 but not over $50,000	5
Over $50,000 but not over $100,000	6
Over $100,000 but not over $200,000	8
Over $200,000	10

Thus, a family earning $9,000 which saves $500 in eligible assets receives a 50 percent tax credit on the full amount. A family earning $18,000 would be expected to save 3 percent, or $540, before being eligible for the credit. If it saved $1,000, it would receive a credit on the $460 in excess of the required $540. A family earning $36,000 would be expected to save 5 percent or $1,800, before being eligible for the credit. If it saved $3,000, it would receive a credit on the excess of $1,200.

The bill then defines Eligible Net Savings as the sum of Net Saving less Ineligible Debt.

Net Saving is:

(1) Saving in Certain Businesses,

The taxpayer's share in the increase in book value (largely cash increases, inventory increases, investment in additional equipment and structures) of small businesses such as partnerships, proprietorships, and closely held corporations, plus purchases of and loans made to small business. These amounts are readily available, since they are already calculated for tax purposes;

(2) Saving in Liquid Assets,

Saving in checking accounts, savings accounts, and savings bonds. Amounts in accounts at commercial banks, savings and loan institutions, mutual savings banks, and credit unions at the end of the year would be compared to the amounts on deposit at the end of the previous year. The net increase would be part of Eligible Net Saving, as would savings bond purchases less redemptions;

(3) Saving in Certain Investment Assets,

Stock purchases minus sales, and purchases of taxable bonds (Federal or private sector) minus sales are eligible. These records are already kept for tax purposes;

(4) Savings in Mortgage Assets and Investment Real Estate,

Investment in mortgages or real estate, plus improvements, less loans repaid or property sold; and

(5) Saving in Company Savings Plans, Retirement Plans, and Life Insurance,

Payments into plans or on premiums, less withdrawals from or borrowing against such plans or policies.

Ineligible Debt must be subtracted from Net Saving. Not only is debt a form of "negative" saving, but this provision prevents borrowing on existing assets to make deposits solely to get the tax credit. Ineligible Debt is debt acquired in the tax year other than for the purchase or repair of a home or other property or the payment of medical or tuition expenses of the taxpayer or dependents.

Another safeguard is a recapture provision for credits on savings not left in some form of eligible assets for five years. This provision would not apply to withdrawal from savings for retirement income.

The income levels attached to each threshold percent would be indexed to prevent inflation from making the credit harder to receive over time.

STATEMENT BY SENATOR LOWELL WEICKER, JR.

Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to give my views on tax legislation pending before this Subcommittee which would allow savers to exclude interest income earned from a savings account from gross income. In particular, I am pleased to comment on S. 1697, the All Savers Tax Incentive Act, which I introduced on August 3, 1979.

As you all know, Americans today are victims of high interest rates on loans, chronic high inflation, low interest rates on savings, and a tax system that encourages consumption. Savers utilizing a passbook account can earn only 5.5 percent at savings and loan asssociations and 5.25 percent at commercial banks. The Administration has estimated that a person in a 30 percent marginal federal income tax bracket would receive an after-tax yield of about 3⅗ percent, but when this is adjusted for the 1978 inflation figure of over 9 percent, the return is a negative 5½ percent. A negative rate of return on interest obviously discourages savings.

Instead, we must encourage people to save their money. With an incentive to save, we can help stimulate the housing industry by creating more available funds in our banks and thrift institutions and by relieving the pressure of high interest rates which prevent young couples from purchasing their first home. With adequate savings at their disposal, banks, savings and loan associations and credit unions could also fund the construction of new plants and purchases of equipment. As a consequence, productivity increases, inflation declines and new jobs are created.

Pending before this Subcommittee are a number of similar bills which seek to grant tax relief for small savers. Under S. 1697, I propose to offer a tax credit with the option of an exclusion from interest earned from savings accounts. An individual would exclude from taxes the first $1,000 of earned income from a passbook savings account. A taxpayer with more modest savings could receive an alternative tax credit of up to $250 on income tax payments. In case of joint returns, both the credit and the exclusion would also be offered as options. In this way, all savers can take advantage of that option which yields the greatest tax dollar savings.

Specifically, Section I provides a tax credit of up to $250 per individual taxpayer. The credit has been made such that most credits provided in current tax laws are taken before the propsoed credit for interest earnings. The proposed credit is a

nonrefundable credit. Thus, if tax liability is zero, the credit would cause a negative tax liability, and no monies would be refunded by the Federal Treasury. Therefore, the loss to the federal deficit is lessened. According to the Joint Committee on Taxation, for fiscal year 1980, the revenue loss is estimated at $1.2 billion.

Section II provides an alternative to the $250 credit by an exemption of $1,000 from gross income. The taxpayer may not take advantage of both the credit or exemption, but has the right to choose which would be more profitable. The basic provisions for the exemption are the same as for the credit.

Mr. Chairman, in 1975, when I first proposed this legislation, by way of an amendment to the Tax Reduction Act, I stated that savers were seeking higher yields in the open market to prevent inflation from eroding earnings. With inflation hovering around 13 percent, savers today are being lured further away from saving—Americans have become insatiable consumers, gorging their salaries and increasing their debt at a frightening pace. Furthermore, the current investment options favor the large investor because of the exemption from ceilings on certificates of $100,000 or more. Money market certificates also provide high interest rates for depositors with at least a $10,000 investment.

I am encouraged to see that this Subcommittee has moved with all deliberate speed to hold hearings on this most urgent mattter. I cannot overstate my concern about the declining rate of savings and productivity in this country, the depressed housing industry, and most importantly, the inequities suffered by the people of this country who try to save their hard earned income for retirement, education, housing and other necessities of life, only to see those savings eaten away by inflation and taxation.

We must get back to the priorities of the people. We must provide incentives for people to save, so that we can help stimulate the housing industry, provide new jobs and capital investment, reduce inflation and consumption and increase productivity. And in turn, the savers of this country can then truly reap the benefits of their thrift.

The All Savers Tax Incentive Act, S. 1697, and the other tax incentive legislation before the Subcommittee address this issue. I, therefore, strongly urge that the Subcommittee expeditiously act on these proposals and report a bill to the Senate.

STATEMENT OF SENATOR HOWARD H. BAKER, JR.

Mr. Chairman, I am making this statement in support of S. 555, The Independent Local Newspaper Act, as one of its sponsors this year and in the last Congress, because I sincerely believe that legislative action is essential to preserve a truly diverse and independent press. We are all aware of the growth of newspaper chains and media conglomerates during the past 20 to 30 years. Today, these chains own over two-thirds of the daily newspapers in the United States, and through them control over 72 percent of daily circulation and 76 percent of Sunday circulation. Chain control of weekly newspapers has, similarly, reached remarkable proportions.

The Department of Justice has monitored these purchases of newspapers, but asserts that the antitrust laws provide no bases for intervention by the Government to preserve the remaining locally owned newspapers. The records show that chain newspapers are buying one daily newspaper and three to four weekly newspapers each week. At this rate, there soon will be no independent newspapers left, and we will never be able to fill this void in our democratic fabric.

Supreme Court Justice Stewart stated, in an address at Yale Law School in 1974, that publishing is "the only organized private business that is given explicit constitutional protection." The Congress has a responsibility to assure the nation of the continued existence of a free and diverse press. In 1970, we enacted The Newspaper Preservation Act to preserve independent newspaper voices. Now, we are called upon to preserve independent, locally owned newspapers.

Let me note that I am not criticizing newspaper groups or chains, or contending that a locally owned newspaper is necessarily better than one owned by a chain. I am certain that there are good and bad examples in each category.

My purpose in sponsoring S. 555 is to make it possible for independent owners to retain local ownership of their newspapers. The bill does nothing to adversely affect chain newspapers, or to benefit one group at the expense of the other.

Mr. Chairman, the last few years have witnessed sales of independent newspapers at extraordinary prices, with sales at 60 times earnings, or more. This has created a problem for those owners who sincerely want to maintain their newspapers within their families. The Internal Revenue Service determines the value of a newspaper as the amount a buyer will pay for that newspaper. Therefore, at the death of an owner, the value of his estate is calculated at the amounts being paid for like

newspaper properties. The assessed values, because of the exacerbated prices being paid for newspapers, are often at levels which preclude the heirs from being able to maintain ownership. The are simply forced to sell in order to pay estate taxes.

Mr. Chairman, S. 555 does not eliminate estate taxes, or, as in the Family Farm Act of 1976, change the valuation formula. This bill would allow the owners of an independent, locally owned newspaper to pre-pay their estate taxes. The bill is permissive, and would not require such owners to act, but for those who so determine, the provisions of S. 555 enable them to arrange during their lifetimes for the payment of estate taxes in order to insure continuity of ownership.

The Independent Local Newspaper Act offers an equitable solution to a problem which is not caused by owners of independent papers. The relief offered in this bill will redound to the public benefit by helping maintain a free, diverse, and independent press.

STATEMENT BY AMON C. EVANS

I am Amon C. Evans Nashville, Tennessee. My family has owned the *Nashville Tennessean* for 42 years. On July 5, 1979, my mother and I sold the *Tennessean* to Combined Communications, Inc., a wholly owned subsidiary of Gannett Co., Inc.

One major reason for our selling the newspaper was the anticipated effect of the federal estate tax laws upon our situation. My mother, who is 78 years of age, and not in good health, owned a substantial share of the stock of the Tennessean. If she were to pass on, this likely would have placed us in the position of having a forced sale in order to pay estate taxes.

To state it simply, if my mother had died owning her stock in the Tennessean, under the circumstances as they exist in Nashville, there is every reason to believe I could not have paid the estate taxes which would have been levied against this stock, nor could I have borrowed the amount necessary to pay these taxes without further jeopardizing financially my family. This is because newspaper chains have been paying such high multiples, 30 and 40 times earnings, for newspaper properties, and estate taxes are based on what a willing buyer will pay for the property. Thus, we either had to sell now under relatively favorable conditions, or face a situation where a sale likely would have been required.

This really wasn't much of a choice. Acting in the best interests of the Evans family, we determined to accept Combined's offer.

We supported S. 555, the Independent Local Newspaper Act, as well as precedessor legislation during the 95th Congress. We were very much aware of the problem we faced under the estate tax laws, and sought the legislative relief your subcommittee is now considering. We had seen many of our friends sell their properties at the death of a major owner of the newspaper. We had hoped that the Independent Local Newspaper Act would be enacted in time to meet our problem.

Let me add that it was not the fact that we had repeated, if not constant suitors seeking to purchase the Tennessean. That has been the case for years, though the offers had increased substantially in the past two or three years. Nor was it just a matter of a buyer meeting our price. Were it not for the impact of the estate tax laws and the particular situation in the Nashville market, we would not have felt obligated to sell.

I urge the members of the Subcommittee to give serious and favorable consideration to the bill now before you. I sincerely believe that enactment of S. 555 will aid other owners of independent local newspapers in maintaining their properties.

STATEMENT OF CHARLES H. SMITH III, PRESIDENT-PUBLISHER, THE KNOXVILLE JOURNAL

I am Charles H. Smith, President and Publisher of The Knoxville Journal, Knoxville, Tennessee. I am submitting this statement in vigorous support of S. 555, the Independent Local Newspaper Act.

Independent newspapers, those not owned by chains, are fast becoming a dying breed in danger of extinction. At least once a week, another daily newspaper and as many as three or four weekly newspapers disappear from the ranks of the independents and into the control of chains or groups. In the past few years, the toll has been tremendous, and it would appear to me that as the number of remaining independents declines, there is a greater frenzy by the chains to snap up the survivors.

As the publisher of an independent, I can tell you that I am constantly besieged by brokers and agents for those seeking to buy newspapers. Moreover, the offers are not just good, they are spectacular.

Normally, the owner of an independent newspaper would be flattered by such bids, and bask in the warmth of knowing of his financial security. However, the result is quite the opposite. The inflated and hyped-up bids for newspapers raise their values for estate tax purposes far beyond the ability of the owners to arrange for payment of such taxes.

I do believe that federal estate taxes are to high. But when you apply these taxes to the inflated values placed on independent newspapers by the chains, the result is to force the sale of the independents to the only ones willing to pay such prices, the newspaper chains.

We are the third generation of my family to own The Knoxville Journal. We do not want to sell to a chain, or to anyone else, but to see our children, already active with the newspaper, take our places when their time comes. Maybe we could provide a more financially secure future for them if we sold out, but we don't want to, and, I am proud to say that our children agree with us.

The sad fact is that the choice is not really left to us. The inflated prices paid by chains makes it just about impossible for an independent's owner to pass the paper on to his children.

That is why we have come here to the Congress to seek relief under the estate tax laws. There is nowhere else to turn. The American Newspaper Publishers Association took a look at our problem, but when they announced their report and recommendations at the annual meeting last April, everyone in the room who commented was an independent, and each objected to the proposals made. In fact, if my memory serves me, each of the independent owners present who were heard did vocally endorse S. 555. Nevertheless, the American Newspaper Publishers Association did not change its position on this vital legislation.

I have no bone to pick with the Association. It does a good job in a number of areas. I do recognize that the bulk of its members are chains, and their interests are not the same as those of us who are independents. Really, the pursuer and the pursued do not have the same interests, or even the same point of view.

I have no quarrel with the chains, except that they have put me and all other independents in this very difficult position by their unsolicited and overly inflated bids for our newspapers. I am not a lawyer or tax expert, but I do know what these high values do to estate taxes.

There are only some 600 dailies owned by independents left in the United States. Most of these are the medium to small sized newspapers, our bigger brothers having already been picked off. I believe there is a need for the continued existence of independents, and that our continued existence is beneficial not only for our own communities, but for the nation.

We do not seek or need subsidies. We are not asking for lower taxes, or special exemptions. We do ask for a reasonable means to prepare for the payment of estate taxes by the methods set forth in S. 555.

I very much appreciate the opportunity to present this statement today. I know that a year ago, the publisher of the Nashville Tennessean testified for a like bill, but that his paper has since been sold to a chain, primarily because of estate tax problems. I can only hope that this legislation is enacted before many more independents become statistics in this numbers game.

STATEMENT OF DOUGLAS L. MANSHIP, EDITOR AND PUBLISHER, BATON ROUGE ADVOCATE AND STATE TIMES

I am Douglas L. Manship, the Editor and Publisher of the Baton Rouge Advocate and State Times. I am submitting this statement to the Subcommittee on Taxation and Debt Management of the Committee on Finance, United States Senate, in support of the Independent Local Newspaper Act, S. 555, introduced by Senator Robert Morgan and twenty-seven co-sponsors.

The Advocate and State Times are the largest locally owned newspapers in the State of Louisiana. Only three other cities in Louisiana have independent daily newspapers which are not owned by newspaper groups or chains. However, not too many years ago, the majority of our daily newspapers were owned and operated by local families. The last several years have witnessed, in Louisiana and throughout the United States, the purchases of newspapers by groups. In the recent past, industry statistics show that approximately one daily newspaper is sold to the chains each week. In 1978, there were 47 daily newspapers purchased by newspaper groups, and it is my understanding that the pace has quickened during 1979.

While I cannot state the underlying cause for each sale to a group, there is no question but that the Federal estate taxes have played a major, if not the most predominant, role in bringing about the sales. Obviously, estate tax problems affect all businesses, but they have a particularly egregious effect upon newspaper ownership. That is because the newspaper groups have been paying 30, 40, and even over 60 times earnings to purchase formerly independent newspapers. For example, the purchase of the Shreveport and Monroe newspapers in Louisiana in 1977 was estimated to be at over 80 times earnings.

The inflated prices paid for independent newspapers—which are now eligible for designation as an endangered species—have an exacerbating effect upon the estate taxes due from owners who do not want to sell their properties. The Internal Revenue Service bases its value on a property for estate tax purposes at what a willing buyer will pay a willing seller. Thus, if the owner of a newspaper dies, the IRS will assess estate taxes based primarily on the amount a chain would pay for the newspaper, and not on its earnings or plant value. The heirs, who want to continue to own and operate the newspaper, find themselves unable to borrow sufficient sums to pay the taxes, in that their earnings will not even cover the interest charges on the moneys owed to the Government.

This phenomenon, peculiar to newspapers, is the basis for the legislation you are now considering, just as the inflated (but not as inflated) prices being paid by shopping centers and developers for farm land was the basis for the Family Farm Act of 1976. As recently stated by the Executive Vice President of the American Newspaper Publishers Association in testimony before the Senate Small Business Committee:

"ANPA feels strongly that decisions by owners on whether to buy, sell or retain a newspaper should not be affected by laws which penalize one party to a transaction and thereby serve to reward another. Unfortunately, that is the case today in the federal estate-tax laws. And this presents an arena in which the Congress can and should act—not to influence or direct newspaper ownership decisions, but to remove a bias in those laws so that buy/sell decisions can be made in an atmosphere of tax neutrality."

I have a very parochial interest in this legislation, as well as a firm belief that the public is best served by ownership and operation rooted in the community served by the newspaper. The Advocate and State Times are now being operated by the third generation of our family. We want the newspapers to remain with our family, and not be required or forced to sell our newspapers because of the anomalies in the estate tax laws which have a pernicious effect upon newspaper ownership.

We could sell our newspapers today in response to one of the very attractive offers we regularly receive. We could certainly make more money investing such sums in treasury notes than we earn operating our newspapers—and with a lot less headaches. This is not our interest or intent. We hope to continue to serve our community by operating the Advocate and State Times. We do not ask this Subcommittee and the Congress for special favors, but only for tax law neutrality, so we can continue the local ownership of these newspapers.

I am not versed in the tax laws. It is my understanding that S. 555 would enable an owner of an independent newspaper to prepay, during his lifetime, his estate taxes, in order to be able to pass his newspaper on to his heirs. That is why I favor this proposal.

Maybe there is a better way to accomplish the purposes of S. 555. If so, I would hope the Congress would expeditiously address this problem and provide a fair and workable solution.

In conclusion, I would like to state my appreciation for the consideration being extended by the Congress to a situation which affects not only one industry, but also the public at large. I would like to believe that any relief offered by legislation which corrects the current unbalance in the estate tax laws would redound to the benefit of the public by allowing for the continued existence of family owned newspapers rooted in their own communities.

Testimony of K. Prescott Low, Chairman, American Newspaper Publishers Association Tax Law Action Group

Mr. Chairman, my name is K. Prescott Low and I am the publisher of The Patriot Ledger, a regional daily newspaper published in Quincy, Massachusetts. I am a member of the Board of Directors of the American Newspaper Publishers Association (ANPA) and have served as chairman of ANPA's Tax Law Task Force.

ANPA is a trade association whose more than 1350 member newspapers comprise more than 90 percent of the daily and Sunday newspaper circulation in the United

States. Many non-daily newspapers also are members. Approximately one-third of ANPA member newspapers are locally-owned independent newspapers.

I also am authorized today to speak on behalf of the National Newspaper Association (NNA), which represents some 500 smaller-city daily newspapers and about 5,000 weekly newspapers throughout the United States—primarily locally-owned newspapers. Our newspaper is also a member of NNA.

The Patriot Ledger is an independent, locally-owned newspaper which I feel fortunate to be able to publish. It has been a family-owned and operated business for more than 100 years and I can assure you that neither I nor my family have any desire to sell.

ANPA and NNA appreciate this opportunity to comment upon S 555, the "Independent Local Newspaper Act" sponsored by Sen. Robert Morgan and others, and to acquaint you with the report of the Tax Law Task Force of the American Newspaper Publishers Association.

At the outset I wish to stress that we share the concern of Sen. Morgan and a number of others in Congress that current federal estate tax laws work to encourage—in some cases force—the sale of independent, locally-owned newspapers.

Mr. Chairman, S 555 in the 96th Congress is identical (with the exception of the recapture provision, effective date and some technical corrections) to that of S 3441 in the 95th Congress.

Last year, Mr. Chairman, I reported to this subcommittee that the ANPA Tax Law Task Force had been formed in December of 1977 by the ANPA Board of Directors and directed "to seek legislative changes encouraging neutrality in federal estate tax laws so that newspaper publishers and other businessmen may make such ownership decisions as they deem appropriate without unnecessary and counterproductive legal strictures." I reported in August of last year that NNA had formed a similar group and that both groups were actively studying the situation—and paying special attention to the Independent Local Newspaper Act.

Mr. Chairman, after a full year of study and nine meetings, the ANPA Task Force completed its work. It has made a detailed report including a series of recommendations. The report and recommendations have been approved by the ANPA Board of Directors and the ANPA Government Affairs Committee as submitted. The report and recommendations have also been endorsed in their entirety by the NNA Board of Directors. The two organizations have announced a joint effort to work for adoption of the recommended legislative changes in the federal estate tax laws.

Mr. Chairman, I wish to submit for the record the entire "Report and Recommendations to the ANPA Government Affairs Committee and Board of Directors from the ANPA Tax Law Task Force," together with a text of a public announcement of the joint effort in this matter by ANPA and NNA. But I also want to summarize for the subcommittee the major findings and recommendations of the Task Force.

The findings:

There is bias in the federal estate tax laws which presents formidable barriers to the continuation of independent ownership.

Legislation is needed to correct this bias.

S 555 would provide substantial benefits to many local, independent newspaper owners.

There are, however, several problems with this legislation—principally that it is "special interest" legislation. In addition, the bill provides relatively narrow coverage in that the owner of small newspapers in adjoining states—perhaps only a few miles apart—would be ineligible; some of the definitions in the bill are vague, and the bill contains very severe penalty provisions in the event of inadvertent overfunding of the allowed trust fund.

There are viable, alternative, legislative approaches which are outlined in our recommendations.

The recommendations:

That ANPA work for tax law changes for *all* closely-held companies in the following areas:

liberalization of accumulated earnings penalty tax;
changes in the valuation approach used by the Internal Revenue Service;
liberalization of the timing of estate tax payments;
liberalization of redemption rules;
amendment of the tax provision on generation-skipping transfers;
examination of the possibility of legislation to allow purchase of a special class of life insurance solely for payment of estate taxes.

That ANPA support those new laws which have improved tax treatment of capital gains.

That ANPA continues its policy of neither endorsing nor opposing the Udall bill.

That ANPA and other newspaper associations develop ongoing programs to acquaint members with estate planning techniques and with the need for proper and timely estate planning.

With the work of the Tax Law Task Force complete, ANPA is forming a new Tax Law Action Group to guide the implementation of the recommendations I have just listed. I will chair the Action Group.

Mr. Chairman, ANPA and NNA agree that burdensome, some would say "punitive," federal estate tax laws are one of the reasons that owners of independent, locally-owned newspapers sell their properties. We commend Sen. Morgan and the other sponsors of S. 555 for seeking to revise the estate tax laws so as to neutralize their impact on decisions to sell or retain independently owned newspapers. We recognize that the legislation, if enacted, would bring considerable relief to those independent newspaper owners who would qualify under the bill.

But we believe that legislation should not provide relief for one class of citizens only—in this case, newspaper owners—when estate taxes press equally hard upon all small, closely-held businesses.

Therefore, Mr. Chairman, ANPA and NNA neither endorse nor oppose S. 555. However, we continue to believe that a better alternative is the enactment of broadbased tax changes affecting all small businesses as recommended by ANPA and NNA. A logical step in this direction is for the staff and members of this subcommittee to devote attention to our carefully developed series of recommendations. Lastly, Mr. Chairman, we believe it is crucial that relief in this area come quickly and we hope you will seriously consider and hopefully support the measures contained in our report.

Thank you. I will be pleased to respond to any questions you may have.

American Newspaper Publishers Association
ANPA

NEWS RELEASE

William Schabacker
Manager/Public Affairs
(703) 620-9600

FOR RELEASE
Friday, March 23, 1979

RESTON, VA. -- The two national newspaper trade associations in the United States have joined forces to seek changes in federal estate tax laws which would benefit owners of all independent, family-owned businesses.

In a joint announcement today, the American Newspaper Publishers Association and the National Newspaper Association said their goal is to revise estate tax laws so that owners of all closely-held businesses can decide whether to sell or to retain their companies in an atmosphere of tax-law neutrality. At present, the associations said, estate tax laws are tilted against ownership retention by family-owned businesses.

Concern about the unfair estate-tax situation prompted both ANPA and NNA to form separate task forces in 1977 to study the tax laws and to develop legislative recommendations.

"We concentrated our study on the reasons newspapers are sold, not on who buys them," said K. Prescott Low, publisher of The Patriot Ledger, Quincy, Mass., and chairman of the ANPA Tax Law Task Force. "We found that there is bias in the federal estate tax laws which presents some formidable barriers to the continuation of independent ownership."

"Our members believe very strongly that because the problem affects all closely-held businesses, the proposed solution should cover that entire group," said William E. Branen, publisher of the Burlington (Wisc.) Standard Press and chairman of the NNA Task Force on Newspaper Ownership.

The ANPA task force and the NNA task force concurred that the estate tax problem is not unique to the newspaper business. Both groups rejected the idea of legislation as a TLTF recommendation

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benefiting only the owners of newspapers.

The specific recommendations approved by the boards of directors of both newspaper associations include:

- eliminating certain penalty taxes on the accumulation of earnings so that a company can prepare in advance to redeem stock to pay death taxes;
- changing the valuation approach used by the Internal Revenue Service so that closely-held companies are valued for estate tax purposes on the basis of their present and historical financial condition rather than on a "comparable sale" basis;
- liberalizing the timing of estate tax payments to allow for deferral and prepayment of the tax;
- reducing the tax on closely-held stock being redeemed for payment of death taxes;
- deferring the new tax on generation-skipping transfers imposed by the Tax Reform Act of 1976;
- exploring the possibility of legislation to permit purchase of a special class of life insurance solely for payment of estate taxes.

"These and other of our recommendations," Low and Branen said, "are consistent with the principles we believe must be met by any tax law change -- namely, that the proposal (1) is based on existing tax principles, (2) would simplify rather than complicate tax law, (3) is flexible, and (4) is neutral."

The two newspaper associations also are continuing their position of neither endorsing nor opposing legislation -- introduced in the House by Rep. Udall (Ariz.) and in the Senate by Sen. Morgan (N.C.) -- which would provide estate tax relief only to independent newspaper owners.

ANPA is a trade association whose more than 1330 members represent more than 91 percent of the daily and Sunday newspaper circulation in the U.S. Several non-daily newspapers also are members. NNA is an association of some 900 smaller-city daily and 5500 weekly newspapers throughout the U.S.

# # #

January 18, 1979

REPORT AND RECOMMENDATIONS TO THE ANPA GOVERNMENT AFFAIRS COMMITTEE AND BOARD OF DIRECTORS FROM THE ANPA TAX LAW TASK FORCE*

The Tax Law Task Force (TLTF) was established in December 1977 by the ANPA Board on the recommendation of the Government Affairs Committee. The Committee and the Board were concerned about increasing evidence that some sales of newspaper companies were forced on owners by the federal estate tax laws and particularly by inequities in those laws and their application.

At its September 1977 meeting, the Government Affairs Committee had expressed its concern that estate tax laws, rather than being neutral, now actually discourage owners of newspapers from passing their properties to their heirs.

The TLTF was created as a subgroup of the Committee. It was instructed by the Board "to seek legislative changes encouraging neutrality in federal estate tax laws so that newspaper publishers and other businessmen may make such ownership decisions as they deem appropriate without unnecessary and counterproductive legal strictures." In all of its deliberations, the task force focused on why an owner decides to sell rather than on who buys. The task force's primary concern was not ownership patterns in the newspaper business but federal tax laws that unfairly affect decisions whether to sell or retain a company.

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*Task force members supporting this report are Chairman K. Prescott Low, Cecil B. Highland, Walter E. Hussman Jr., Donald C. Meyer, Frank E. Russell, Len R. Small and William E. Branen (ex officio). Task Force member John P. Wolfe does not support the report for reasons outlined in his letter to Chairman Low which is Attachment A.

The task force met nine times in 1978, including its organizational meeting Jan. 12 and its latest meeting Dec. 13 at which this report and recommendations was approved. In addition, Chairman Low twice testified before the 95th Congress on the Independent Local Newspaper Act [HR 12394 introduced by Rep. Morris K. Udall (Ariz.) and S 3441, identical legislation introduced in the Senate by Sen. Robert Morgan (N.C.)]. (A copy of Chairman Low's House testimony is Attachment B).

The initial thrust of the task force was to analyze the Udall legislation because it already was before the Congress and supporters were seeking active consideration. At the same time, however, the task force began to study all aspects of the federal estate tax laws and to identify those provisions which serve to induce or compel sales of closely-held companies.

Task force members next developed their individual preferences for measures which, if enacted, would tend to neutralize the tax laws as a factor in these ownership decisions.

From its inception, the TLTF has maintained communications with other organizations and individuals involved in this issue. Guests at task force meetings included an aide to Congressman Udall; the lobbyist and tax counsel for the Independent Local Newspaper Association, which supports HR 12395; Rep. Dan Quayle (Ind.), a newspaper publisher and cosponsor of HR 12395; and executives of Management Planning, Inc. of Princeton, N.J., financial consultants. In addition, Chairman Low met privately with Rep. Udall to inform him of the task force's efforts and also conferred with Treasury Department officials on this subject.

The National Newspaper Association, which established its own similar but broader Task Force on Newspaper Ownership, was represented at TLTF meetings by the ex officio membership of NNA Task Force Chairman William Branen and by NNA general counsel. At its annual convention Nov. 11 NNA members unanimously adopted a public statement noting the "questionable special treatment" accorded newspapers under the Udall bill and stating that "the public interest would be served better by changes in the federal estate tax law...benefiting to the greatest extent possible the interests of similarly situated local businesses." (The full text of the NNA resolution is Attachment C.) It should be noted that the TLTF was represented by invitation at both 1978 meetings of the NNA task force, and that NNA joined ANPA in its congressional testimony on the Independent Local Newspaper Act.

FINDINGS

The ANPA task force's work has resulted in the following findings:

1. The bias of the federal estate tax laws presents some formidable barriers to the continuation of independent ownership. The laws and their inequities are key factors which induce or compel the sale of closely-held companies, including local, independent newspapers.

2. Legislative rather than administrative relief is needed to correct effectively this tax bias.

3. The Udall legislation (HR 12395 in the 95th Congress) would provide substantial benefits to many local, independent newspaper owners.

(A) It would permit voluntary creation of trusts for accumulation of funds to be used to pay taxes at death. This proposal would

(1) allow income tax deductions for company contributions to the trusts;

(2) exclude such contributions from owners' taxable income;

(3) permit tax-free accumulations of income in the trusts; and

(4) exclude such amounts from the owners' estates and from the income of the estates when used to discharge estate tax obligations.

(B) It would permit extension of the time in which estate taxes must be paid to as much as 15 years after death.

4. While the Udall bill addresses an important matter of concern to the newspaper business, there are problems with the legislation.

(A) It is "special interest" legislation offering tax relief only to newspaper owners.

(B) The tax benefits, by providing relief from both income tax and estate tax, may be disproportionately large and serve to emphasize the bill's "special interest" aspect.

(C) Coverage under the bill is somewhat arbitrarily devised -- e.g. an owner of a large, metropolitan newspaper could get tax relief, but an owner of two, small community newspapers would be a "chain" and not eligible for relief (unless it is an intra-state chain).

(D) The bill poses definitional problems -- e.g. what is "local," "independent," "a newspaper"?

(E) The bill limits the flexibility which is necessary in ongoing estate planning because its penalty provisions tend to lock a participant into the plan.

5. There are viable, alternative legislative approaches to providing the needed tax relief which

(A) would benefit all closely-held businesses;

(B) would be reasonably consistent with established tax principles;

(C) would avoid complexity in interpretation;

(D) would allow flexibility in adjusting established estate plans;

(E) would provide greater predictability in the estate planning process; and

(F) would be considered neutral by those not benefitted.

6. As a matter of strategy, the needed changes to the tax laws may better be effected by a series of legislative measures -- each addressing a specific area of the tax law -- than by an omnibus bill incorporating all of the tax code changes the task force supports.

7. Many newspaper owners have failed to plan and prepare properly for the inevitable estate taxes that result upon their death.

RECOMMENDATIONS

Based on these findings and on its study of this subject, the Tax Law Task Force makes the following recommendations:

1. That the ANPA Board pass a resolution endorsing the following tax law revisions as they affect decisions by all closely-held companies whether to sell or retain ownership:

The revisions would:

(A) Liberalize provisions of the accumulated earnings penalty tax so that the company can prepare in advance to redeem stock to pay estate taxes upon the death of an owner. Sec. 531 of the tax code, which usually is applied only to closely-held corporations, requires that any corporation which accumulates more than $150,000 must show that the accumulation is justified by reasonable business needs. If it is determined that the accumulation is unreasonable, and thus taxable, the excess accumulation each year is taxed at the rate of 27½ percent on the first $100,000 and 38½ percent on the excess. (Sec. 537 authorizes accumulations to redeem stock to pay death taxes and funeral expenses, but that is often of little help as the accumulation must have been made in the year in which the shareholder dies or in later years.) The TLTF recommends elimination of the penalty tax on accumulations to pay death taxes (Sec. 303 redemptions) by designating such redemptions as "reasonable business needs" for Sec. 531 purposes.

(B) Change the valuation approach used by the IRS. Currently the IRS can value a company in an estate tax case on its sale or merger value, whether or not such a sale or merger takes place. With newspapers, for example, sometimes selling for up to 50 times earnings, the problem of valuation on a "comparable sale" basis is particularly acute. The TLTF recommends an amendment

to the tax laws to provide that the stock of closely-held companies by valued for estate tax purposes on the basis of their present and historical financial condition ("going concern" basis) without regard to sale prices of comparable properties. This proposal is consistent with the same general principles as the present law concerning family farm valuations. Such an amendment should include a "recapture" provision in the event the company is sold within a designated time after the death.

(C) Liberalize provisions for the timing of estate tax payments by allowing for deferral and prepayment of the tax.

(1) Deferral: Sec. 6166A allows up to 10 years to pay estate taxes attributable to closely-held stock, and Sec. 6166 allows a 15-year installment payment plan. But both provisions are loaded with qualifications which limit their use. To qualify for the 10-year payment the stock must be more than 35 percent of the decedent's gross estate or 50 percent of the taxable estate. The corporation itself is limited to 10 shareholders, or the estate must own at least 20 percent of the voting stock. To qualify for the 15-year plan the stock must exceed 65 percent of the adjusted gross estate, and the estate must own at least 20 percent of the voting stock or the corporation must have no more than 15 stockholders.

The TLTF recommends reducing the percentage of the estate tests, removal of the limits on the number of stockholders and elimination of the voting stock tests. These actions would allow more closely-held companies to pay off their estate tax obligations over a longer period of time in a more business-like fashion.

(2) Prepayment: The TLTF recommends a new provision to the tax code to allow estimated advance payments of estate taxes prior to death, with those advance payments to be invested in a special issue of government securities which yield a fair interest rate. Only the interest on such securities would be exempt from both income and estate taxes under the terms of this recommendation.

(D) Liberalize redemption rules to reduce the tax on closely-held stock being redeemed for payment of death taxes. The goal here is to get a redemption treated as a sale or exchange so that it would be taxable at the lower capital gains rates rather than at the higher rate for ordinary income. Sec. 303 of the tax code, "Distributions in Redemption of Stock to Pay Death Taxes," allows capital gains treatment for such redemptions, but only if the value of the closely-held stock being redeemed is at least 50 percent of the decendent's adjusted gross estate. Also, if the estate owns stock in two or more corporations, these interests can be combined for purposes of the 50 percent test only if at least 75 percent of the value of the stock of each corporation is owned

by the estate. The TLTF believes both of these percentage tests are overly restrictive and recommends lowering both, with special emphasis on reduction of the 75 percent test. This specific recommendation reflects the broader concern of the task force that this and other sections of the tax code lack the consistency and uniformity they once possessed with regard to the qualifying percentage tests. We believe that consistency and uniformity should be returned to these sections for more even application of these provisions. On redemptions other than for death taxes, changes in Sec. 302 (disproportionate redemptions) and Sec. 306 (stock recapitalizations) could be valuable tools to help closely-held companies stay closely-held. The TLTF recommends that the two principal requirements for utilizing Sec. 302 should be reduced and that Sec. 306 redeemed stock passing through an estate should be subject to capital gains tax rather than be taxed as ordinary income. Prior to the Tax Reform Act of 1976, Sec. 306 stock was taxed as capital gains. The 1976 act makes it subject to tax as ordinary income, but that provision has been delayed until Jan. 1, 1980.

(E) Amend tax on generation-skipping transfers to help defer the new tax on such transfers imposed by the Tax Reform Act of 1976. The new tax will not have a significant impact for several years because it does not apply to trusts which were irrevocable on June 11, 1976 or to trusts provided for in a will or revocable trust which was executed prior to that date if the decedent dies before Jan. 1, 1982. However, when it does become applicable, it could have an adverse impact on the ability of a family to retain

a closely-held business. The funds from Sec. 303 redemptions could be used to pay this tax, but such redemptions must take place within a relatively short, specified time after the taxpayer's death. What is needed then is more time after the death to pay the tax, but the provisions for deferral of estate tax under Secs. 6166 and 6166A are not applicable to this new tax. The TLTF recommends that the liberalized versions of Secs. 6166 and 6166A called for in Recommendation C be made applicable to this new tax on generation-skipping transfers.

(F) Insurance: The TLTF recommends that tax counsel examine the possibility of a legislative proposal that would permit purchase of a special class of life insurance solely for payment of estate taxes. Under such an insurance plan only the premium cost would be included in a taxable estate, with the remainder of the proceeds exempted from both income and estate taxes.

2. That ANPA engage outside tax counsel on a consultant basis to help in drafting the recommended legislation.

3. That ANPA take an active role either in support of, or if necessary initiating action on, the following tax proposals which already have become matters of debate between other organizations and the government:

(A) Repeal "carryover basis" provisions enacted in the Tax Reform Act of 1976 and postponed until Jan. 1, 1980 by the

Revenue Act of 1978 and oppose adoption of any proposed alternatives. Prior to the 1976 act an appreciated asset owned at death had as its tax basis the value of the asset at the time of the death. If heirs sold the asset (to pay estate taxes, for example), they would only have to pay a capital gains tax on the amount the asset appreciated since the death. If the now-deferred 1976 provision goes into effect, however, the tax basis for all assets acquired from a decedent who died after Dec. 31, 1976 would be the same as the decedent's tax basis immediately prior to his death. In other words, the heirs would have to pay a capital gains tax on the appreciation of the asset since the time it was acquired by the decedent. This would impose an additional heavy financial burden on heirs. There already is considerable sentiment in Congress to repeal these "carryover basis" provisions, and the TLTF recommends that ANPA support this effort.

(B) Provide lower rates for gift taxes in part because of recognition of the fact that gift taxes essentially represent prepayment of death taxes.

(C) Eliminate double taxation of dividends.

4. That ANPA, as a matter of policy, support those new laws which have improved the tax treatment of capital gains. Recent examples of such tax law changes which are helpful to all closely-held businesses are two measures enacted during the 95th Congress -- the moratorium on the carryover basis provisions and the lowering of capital gains tax rates.

5. That the ANPA staff take whatever steps are necessary and appropriate to explain details of Recommendations 1 and 3 to the ANPA membership.

6. That the ANPA members and staff work actively with members of Congress, their staffs, officials of the Executive Branch and all supporting organizations for enactment of these proposals.

7. That ANPA continue at this time its position of neither opposing nor endorsing the Independent Local Newspaper Act as introduced by Congressman Udall in the 95th Congress.

8. The TLTF strongly recommends the development of programs by ANPA and other newspaper associations to acquaint the memberships with estate planning techniques and with the need for proper and timely estate planning. The TLTF places great emphasis on the importance of such ongoing educational programs. The task force believes that proper planning and education of members can have a positive benefit in retarding tax-motivated dispositions of local, independent newspapers.

FUTURE STATUS OF TLTF

Having completed its charge, TLTF recommends that the task force dissolve, and that the Board at its pleasure reconstitute this or another group to assist in carrying out these recommendations.

Respectfully submitted,

K. Prescott Low, Chairman

Cecil B. Highland
Walter E. Hussman Jr.
Donald C. Meyer

Frank E. Russell
Len R. Small
William E. Branen (ex officio)

Attachment A

THE DISPATCH PRINTING COMPANY
34 SOUTH THIRD STREET · COLUMBUS, OHIO 43216

PUBLISHERS OF
The Columbus Dispatch
AGENTS FOR
Columbus Citizen-Journal

JOHN F. WOLFE
PRESIDENT
461-5000

January 11, 1979

Mr. K. Prescott Low, Chairman
The Patriot Ledger
13 Temple Street
Quincy, Massachusetts 02169

Dear Mr. Low:

After reviewing the "final working draft" of the Tax Law Task Force's report and recommendations, I must request that my name be deleted from those listed as supporting the report and recommendations. I take this step most reluctantly, since I recognize how hard you have worked as chairman of the TLTF, and the good faith effort made by all of its members. However, I cannot in good conscience subscribe to this document.

The report and recommendations do not meet or respond to the problems perceived, that is, how to protect and preserve independent (non-chain) newspaper publications by seeking changes in federal estate tax laws which would allow the present owners to pass their newspapers on to their chosen heirs, rather than force a sale of their newspaper properties.

The recommendations are an amalgam of all of the proposals considered by the TLTF during the past year, without appreciation of the fact that several are mutually inconsistent. Some of the recommendations appear to be designed to benefit closely controlled newspaper groups rather than those owning one newspaper. One proposal seems to be for the benefit of the insurance industry, with only limited utility to owners of newspapers.

As you know, I support the legislation sponsored by Congreeman Udall and Senator Morgan, together with House and Senate co-sponsors. I continue to believe their proposal offers achievable benefits for owners of newspapers, at little or no cost to the Treasury, and could be used as a model for like legislation covering owners of similarly situated businesses.

Finally, I am deeply concerned by draft recommendations 3 and 5,* which would involve the ANPA in the support of legislative proposals which may not be in the best interests of all of its members.

I request that my comments be attached as an addendum to the report and recommendations of the TLTF.

Sincerely,

John F. Wolfe
President and Publisher

*Now Recommendations 2 and 6 in final report.

Attachment B

Statement of K. Prescott Low,
Publisher, The Patriot Ledger, Quincy, Massachusetts, and
Chairman of the Tax Law Task Force of
The American Newspaper Publishers Association

Before

The Subcommittee on Miscellaneous Revenue Measures of
The House Ways and Means Committee

on

HR 12395 et al, The Independent Local Newspaper Act

August 11, 1978

Mr. Chairman:

I am K. Prescott Low, publisher of The Patriot Ledger, a locally-owned, independent daily newspaper published in Quincy, Massachusetts. I also am a member of the Board of Directors of the American Newspaper Publishers Association and chairman of that Association's Tax Law Task Force. It is in this latter position that I appear before you today.

ANPA is a trade association whose more than 1300 member newspapers comprise some 91 percent of the daily and Sunday newspaper circulation in the United States. Many non-daily newspapers also are members.

With me this morning is W. Terry Maguire, general counsel of the National Newspaper Association. NNA is an organization of some 900 smaller-city daily and 5,500 weekly newspapers throughout the United States. NNA and ANPA are working together in analyzing HR 12395.

Mr. Chairman, NNA has authorized me to say that my testimony this morning also represents NNA's general position toward this legislation. With your permission Mr. Maguire will submit a short additional statement for the record.

On behalf of the ANPA and NNA membership, I thank the chairman and members of the subcommittee for this opportunity to testify on HR 12395, the Independent Local Newspaper Act.

As you know, Mr. Chairman, this legislation is aimed at helping to preserve independent ownership of newspapers by addressing one of the reasons why such owners sell their

newspapers to newspaper groups -- that is, the burdensome, some would say punitive, federal tax laws.

ANPA, whose membership includes both independently-owned and group-owned newspapers, does not at this time endorse HR 12395 as the possible final vehicle for best accomplishing this end. Neither do we specifically oppose the bill. We do encourage the Congress to continue its analyses and deliberations. We are in the hope that prompt and proper solutions may be found, including ways to make the estate tax laws neutral on the question of the succession of closely-held ownership.

We very much appreciate the concern of the chief sponsor of this legislation, Mr. Udall. We commend him for following up that concern with specific legislation to remove federal estate taxes as one of the factors which, in many cases, inordinately influence decisions to sell newspapers.

Further, we acknowledge that if this legislation were enacted in its present form, it would bring considerable relief to those independent newspaper owners who would qualify under the bill.

However, ANPA is not yet convinced that the approach set forth in HR 12395 is the sole or best one to pursue -- either for the country in general or the newspaper business in particular.

Before mentioning some of the questions we have about this specific legislation, I think it is important that the subcommittee know ANPA and NNA do not come here today as late starters in this matter.

Indeed, it was many of our member publishers who pointed out to Mr. Udall and others the deleterious role of federal estate taxes on newspaper ownership.

More important, ANPA and NNA decided this situation warranted special attention by the newspaper business.

The ANPA Board of Directors late last year established its Tax Law Task Force and directed it:

> "to seek legislative changes encouraging neutrality in federal estate tax laws so that newspaper publishers and other businessmen may make such ownership decisions as they deem appropriate without unnecessary and counterproductive legal strictures."

This Task Force, which I head, has met six times this year; another meeting is scheduled next month, and more are planned. NNA has a similar group. Our initial efforts were to analyze the Udall legislation -- HR 12395 and its predecessor, HR 9484. Recent meetings have focused on examination of possible alternative approaches to provide tax relief.

In keeping with the subcommittee's request to be brief, I will just list some of the questions our Task Force has expressed after analysis of HR 12395.

First and foremost is the unanswered question of whether legislation should provide relief for one class of citizens only -- newspaper owners -- when estate taxes press equally hard on all small, closely-held businesses. In fact, the

feeling that all affected businesses need relief has been the chief concern expressed by the many publishers who have contacted me concerning this issue.

Other questions about HR 12395 which our Task Force has identified include:

1. The relatively narrow coverage of the bill. Even though coverage has been expanded to include intra-state newspaper groups, HR 12395 still has the situation that the owner of two small newspapers in adjoining states -- perhaps only a few miles apart -- would be ineligible for relief.

2. The vagueness of some of the definitions in the bill.

3. The very severe penalty provisions in the event of inadvertent over-funding of the allowed trust fund.

The alternatives or supplemental actions which our Task Force is exploring include possible changes in the tax-rate schedule, deductions, valuation and timing of tax payments. For example, under the valuation category, a newspaper could be valued on its individual financial performance rather than under the present "comparable sale or merger price" basis. As you know, Mr. Chairman, a somewhat similar approach was appropriately adopted by Congress in 1976 for family farms.

I hope it is clear from this short summary of ANPA's activity in this area that we do not now profess to have any definitive answer to what should be done to best provide the federal estate

tax relief which is needed.

We do want the subcommittee to know that the newspaper business is deeply concerned about the issue and hard at work on it. Our ANPA Task Force has as its goal presentation of a firm recommendation to the ANPA Board of Directors by the end of this year.

The National Newspaper Association's task force will meet again in November at NNA's Convention and will submit recommendations to the NNA Board of Directors soon after that meeting.

Thus, both associations are seeking early adoption of positions on this issue. At this point, I have no idea what the final ANPA recommendation to the Congress will be.

But, Mr. Chairman, the important point is that any legislation dealing directly with the newspaper business should have, if possible, a consensus of support from this country's newspapers. That consensus does not yet exist for HR 12395 as the best or sole solution.

ANPA and NNA will continue their work. I sincerely hope that both associations can come before this subcommittee early next year and present definitive recommendations that reflect broad support from among our member newspapers.

Again, I thank you for this opportunity to inform you of our continuing activity on this important issue.

I will be happy to respond to any questions you may have.

Attachment C

Statement adopted by the National Newspaper Association November 11, 1978
San Diego, California

The National Newspaper Association believes strongly in promoting opportunities for local ownership of newspapers. The Association continues to work toward developing a more precise legislative recommendation on changes in federal estate tax law which would restore freedom and fairness to the marketplace. It is important that a decision to sell a newspaper be made without undue or discriminatory federal tax pressure.

Legislation introduced in the 95th Congress contained provisions which would have granted newspapers questionable special treatment. For many NNA members, this legislation would have been of substantial economic benefit. The public interest, however, would be served better by changes in the federal tax law which would accomplish the goals set out by Rep. Morris Udall (D-AR) and Senator Robert Morgan (D-NC), while at the same time benefiting to the greatest extent possible the interests of similarly situated local businesses.

NNA wishes the Congress to know that the Association will present more specific recommendations in the next few months. These will cover a number of federal estate tax law provisions, including valuation, accumulation of earnings, carry-over basis, deferral of payments, among others.

Santa Monica, California
11-2-79

Senator Russell B. Long
Room 217
Russell Senate Office Bldg.
Washington, D.C.
20510

Dear Mr. Long:

This is my input into your recent hearing on 10-31-79 regarding tax credits for savings accounts.

Let me present an alternative monetary instrument that will assist the small saver AND the nation in increasing and improving its housing stock. The improvement of the housing stock is the evident, as I see it, reason for considering tax credits for savings accounts. As a byproduct, the small saver also earns some tax free money on his savings.

This proposed monetary instrument is an adjunct to the high denomination ($5,000.00) tax exempt mortgage subsidy bonds considered in H.R. 3712. The instrument is a "low denomination ($100.00 to $500,00) tax exempt housing rehabilitation bond". The limit for ownership would be $1,500.00 for a single person and $3,000.00 for a married couple. Even at a 7% tax-free rate, these proposed bonds would give more monetary benefit to a saver than would a $100.00 or $200.00 tax credit on savings accounts. In addition, all proceeds would be used in the housing area.

I have elaborated on the nature of these low denomination bonds in my submitted 11-2-79 letter to Mr. W. Henson Moore. Mr. Moore is the Congressman who proposed the tax credit on savings accounts alternative to H.R. 3712.

Essentially, this new instrument directs rehabilitation and remodeling funds to low and moderate income families and at lower than free market.

interest rates. Thus, these families do not have to directly compete for free market funds.

In the attached correspondence that I recently sent to all U.S. Congressman and others is a discussion on how high denomination ($5,000.00) tax exempt mortgage subsidy bonds can be used to generate and maintain more low and moderate income housing.

My feeling is that the proper usage of tax exempt mortgage subsidy bonds and housing rehabilitation bonds will do more for the small saver AND more for the nation's housing in areas of greatest need than will tax credits on savings accounts.

In conclusion, tax credits on savings accounts should compete next year with other proposals for stimulating savings and investment.

Sincerely Yours,

William R. Teachworth

William R. Teachworth
P. O. Box 3157
Santa Monica, California
90403

CC Congressman Al Ullman
Congressman Barber B. Conable, Jr.
Donald C. Lubick-Assistant Secretary for Tax Policy.

DISTRIBUTION

All members of the U.S. House of Representatives Rules Committee.

All members of the U.S. House Ways and Means Committee.

All members of the Senate Finance Committee-Taxation Subcommittee.

Senator Russell B. Long.

Jay Janis-Chairman, Federal Home Loan Bank Board.

John G. Heimann-U.S. Comptroller of the Currency.

Donald C. Lubick-Assistant Secretary for Tax Policy-Treasury Dept.

Richard J. Woods-Associate Director, Community and Economic Development Division, General Accounting Office.

Santa Monica, California
11-2-79

Congressman W. Henson Moore
Rm 2444
Rayburn House Office Bldg.
Washington, D.C.
20515

Dear Congressman Moore:

My understanding from a Wall Street Journal article (Exh. A) dated Oct. 24, 1979 is that your amendment to H.R. 3712 was instrumental in causing the return of H.R. 3712 to the House Ways and Means Committee.

Your concern for allowing single persons and married couples to avoid as much as $100.00 or $200.00 a year in taxes on interest earnings is admirable. However, may I present a better alternative for your consideration.

This alternative would allow a single person to save up to a total of $1,500.00 tax free and a married couple up to $3,000.00 (total) tax free. The instruments for such savings would be low denomination tax exempt housing rehabilitation bonds. These bonds would have a denomination range of from $100.00 to $500.00. Such bonds are known to exist as seen on page 25 of the attached article (Exh. B) from the premier edition of E.P.O. magazine. The bonds themselves are issued in checkbook form with the interest payments being made by cashing preprinted checks with the bond principal amount being the last check.

These bonds could be issued by authorized mortgage subsidy bond issuers via banks and savings and loan associations. The bonds could be purchased by any resident within the State where the issuer was located. The resident would have to have their principal residence

within the State where the issuer was located. Thus, these low denomination bonds could be made exempt from Federal, State, and perhaps, local taxes. My understanding is that your proposed tax exemptions on interest earnings would be only at the Federal level.

The usage of these bond monies would be limited to the making of Qualified Home Improvement Loans and Qualified Rehabilitation Loans as defined in proposed Section 103A-Mortgage Subsidy Bonds subsections (n)(6) and (n)(7) (Exh. C) of H.R. 3712. The bond monies distribution would be limited to the geographic area under consideration by the authorized bond issuer. The loan rates would be one percent above the bond interest rate. Where more than one issuance of such low denomination bonds was made and the proceeds co-mingled, the loan interest rate would be one percent higher than the weighted average (the remaining amount of each issue and the interest rate on each such issue) as determined on a weekly or monthly basis.

The total monetary amount of these low denomination bonds that could be legally issued per year within a State would be 10% of the limitation on the aggregate amount of qualified mortgage subsidy bonds issued within the State during any calendar year.

Qualified usage of these specific bond monies could include: earthquake reinforcement loans up to $15,000.00 per living unit, flood damage repairs up to $15,000.00 per living unit, upgrading of household plumbing, painting, and remodeling.

The large tax exempt bond sales houses would not be effected to a significant degree since the smallest present bond size handled by them, to my knowledge, is $5,000.00. In addition, the limited qualified usage for such bonds is in areas where $5,000.00 denomination bonds are not heavily issued, as far as I know at present.

The market makers for these bonds could be the issuers or their designated mortgage originators. The interest rate for each bond issuance would be determined by prover comparison with the tax exempt bond market for high denomination ($5,000.00) tax exempt mortgage subsidy bonds. To encourage purchase of these low denomination bonds, the interest rate should be one-half point higher than the high denomination tax exempt mortgage subsidy bond interest rate existent at the time of issuance of the low denomination bonds. For example, if 6% tax exempt mortgage subsidy bonds are selling at a market interest rate of 7% on a certain day, then an issuance of these low denomination bonds is made at a 7½% interest rate at 100% of face value.

In order to maintain a responsible market for the resale and repurchase of these bonds, the price of the bonds would vary from an amount equal to the principal sum minus up to three unused interest checks or the principal sum plus up to three unused interest checks. The length of term for these low denomination bonds should be four years with the privilege of repurchasing the same amount of a new issue at the market rate at the time the first issue was cashed in. Additional confirmation of the benefits of such a usage of low denomination tax exempt bonds is seen in the attached article (Exh.D) from page 44 of the October 29, 1979 issue of the Wall Street Journal. There is a discussion about a new plan offerring a tax deferral on bank savings interest. NOTE that the last paragraph says tax exempt bonds are more attractive than this tax deferral procedure even though tax deferred certificates or annuities have higher yields.

Thus, you have a mechanism where people who have savings in the range ($100.00 to $3,000.00) you are concerned with will have the direct ability to improve the nation's housing stock.

In conclusion, I hope you will reconsider and modify your interest exclusion amendment to make it pertain specifically to aspects of H.R. 3712.

Sincerely Yours,

William R. Teachworth

William R. Teachworth
P. O. Box 3157
Santa Monica, California
90403

EXH. A

36 THE WALL STREET JOURNAL, Wednesday, Oct. 24, 1979

Bill Curtailing Mortgage-Subsidy Bonds Goes Back to Ways and Means Committee

By a WALL STREET JOURNAL Staff Reporter

WASHINGTON—A bill to limit the use of tax-exempt bonds to subsidize home buying is back in the lap of the House Ways and Means Committee.

After two days of haggling, the House Rules Committee sent what Chairman Richard Bolling (D., Mo.) called "this monster" back to the Ways and Means panel for further work. Ways and Means Chairman Al Ullman (D., Ore.) said he didn't know when his committee would resume work on the mortgage-bond bill or what the outcome would be.

The Rules Committee's eight-to-seven decision seems likely to add further confusion to the tax-exempt bond markets, already affected by the April 25 introduction of legislation by Rep. Ullman and other influential Congressmen to end all tax-exempt financing for single-family housing while limiting its use in rental housing to needy families.

States and localities sell the bonds, whose interest isn't subject to federal income tax. Tax exemption permits the sellers to offer investors a lower return on their money and then to relend the proceeds to home buyers for less than they'd pay for conventional mortgages.

The Ways and Means Committee rejected an absolute prohibition, but voted late in July to limit mortgage-subsidy bonds to 5% of the annual mortgage market, while directing the proceeds to home buyers with low or moderate incomes. It also approved a controversial set of rules to permit states and localities to proceed with bond issues under way on April 25.

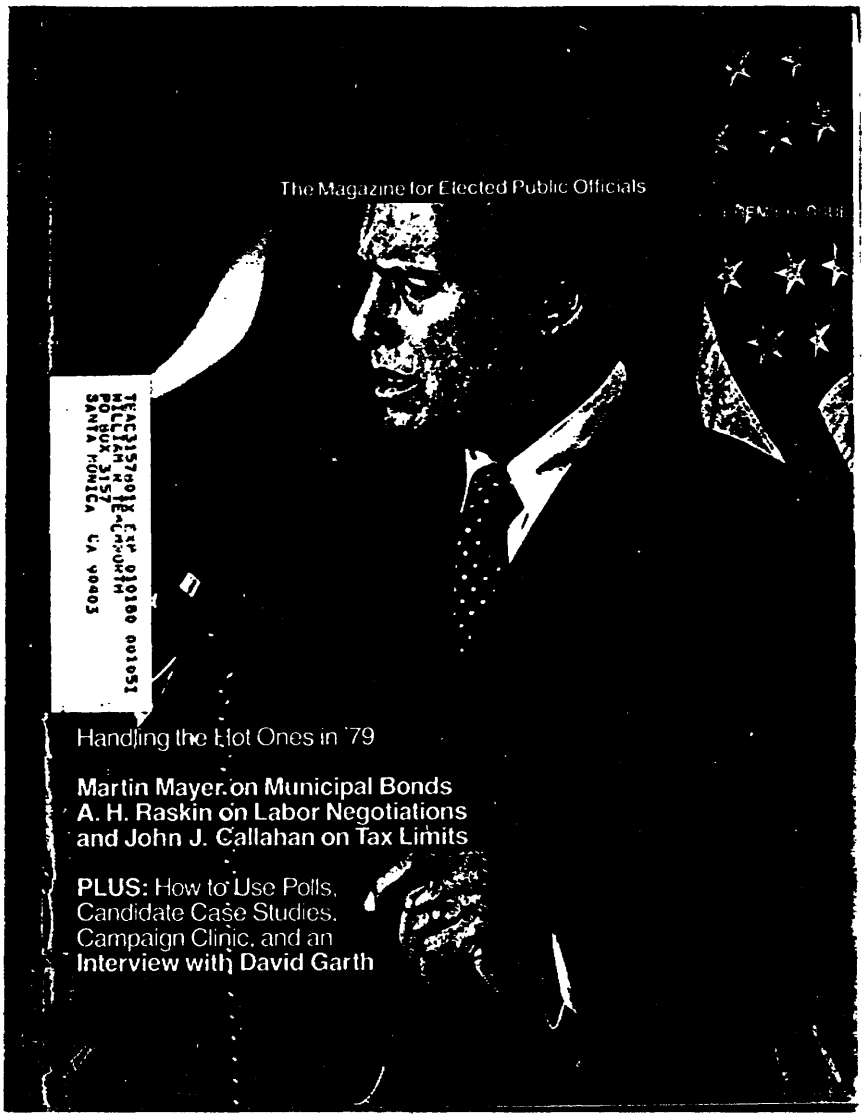
Finally, without endorsement, the Ways and Means Committee agreed to ask the Rules Committee to let the House vote on a substitute offered by Rep. Henson Moore (R., La.). Rep. Moore would allow single people to avoid taxes on as much as $100 a year of interest from savings accounts; couples would be allowed $200 a year.

In the past several weeks, Rules Committee members have been the target of heavy lobbying by the savings and loan industry, which favors an interest exclusion, and by the mortgage bond industry, which prefers the Ways and Means bill.

Yesterday, the Rules Committee took the easy way out. It voted, eight to seven, to give the House a chance to accept both an interest exclusion and limited mortgage-subsidy bonds, rather than having to choose between the two.

But doing both would more than double the Treasury's revenue loss. The Ways and Means Committee's bond bill would cost the Treasury an estimated $892 million a year by 1984, while adding Rep. Moore's interest exclusion would swell the tax loss to $2.3 billion.

What's more, according to both the Treasury and Rep. Ullman, a tax exclusion for savings bond interest should be required to compete next year with other proposals for stimulating savings and investment. So, at Rep. Ullman's request, the Rules Committee then voted to send the matter back to the Ways and Means panel.


The Magazine for Elected Public Officials
Handling the Hot Ones in '79
Martin Mayer on Municipal Bonds
A. H. Raskin on Labor Negotiations
and John J. Callahan on Tax Limits
PLUS: How to Use Polls,
Candidate Case Studies,
Campaign Clinic, and an
Interview with David Garth

Municipal Bonds

Scrambling for High-Priced Dollars

Money will be hard to find and costly, but count on a market for small issues.

By Martin Mayer

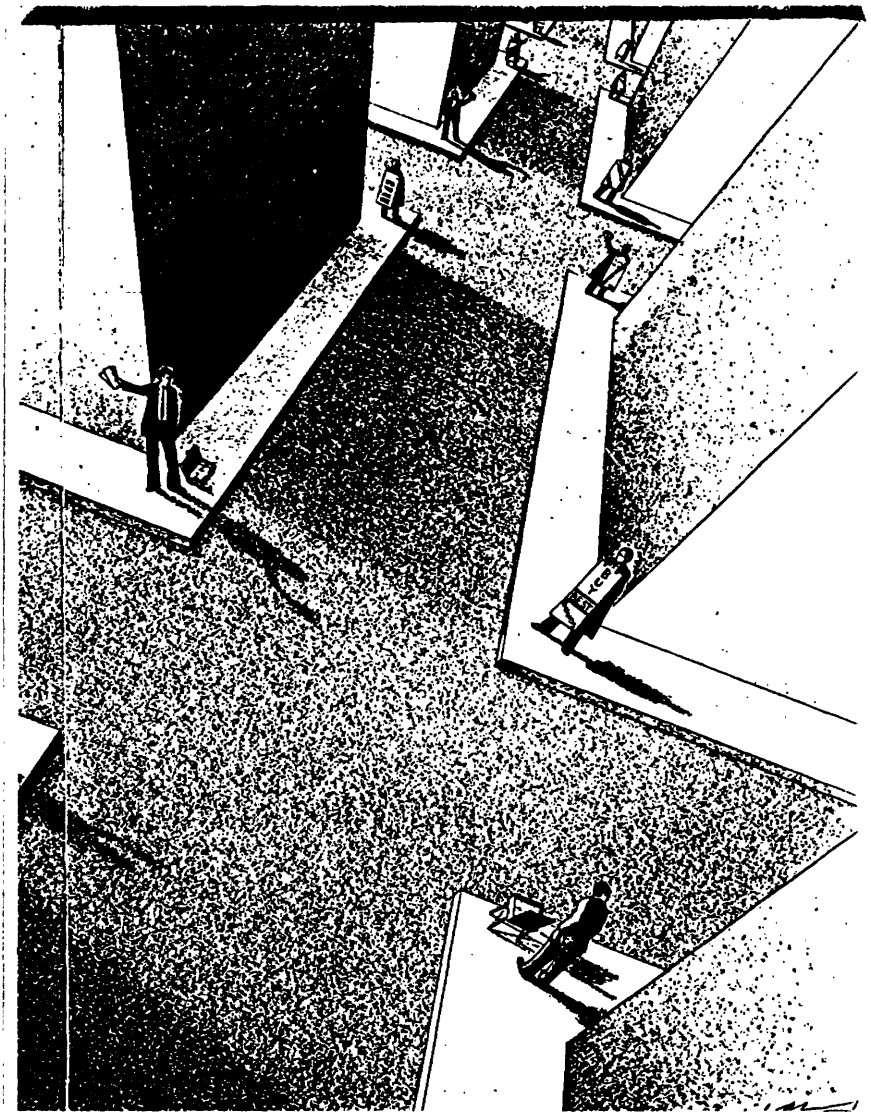
The good news for 1979 is that the Federal government probably won't do anything else to make raising money harder for state and local governments, and there is hope for a new provision in the tax code to draw fresh buyers to tax-exempt bonds. The bad news is that money will be hellishly tight, maybe as hard to find—and as expensive—as it was in the horror days of 1974. Moreover, the popularity of new housing and hospital bonds, as well as the spread of pollution control and industrial development bonds, argue that there may be more competition for that money than market analysts have predicted.

Martin Mayer writes frequently on government, finance and the arts. His books on the professions include The Builders, The Bankers, The Lawyers, The Schools *and* Wall Street: Men and Money.

Who Buys and Why

The central fact about municipal bonds is, of course, the tax-exempt status of the interest they pay. Cities and states and school boards and sewer districts and port authorities and municipal power systems can thus borrow in the market more cheaply than private companies or the Federal government.

Taking the most recent report at hand, *The Daily Bond Buyer*'s index of 20 representative municipals showed an average annual interest rate of 6.17 percent, while Moody's Aa corporate bonds averaged 9.25 percent and United States Government bonds of similar duration averaged about 8.77 percent. At this writing, in short, municipal bond issuers are paying about 67 percent of the interest the market charges a corporation and more than 70 percent of what the Fed-



eral government has to pay for long-term borrowing. But it's still a very good deal from the customer's point of view, because that 6.17 percent is tax-free and the "taxable-equivalent yield" to a corporation or bank runs 11.86 percent, which is a lot better than the bank does on a mortgage. For the individual rich taxpayer in the 70 percent bracket, the 6.17 percent from a municipal bond equals 20.26 percent from a taxable investment, a return nobody can hope to get from anything else that is safe or honest, let alone both.

Unfortunately, none of these numbers is stable, nor anything like stable. J. P. Morgan once observed that the one thing you can say for sure about the stock market is that it fluctuates, and that goes double for the bond market—and maybe double again for the municipals market.

Rates on municipals, like rates on corporate bonds, tend to rise and fall every day. But the two interest rates don't keep in step. In 1978, the ratio between what tax-exempts and corporate issues paid started at about 62 percent and probably hit 70 percent before the year was out; in 1976, by contrast, the ratio started at about 72 percent and was down to 64 percent by the last quarter. Some years this changing ratio means municipal bond interest rates are rising or falling more slowly than corporates; most of the time—including 1978 and probably 1979—it means they're moving faster.

The problem is that the very tax exemption which keeps interest rates down limits likely buyers of the bonds to investors who place a high value on tax exemptions. In practice, this group reduces to commercial banks (which can't invest in stocks or income-producing real estate), fire and casualty insurance companies, and just plain rich folks.

Banks are in business to make loans, not buy paper. When loan demand is heavy (which means interest rates are rising), they cut back buying of municipal bonds, shrinking the market for municipals and making tax-exempt interest rates rise even faster.

Fire and casualty companies run surpluses the year after they are permitted rate increases by the state officials who control them—but the year after *that* they've got no money for bonds, because client claims and jury awards have taken it all away.

That leaves "households," and they're greedy. For the very rich, tax "shelters" (oil wells, real estate, etc.) compete for attention against mere tax "exempts." For the only fairly wealthy, whose tax rates are below the top brackets, income tax savings may not amount to much more than the gap between the yields on municipal bonds and the interest on long-term savings accounts. To make households buy heavily, tax-exempt interest rates must look high to householders who read every morning about spectacular yields at the savings and loan.

Pricing—a Can of Worms

Because tax-exempt bonds and notes are issued by 50 states and their municipalities and districts, there's no such thing as a single "interest rate" on municipal bonds as a group. "General obligation" bonds that are backed by a taxing power usually cost issuers less in interest than "revenue" bonds backed only by the earnings of the toll bridge or industrial park or housing or electric generators they will build. (And *these* ratios change, too: In January, 1978, new revenue bonds carried interest "coupons" averaging 0.1 percent higher than new "G.O.s"; by July, the spread was up to 0.7 percent.) Here, as in the corporate world, the market also makes judgments on the safety of the loan and the quality of the management that seeks it. These judgments are usually encapsulated with complete simplicity into a bond "rating" by Moody's or Standard & Poor's, but even the rating doesn't tell the whole story.

States with less paper outstanding, or those whose constitution or local tradition seems to give greater protection to bondholders, may win lower interest costs for themselves and their districts than states already loaded with debt. In 1977, three states—Maine, Maryland and Utah—had average interest costs of less than 5 percent a year; three—Pennsylvania, Massachusetts and West Virginia—had average interest costs of more than 6 percent a year. (New York State was under 6 percent because New York City couldn't sell paper at all.) It's interesting to note that Maryland, where the Governor was under indictment for fraud (he was later convicted) and the Legislature was a notorious zoo, earned low interest rates; the market looks to long-term appearances of fiscal health, not short-run problems of management.

The last-straw complication is that a municipal bond issue is not, like a corporate issue, a collection of interchangeable certificates that add up to the total being borrowed. A corporate bond has a single maturity date, years off; a municipal bond is usually a "serial," with pieces of the loan maturing every year until the entire amount is paid back. Each maturity year is, in financial theory and in market fact, a different bond, selling at a different interest rate. And the ratios between short-term and long-term rates are unstable, too. Normally, the longer the term, the higher the interest rate. But when the country's in a bad inflation that people feel will be stopped somewhere down the line, interest rates on short maturities may actually be higher than those on long maturities. Pricing municipal bonds to sell at times like ours, in other words, is a can of worms not even a fisherman could love.

No Lack of Bidders

About the only comforting aspect of this odd market from the public official's point of view is that buyers really are scattered and will give their attention to small issues. New York's giant Salomon Brothers, which chews up $100 million of Treasury paper for breakfast and spits it out casually through the telephone in an hour or so, may bid on municipal issues as small as $2 million or $3 mil-

The Treasury has tried for years to dump the idea of tax exemption.

lion. "We don't consider a $5 million municipal to be a small issue," says a Salomoner.

The Public Securities Association (PSA), an organization of securities dealers and banks spun off from the Securities Industry Association in early 1977, gathered members from 55 cities in 30 states during its first nine months of life. Three years ago, a Twentieth Century Fund study by Ronald W. Forbes and John E. Petersen estimated that there were 450 securities dealers and banks around the country prepared to "underwrite" — buy from the issuer and distribute to the public, at their own risk — new issues of municipal bonds.

If you're a reputable municipality or taxing district or public revenue generator (and maybe even if you aren't reputable, as some spectacular recent frauds in California demonstrate), you can get a bid for your bonds. In fact, if your issue is for more than $1 million, PSA figures indicate that you'll get at least three bids from competing underwriters, which holds down the selling costs.

But you're still stuck with the changing rate of interest and the changing ratio between tax-exempt and taxable interest, and small movements in those numbers can mean big differences in the tax revenues you have to raise or the services you can offer. The difference between a 5 percent and a 6 percent average rate on the bonds sold to build a new elementary school, for example, will be roughly as much money each year as the salary of one experienced teacher (or two beginners).

You can't personally do more about market rates of interest than you can about the weather. Delaying a project because interest rates are high means paying so much more for the construction that any savings on financing are gobbled up. Still, it's worth understanding what makes those rates move, so you can lobby to some purpose with the Feds, plan your projects on a fail-safe basis to avoid embarrassments when all the figures are in — and keep on reasonable terms with the voters who will have to pay the bills.

Subsidies as Substitutes

The Federal government controls what happens in the municipals market in three quite different ways. First, subject to some instruction by Congress, the Treasury decides what is and what isn't a tax-exempt security.

For a long time, the Treasury has been trying to dump the idea of tax exemption altogether and substitute a taxable bond with a direct subsidy from the Federal government to the issuer to make up for higher interest rates. The Treasury argument, unquestionably true, is that the Feds lose in unpaid taxes from the rich much more than states and taxing districts gain from reduced interest costs. But nobody can imagine Congress writing a blank check that gives states and municipalities a bonus of so many cents for each dollar of municipal bonds they sell, and everybody has nightmares about the rules that might be written to tell states and cities and local authorities what they can and can't sell — and about the bureaucracy that would be necessary to enforce those rules. In any event, 1978 may go down as the year when the Treasury decided that this idea won't fly.

Whether or not one sympathizes with the Treasury's main complaint, it's hard to disagree with some of the department's sub-crusades, especially those designed to suppress the various schemes by which states and municipal authorities have ripped off the spread between the interest rates on taxable and tax-exempt paper. The basic game was to issue tax-exempt paper long before the proceeds were really needed and invest the money in Treasury bills or other safe higher-interest securities. The New York State Housing Finance Agency made millions that way every year in the late 1960s and early 1970s — which is one reason the Treasury was not very sympathetic to New York when it started down the tubes.

In 1969, Congress tried to close the loophole which permitted this sort of no-risk arbitrage, but the bond lawyers found a way around it. Early in 1978, appalled by the billions of dollars of "advance refunding bonds" cities were issuing to take advantage of the interest spread, the IRS slammed a door on the loophole — but the bond lawyers kicked it open again. Last summer, the IRS lawyers finally handcrafted what looks like a tight seal on the loophole, denying tax-exempt status to just about all the bonds that might be issued for reinvestment purposes. This produced a burst of almost $5 billion of new tax-exempt paper issued in August before the new rules took effect. Take effect they did, and never again will we repeat the experience of 1977, when states and municipalities took in $7 billion more from the sale of new bonds than they spent on the construction the bonds were supposed to finance — and earned themselves profits totalling $150 million.

Incidentally, one of the Treasury's earliest and most sensible rules to prevent the abuse of tax-exempt paper has turned into an example of governmental overkill. The law now forbids tax deductions for interest payments on money borrowed for the purpose of holding tax-exempt securities. Without such a rule, high bracket taxpayers could boost their return on municipals by a free ride at government expense.* An unintended side effect of the rule is that dealers and underwriters in the municipal bond field

*Example: Mr. Moneybags is in a 70 percent tax bracket at a time when municipals sell to yield 60 percent and the interest rate on personal loans to the Moneybags family is 10 percent. He buys $1 million in bonds, yielding him $60,000 a year, meanwhile borrowing $600,000 at a cost of $60,000 a year. His receipts and expenses wash out, leaving him a $400,000 investment with no return. But the $60,000 interest he pays is a tax-deductible expense, and at 70 percent that means he saves $42,000 in taxes on his other income. In effect, the Federal government gives him a $42,000 tax-free return on a $400,000 investment — 10.5 percent — at a time when the interest rate on the bonds is 6 percent.

56-074 O - 80 - 34

can't write off as a business expense the cost of the money they borrow to carry inventories—though dealers and underwriters in corporate bonds do just that, routinely. And that pushes up the price municipalities have to pay to sell their paper. Among the most productive lobbying opportunities for elected officials in the next couple of years would be an amendment to the tax laws allowing bona fide dealers in municipals to deduct borrowing costs incurred for the purpose of holding inventories of tax-exempt bonds and notes. As the dealers point out, they have no clout with Congress, but the municipalities are masters of the lobby.

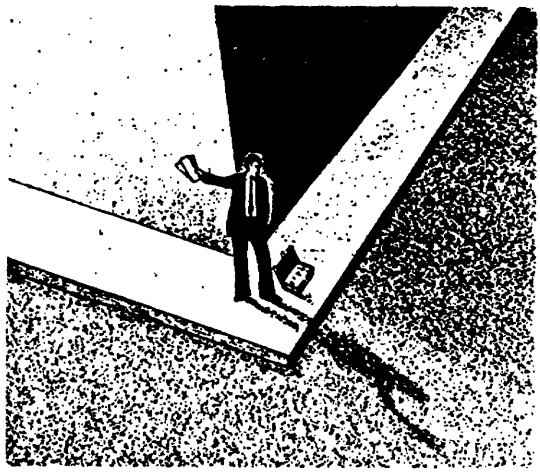
Increasing the Flow

Washington influences the municipal market when it promotes new categories of bonds, stimulating a greater supply of tax-exempt instruments, thus reducing the price (and increasing the interest rate) on all such paper.

The most obvious example of this costly inflation is the pollution-control bond, by which, in effect, Washington has allowed big industries to issue tax-exempt paper behind a municipal shield. The bonds to build pollution-control facilities are issued by the city but guaranteed by the company that will use the facilities.

Housing bonds and hospital bonds are two other major categories of Federally-suggested paper. Both were promoted by government programs that appear to guarantee the revenue streams to support the borrowing. In the 1960s, when the state universities were still growing lickety-split, there was also a fair amount of federally-encouraged state debt issued to build higher education facilities. Oddly enough, though the universities are supposed to be bracing for an enrollment decline, the quantity of such paper has been rising again in the last few years.

In fairness, the Federal government has little to do with the two fastest-growing categories of new state and municipal bonds. One is the electricity-and-gas bond, reflection of a public displeasure over rising energy costs strong enough to revive the long-dormant political drive for public ownership of public utilities. The other category—the most rapid growth market of all—is the "industrial development bond," which a city uses to build a factory to be leased by a private corporation. This form of competitive bidding for factories and jobs is one of the worst aspects of the current war between the regions, and both Congress and the Treasury would like to see an end to it; but nobody has yet figured out a law that would keep communities in the South and Southwest from issuing such paper while still allowing older cities of the Northeast what are considered necessary bootstrap promotion schemes.



Recently, a new kind of housing paper has been coming on the market in large quantities: the bond issue that supports single-family mortgages. Pioneered by the State of Virginia and the city of Chicago, this paper essentially passes on the reduced interest of a tax-exempt bond to moderate-income families who would be hard-pressed to meet the mortgage payments on a conventional high-interest loan. By reducing the interest on a $35,000 self-amortizing 30-year mortgage from 10 percent to 7.5 percent, this state assistance to homeowners reduces the monthly payment from $307 to $245, making ownership feasible for millions who would otherwise find it all but impossible.

Most new categories of tax-exempt paper are created for good and compelling reasons. But the fact is that every new burst of bonds onto the market raises the interest cost for *all* state and municipal borrowing. If the total annual issuance of new state and municipal paper hadn't jumped from less than $12 billion in 1960 to more than $50 billion in 1978, we wouldn't have the very high interest rates borrowers are paying today.

Tax Law and Tax Exempts

Finally, the Federal government makes itself felt in the municipal market through changes and interpretations of

East Brunswick's low denomination bonds, $500 and less, sold out in an hour.

the tax laws that largely determine the demand for tax-exempt paper.

Sometimes the effects are indirect and unintended. The worst blow the municipal bond markets have suffered was the invention and extension of the investment tax credit for industrial investment. Banks can receive such credits by purchasing computers or airplanes or machine tools themselves and leasing the equipment to users. The revenue from such leases is better than the receipts from coupons on municipal bonds—and the tax credit awarded the bank for making the investment is better than the tax exemption on municipals. As a result, the commercial bank market for municipals has been shrinking—and the banks used to be by far the largest customers for this paper.

Mutual Funds

On the other hand, changes in the IRS rules regarding mutual funds brought in a gaggle of new buyers in 1975-77, bringing down and (for a while) holding down interest rates that had soared to new records in the money crunch of 1974. Allowing mutual funds to "pass through" the tax-exempt features of their income, IRS not only made the market accessible to the small investor (who might not have on hand the $5,000 or $10,000 usually required for the smallest municipal bond) but also to investors who had previously resisted municipal paper because of its limited liquidity. Going the mutual fund route, investors in tax exempts can be sure that any time they want out they can cash in at the market price of the fund's total holdings on that day.

In September the Senate Finance Committee passed an original and unexpected stimulus for the municipals market. This Danforth Amendment would allow taxpayers in lower brackets to take a tax credit instead of a tax deduction, making tax-exempt investments as profitable for them as for the fat cats. In floor debate, the Senate abandoned the new idea—but the Treasury after some consideration went on record as supporting it. Senator Danforth will be back; he could use some help.

In 1978, one device that had been hailed as a help to the small taxing district slowed down to a walk—but another revved up and got started.

The disappointment was the state bond bank, touted a few years ago as a way for states to give their municipalities access to a national market by lumping together into one statewide issue a number of local loans. The theory has turned out to be defective. The strength of the municipal bond market is in the communities where local bankers and businessmen know the story of their own town or school district or sewer authority, and can buy most of the issue themselves. By making their local issue part of a package to be sold in the national market, public officials sometimes found themselves with a higher rather than a lower interest rate—especially in a time of inflation, when underwriters protect themselves against losses from rising interest rates (which mean falling bond prices) by making lower bids.

The promise was an entirely new kind of municipal bond, pioneered by L. Mason Neely, township finance director for East Brunswick, New Jersey. Neely first put his proposal in for approval at the Federal Reserve Board in May 1975 but received no answer until last summer ("It disappeared into committee"). Neely issues his town's bonds not as a certificate with coupons but as a checkbook. Every six months, the bondholder collects his interest simply by depositing in his bank account the preprinted check with that date. When the bond matures, he deposits the large check at the back of the book that closes out the bond.

Neely's new system is a great convenience for the bank, which now must maintain a separate processing system for coupons but could handle the bond checks as it handles any other checks. The system decreases the danger of stolen bonds, because each book of checks is encoded with a number the owner can report, blocking payment. Most important, it eases the job of marketing bonds in small denominations to people who might find it a nuisance to clip coupons and to banks that might otherwise refuse to process coupons for very small amounts of money.

East Brunswick's first issue, out in September, was for $529,000, with $400,000 offered in $500 denominations, the rest in even smaller units. The bonds sold out over the counter in one hour, and Neely reports that he has $200,000 in unfilled mail orders on his desk. He thinks his interest cost was lower than it would have been on a conventional issue—and he knows he saved $10,000 that would otherwise have gone to an underwriter.

Perils Ahead

The perils on this horizon, as on so many others, are the tax revolt and inflation. Most experts do not expect a reduction in municipal borrowing to result from the Jarvis-Gann threat to future tax revenues. What they do expect is that the tendency to raise money through revenue bonds rather than general obligation bonds will now become overwhelming—and it was already strong. (Revenue bonds raised only 33.7 percent of the dollars in the municipals market in 1970, but they accounted for 61.5 percent in 1977.) The worry nobody wants to talk about is that municipalities deprived of anticipated tax revenues will go the New York route, borrowing to sustain programs without any clear idea of how they are to pay back what they borrow.

Overall looms the specter of accelerating inflation. Wall Street used to have a motto that "a rising tide floats all boats"—but a rising price level drowns everybody. Tax-exempt or not, a 6 percent return doesn't look good if the cost of living is rising at a rate of 8 percent a year. What public officials, and everybody else, need most from their government in 1979 is economic policy making that will give people a reason to invest in the future of their communities. ☒

I

Union Calendar No. 235

96TH CONGRESS
1ST SESSION

H. R. 3712

[Report No. 96-414]

To amend section 103 of the Internal Revenue Code of 1954 to provide that the interest on mortgage subsidy bonds will not be exempt from Federal income tax.

IN THE HOUSE OF REPRESENTATIVES

APRIL 25, 1979

Mr. ULLMAN (for himself, Mr. REUSS, Mr. ASHLEY, Mr. CONABLE, and Mr. STANTON) introduced the following bill; which was referred to the Committee on Ways and Means

AUGUST 31, 1979

Reported with an amendment, committed to the Committee of the Whole House on the State of the Union, and ordered to be printed

[Strike out all after the enacting clause and insert the part printed in italic]

A BILL

To amend section 103 of the Internal Revenue Code of 1954 to provide that the interest on mortgage subsidy bonds will not be exempt from Federal income tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

"(A) IN GENERAL.—The term 'acquisition cost' means the cost of acquiring the residence as a completed residential unit.

"(B) EXCEPTIONS.—The term 'acquisition cost' does not include—

"(i) usual and reasonable settlement or financing costs,

"(ii) the value of services performed by the mortgagor or members of his family in completing the residence, and

"(iii) the cost of land which has been owned by the mortgagor for at least 2 years before the date on which construction of the residence begins.

"(C) SPECIAL RULE FOR QUALIFIED REHABILITATION LOANS.—In the case of a qualified rehabilitation loan, for purposes of subsection (f), the term 'acquisition cost' includes the cost of the rehabilitation.

"(6) QUALIFIED HOME IMPROVEMENT LOAN.—The term 'qualified home improvement loan' means the financing (in an amount which does not exceed $15,000)—

"(A) of alterations, repairs, and improvements on or in connection with an existing residence by the owner thereof, but

"(B) only of such items as substantially protect or improve the basic livability of the property.

"(7) QUALIFIED REHABILITATION LOAN.—

"(A) IN GENERAL.—The term 'qualified rehabilitation loan' means any owner-financing provided in connection with—

"(i) a qualified rehabilitation, or

"(ii) the acquisition of a residence with respect to which there has been a qualified rehabilitation,

but only if the mortgagor to whom such financing is provided is the first resident of the residence after the completion of the rehabilitation.

"(B) QUALIFIED REHABILITATION.—For purposes of subparagraph (A), the term 'qualified rehabilitation' means any rehabilitation of a building if—

"(i) there is a period of at least 20 years between the date on which the building was first used and the date on which the physical work on such rehabilitation begins,

 EXH. D

Your Money Matters

Being Both a Borrower and a Lender Can Pay; New Plan Offers Tax Deferral on Bank Savings

By Donald Moffitt
Staff Reporter of The Wall Street Journal

NEW YORK—Two years ago, a young New York City doctor bought a cooperative apartment for cash. Then he and his wife decided it was "stupid" not to take out a loan on the apartment. Last week, they got a large, 10.5% loan from a savings bank and promptly invested the proceeds in U.S. Treasury bills yielding more than 13% a year.

The chance to do to your bank and other institutional lenders what they have customarily done to you—that is, borrowed your money at low rates and reinvested it at higher rates—doesn't come along very often. But at times last week, with some government-agency securities yielding upwards of 14%, even the 12% rate that banks typically charge for credit-card cash loans looked like a real bargain. There was only one reason why a savvy borrower couldn't make himself a rich man in a few months by borrowing and investing at no risk. The reason is simply that no law-abiding banker will lend you enough money at 12% to make a fortune on a two-point interest-rate difference.

Aside from the cost of bank borrowing, a number of obscure obstacles face the unwary borrower who takes out a loan to finance securities purchases. You and your bank violate Regulation U of the Federal Reserve Board if you take out an unsecured personal loan, such as a credit-card loan, to purchase securities. As a practical matter, a New York banker observes, bank's can't police the use of such credit—except by limiting the amount of credit you can get on an unsecured basis.

Tax Troubles

Regulation U doesn't apply to securities issued by the U.S. government and by state and local governments. But there's another pitfall in using credit to buy these securities—the tax law.

Interest on loans to buy securities exempt from federal taxes isn't tax-deductible on your federal return. Such securities include tax-exempt bonds issued by state and local governments.

In some states, also, interest on loans taken out to buy securities exempt from state and local taxes isn't tax-deductible on your state and local return. Since the interest on U.S. government securities is exempt from state and local taxation, you may lose your state and local interest deduction if you borrow money to buy government bonds or bills.

In general, too, you stand to lose the interest deduction if you take out a loan on your home specifically to buy tax-exempt securities. However, if you already hold tax-exempt securities, and take out a loan, the law doesn't consider that your money is being used to finance the tax-exempts; you keep your interest deduction.

Buying & Borrowing

Here are some recent figures on financial trends affecting consumers and individual investors.

—DOW JONES INDUSTRIALS—
Closing: 889.30. Year earlier: 811.88.

—MOODY'S CORPORATE YIELDS—
Average for Aa-rated bonds:
Oct. 25: 11.09%. Year earlier: 9.19%

—FEDERAL HOME LOAN BANK—
Average effective conventional mortgage rate on new homes.
September: 11.65%. Year earlier: 9.73%
Average price on new homes:
September: $75,500. Year earlier: $64,600.

Possibly the most attractive way to borrow money to take advantage of interest yields is to take out a loan on the cash value of your insurance policy. Since the cost of borrowing on older polices runs as low as 5%, a borrower of $10,000 could clear, before taxes, about $800 a year by investing his loan proceeds in government securities at 13%. If you die, your heirs receive less insurance proceeds. But they also will receive the government securities that you bought with your insurance loan.

Savings Interest and Taxes

If the nation's bankers get their way, you will soon be able to defer the interest you get on longer-term savings certificates.

Already, a number of Midwestern state-chartered banks and savings institutions are offering tax-deferred savings certificates. For smaller savers, the 7.75% interest rate on longer-term certificates may seem a lot more attractive with a tax deferral.

Lake City Bank, in Madison, Wis., was one of the first institutions to offer the certificate.

The bank credits the idea to Robert Barrow, president of International General Insurance Corp., Milwaukee. A few years ago, Mr. Barrow, then a student at the Harvard graduate school of business, wrote a thesis on the feasibility of treating money put in bank savings certificates as a tax-deferred annunity, interest on which isn't taxable until withdrawn. The problem, he found, was that federal law permits only insurance companies, and not banks, to offer tax-deferred annuities.

An annuity is merely a contract between a buyer and an insurance company. Under the contract, the insurance company agrees to pay specified interest on the amount of the premium that the annuity buyer pays.

In the Lake City Bank plan, the bank has purchased a group annuity contract, from International General, with money deposited in its long-term savings certificates. Certificates in two sizes are offered: A $1,000 certificate with a net annual yield of 7.17% and a $10,000 certificate with a net yield of 8%.

Savers are permitted to withdraw as much as 6% of the principal amount of their premium each year without penalty. Otherwise, withdrawals are subject to charges that start at 7% in the first year and fall by one percentage point a year to the eighth year; then withdrawals of principal can be made without penalty.

The certificates, like other deposits, are insured for up to $40,000 by the Federal Deposit Insurance Corporation.

Nearly $1 million has gone into Lake City's certificates this year. After the Lake City plan started, says Robert Weber, president of the bank, the bank got inquiries about the plan from dozens of other financial institutions. Although some other Midwestern institutions also are offering the tax-deferred certificates, the U.S. Comptroller of the Currency hasn't yet permitted national banks to offer them. However, national banks have asked the comptroller to approve the arrangement so that they, too, can begin offering them.

It should be noted that these 7% and 8% yields are less than the 9% or so yields on tax-deferred annuities offered by brokers or directly by insurance companies. However, Lake City's yields are guaranteed for a longer period of time—eight years—and its certificates are federally insured.

It should also be noted that tax-exempt bonds, currently yielding around 8%, offer a greater tax-free return than the certificates on which taxes are merely deferred until withdrawal of accumulated interest. Still, for savers who would put their money in savings certificates anyway, the tax-deferral feature remains attractive.

★ Los Angeles Times 3
Fri., August 10, 1979—Part I

Van Poolers Will Have to Buy Own Gas

L.A. Council OKs Program to Help in House Buying

BY JEAN MERL
Times Staff Writer

An ambitious program to ease Los Angeles' shortage of affordable housing got under way Thursday when the City Council took the first step toward creating a Municipal Finance Agency.

The program calls for the city to team up with developers and issue tax-exempt bonds to help finance construction of apartments and houses for low and moderate-income families.

Revenue from the bonds could be combined with federal housing grants to help offset high land prices and entice developers to build affordable homes, said Kathleen M. Connell, the city's housing director.

She told the council the funds generated through the proposed finance agency could be used for two ownership programs as well as for subsidizing rental units.

One program would be aimed at helping a family buy its first home. The other would enable tenants about to lose their rental units to condominium conversions to remain in the apartments by buying them.

These and other programs would be overseen by the finance agency, a partially private group made up of the city officials and housing and finance industry representatives.

The agency members would be appointed by the mayor and confirmed by the City Council but would act independently, working with the Community Development Department.

The council Wednesday took several steps to set up the agency machinery, including authorization of a committee to recruit experts in the fields of financing, bonds and housing.

Also approved was the formation of a task force to draw up guidelines for the agency. Its report is due Oct. 9.

Councilman Marvin Braude, impatient to begin the program, first suggested about 2½ years ago, likened Wednesday's first step to merely "creating a box of tools."

"This is a box of monkey wrenches and pliers and drills. To try to decide in advance exactly how you're going to use them is inappropriate," he said.

"Don't delay . . . Let's move ahead

HOME BUYING

Continued from Third Page

to maximize our power and authority to do something about housing and to involve the private sector as quickly as possible."

But Councilman Robert Farrell, who represents part of the poverty-stricken inner city, said he fears the agency will not help people with really low incomes.

Although he labeled the plan, "a good device to give the private sector cheap money to do what they want," Farrell joined the rest of the council in its 11-0 vote.

★ Los Angeles Times 27
Fri., August 10, 1979—Part I

The program also calls for city lobbyists to work for state and federal legislation to permit them to issue the bonds.

A preliminary study of the program recommends issuing some $300 million in bonds

The housing ownership programs would have low down-payment requirements, probably from 5% to 10%, and low mortgage rates. Deed restrictions would prevent owners from selling their units at high profits.

City of Santa Monica

SIXTEEN EIGHTY FIVE MAIN STREET

SANTA MONICA, CALIFORNIA 90401

Donna O'Brien Swink
Mayor

March 14, 1979

Mr. William R. Teachworth
Santa Monica, California

Dear Mr. Teachworth:

It is a pleasure for me to take this opportunity to officially recognize and commend you for your generous contribution of the first funds to be used for the establishment of the Santa Monica Bay Foundation.

The Foundation will provide a means whereby the concerned citizens of our community can provide supplementary support to the tax revenues of our city which will enable us to continue the high level of various necessary services to our citizens. Without the Foundation, the citizens are threatened with the loss of vital community services as a result of the implementation of Proposition 13.

Thank you very much for your generous support and concern for the well-being of our community and its citizens.

Sincerely,

Donna O'Brien Swink

DONNA O'BRIEN SWINK
MAYOR

This advertisement is neither an offer to sell nor a solicitation of an offer to buy any of these securities. The offering is made only by the Offering Circular.

August 17, 1979

20 THE WALL STREET JOURNAL, Friday, Aug. 17, 1979

$30,000,000

Monterey Savings
and Loan Association

9.65% Mortgage-Backed Bonds, Series A, Due June 30, 1989

Price 100%
plus accrued interest, if any, from date of issue

Copies of the Offering Circular may be obtained in any State in which this announcement is circulated from only such of the underwriters, including the undersigned, as may lawfully offer these securities in such State

	WARBURG PARIBAS BECKER A. G. Becker	
BACHE HALSEY STUART SHIELDS Incorporated	THE FIRST BOSTON CORPORATION	BEAR, STEARNS & CO.
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DREXEL BURNHAM LAMBERT Incorporated	GOLDMAN, SACHS & CO.	E. F. HUTTON & COMPANY INC.
KIDDER, PEABODY & CO. Incorporated	LAZARD FRÈRES & CO.	LEHMAN BROTHERS KUHN LOEB Incorporated
LOEB RHOADES, HORNBLOWER & CO.	MERRILL LYNCH WHITE WELD CAPITAL MARKETS GROUP Merrill Lynch, Pierce Fenner & Smith Incorporated	
PAINE, WEBBER, JACKSON & CURTIS Incorporated		L. F. ROTHSCHILD, UNTERBERG, TOWBIN
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BIRR, WILSON & CO., INC.	BOETTCHER & COMPANY	CROWELL, WEEDON & CO.
FOSTER & MARSHALL INC.	HAMBRECHT & QUIST	MONTGOMERY SECURITIES
ROBERTSON, COLMAN, STEPHENS & WOODMAN		SHUMAN, AGNEW & CO., INC.
STONE & YOUNGBERG		SUTRO & CO. Incorporated

This announcement is neither an offer to sell nor a solicitation of an offer to buy these securities. The offer is made only by the Offering Circular.

New Issue / August 17, 1979

$50,000,000

Washington Mutual Savings Bank

9.70% Mortgage-Backed Bonds, Series B, Due July 31, 1989

Interest Payable January 31 and July 31

Price 100% and accrued interest from July 31, 1979

These securities are redeemable prior to maturity in the manner set forth in the Offering Circular. Copies of the Offering Circular may be obtained in any State in which this announcement is circulated only from such of the undersigned as may legally offer these securities in such State.

	Salomon Brothers	
The First Boston Corporation		Goldman, Sachs & Co.
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Donaldson, Lufkin & Jenrette Securities Corporation	Drexel Burnham Lambert Incorporated	E. F. Hutton & Company Inc.
Kidder, Peabody & Co. Incorporated	Lazard Frères & Co.	Lehman Brothers Kuhn Loeb Incorporated
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Crowell, Weedon & Co.	Foster & Marshall Inc.	Hambrecht & Quist
Montgomery Securities	Robertson, Colman, Stephens & Woodman	Stone & Youngberg
Sutro & Co.	Black & Company, Inc.	Campbell, Waterman Inc.	Davis, Skaggs & Co., Inc. Incorporated
Gallagher & Jensen, Inc.	Wm. P. Harper & Son & Company (A Division of Harper, Watson & Company)	Martin Nelson & Co., Inc.

Santa Monica, California
11-2-79

Mr. John G. Heimann
U.S. Comptroller of the Currency
490 L' Enfant Plaza East S.W.
Washington, D.C.
20219

Dear Mr. Heimann:

On page 44 of the October 29, 1979 issue of the Wall Street Journal (attached), there is mention of national banks asking you for approval to issue tax-deferred savings certificates.

May I present a competitive monetary instrument that acts like a tax-deferred savings certificate but is better for bank customers AND improves the nation's housing at the same time.

This proposed instrument is called a "low denomination ($100.00 to $500.00) tax-exempt housing rehabilitation bond" and is described in my attached 11-2-79 letter to Congressman W. Henson Moore. As the article on page 44 states "It should also be noted that tax-exempt bonds currently yielding around 8% offer a greater tax-free return than the certificates on which taxes are merely deferred until withdrawal of accumulated interest".

I have also submitted a full copy of the correspondence I recently sent all the U.S. House of Representative members and others. That correspondence explains how high denomination ($5,000.00) tax exempt mortgage subsidy bonds can be effectively used to generate and maintain single family, owner-occupied detached and attached housing for low and moderate income families WITHOUT government subsidy since the subsidy element exists within the original bond issue.

My feeling, at present, is that the proposed money instrument

known as a "low-denomination tax-exempt housing rehabilitation bond" is better for the public than either the tax deferred savings certificate or the general tax credit of $100.00 or $200.00 on savings account interest. The latter has been proposed by Mr. Moore. Personally, I feel this proposal by Mr. Moore should compete next year with other proposals to stimulate savings and investments.

In conclusion, I feel that tax exempt mortgage subsidy bonds of low and high denomination AND low denomination housing rehabilitation bonds will do more for the saver and the nation's housing supply.

Sincerely Yours,

William R. Teachworth

William R. Teachworth
P. O. Box 3157
Santa Monica, California
90403

CC Congressman Al Ullman
Congressmen Barber B. Conable, Jr.
Donald C. Lubick-Assistant Secretary for Tax Policy.
Senator Russell B. Long

Santa Monica, California
11-2-79

Mr. Jay Janis, Chairman
Federal Home Loan Bank Board
1700 "G" St. S.W.
Washington, D.C.
20552

Dear Mr. Janis:

In the October 30, 1979 issue of the Wall Street Journal on page 6 (copy attached), you mention that the traditional long-term fixed interest mortgage is probably on the way out.

May I present a concept where fixed interest rate mortgages can still exist but only for low and moderate income family housing created by the issuance of tax exempt mortgage subsidy bonds as described in H.R. 3712.

The principles of operation for my proposal are (1) the concept of a controlled sales price, and (2) the multiple usage of the same building over time.

The bond issue used to build or purchase single family housing for low and moderate income families would contain, within itself, the ability to subsidize the difference between the actual cost of building or purchasing and the mortgage assumed by the low or moderate income family purchasing the single family, owner-occupied attached or detached home.

In addition, my concept involves the ability to increase the mortgage amounts at the time of resale of the home to another buyer. This increase in the mortgage amount provides the funds needed to retire the bond issue without having to sell a significant number

of the homes on the free market.

This concept is described in the accompanying set of correspondence that went recently to all U.S. House of Representative members and others.

In addition, I have sent you a copy of my 11-2-79 letter to Congressman W. Henson Moore where I ask him to make his tax-free interest earnings proposal applicable to the concept included in H.R. 3712.

I agree with Congressman Ullman and the Treasury Department when they said that a $100.00 or $200.00 tax credit on interest earnings should compete next year with other proposals for stimulating savings and investment.

In conclusion, the low denomination tax exempt housing rehabilitation bonds mentioned in Mr. Moore's letter act as a tax credit which originates from the tax exempt nature of the bonds. The high denomination bonds mentioned in Mr. Moore's letter are the basis for the generation of more affordable housing for low and moderate income families AND my proposed usage limits for high denomination bonds as seen in the above attached correspondence will tend to maintain that housing for this family income segment of our society.

Sincerely Yours,

William R. Teachworth

William R. Teachworth
P. O. Box 3157
Santa Monica, California
90403

CC Congressman Al Ullman
Congressman Barber B. Conable, Jr.
Donald C. Lubick-Assistant Secretary for Tax Policy
Senator Russell B. Long

Santa Monica, California
11-3-79

Record
Int
Suite
Oct. 31
Int. on
Savings

Senator Harry F. Byrd, Jr., Chairman
Taxation and Debt Management Generally Subcommittee
Room 417
Russell Senate Off. Bldg.
Washington, D.C. 20510

Dear Senator Byrd, Jr.:

The accompanying copy of correspondence mailed on 11-2-79 to Congressman W. Henson Moore and others explains a proposed alternative to generalized tax credits on savings accounts.

This proposed alternative is a "low denomination ($100.00 to $500.00) tax exempt housing rehabilitation bond". The specific uses for the proceeds from these bond sales would be limited to Qualified Home Rehabilitation Loans and Qualified Home Improvement Loans as defined in proposed Section 103A-Mortgage Subsidy Bonds subsections (n)(6) and (n)(7) of H.R. 3712 (attached). Thus, the housing area, in specific, would benefit from the proceeds AND the savers purchasing the bonds would benefit to a greater degree than by a generalized tax credit on savings as proposed by Congressman Moore. This occurs by virtue of the tax-exempt nature of these bonds.

Hopefully, this proposed alternative to generalized tax credits can be incorporated into H.R. 3712 when it arrives intact into the Taxation Subcommittee provided it is not already included at the time of arrival.

A generalized tax credit on savings accounts should compete next year with other proposals to increase savings and investments.

Sincerely Yours,

William R. Teachworth

William R. Teachworth

CC All members of Taxation Subcommitte
Congressman Al Ullman
Congressman Barber B. Conable, Jr.
Senator Russell B. Long
Donald C. Lubick-Asst. Treasury Sec.

DISTRIBUTION

All members of the U.S. House of Representatives Rules Committee.

All members of the U.S. House Ways and Means Committee.

All members of the Senate Finance Committee-Taxation Subcommittee.

Senator Russell B. Long.

Jay Janis-Chairman, Federal Home Loan Bank Board.

John G. Heimann-U.S. Comptroller of the Currency.

Donald C. Lubick-Assistant Secretary for Tax Policy-Treasury Dept.

Richard J. Woods-Associate Director, Community and Economic Development Division, General Accounting Office.

DISTRIBUTION

ALL members of the U.S. House of Representatives.

Donald C. Lubick-Assistant Secretary for Tax Policy-Treasury Dept.

Kenneth Biederman-Director, Office of Economic Research-Federal Home Loan Bank Board.

Paul A. Volcker-Chairman of the Federal Reserve Board.

Robert J. Ryan-Assistant Director of Financial and General Management Studies-General Accounting Office.

Clinton Boo, Jr.-Office of the Assistant Secretary for Housing-HUD.

John J. Bambrick-City Councilman-City of Santa Monica, California.

Donna O'Brien Swink-City Councilwoman and former Mayor-City of Santa Monica, California.

John Jalili-Assistant City Manager-City of Santa Monica, California.

Aubrey E. Austin, Jr.-Chairman of the Board-Santa Monica Bank, Santa Monica, California.

William Mortenson-President-First Federal Savings and Loan Association, Santa Monica, California.

56-074 O - 80 - 35

Santa Monica, California
8-31-79

SUBJECT: H. R. 3712---THE MORTGAGE SUBSIDY BOND TAX ACT OF 1979

Representative
U.S. House of Representatives
Washington, D.C.
20515

Dear Representative

H. R. 3712, as seen in the August 6, 1979 Ways and Means Committee print, is the first substantial step towards solving the long range problem of providing single family, owner occupied, attached and detached homes in a price range affordable to low and moderate income families.

The limitations that H.R. 3712 puts on the usage of such bonds brings an end to the era where families with $40,000.00 annual incomes would get $100,000.00 and larger loans at a lower than market interest rate for use in purchasing expensive homes. Also, there was no limit on the profit these families could make on the resale of these homes.

How would I know of such, loosely speaking, dastardly deeds? One responsible financial leader in the State of California was offerred a bond issuance transaction with such a lack of limitations and such a use by families with such a large income range. He did not feel that that bond issuance was a proper transaction and neither did I.

Now that I have stated my position, here is what I have to help H. R. 3712 work. H. R. 3712 goes a long way to see that lower-cost loans can be made to families most likely to need such loans.

However, let me present a most probable solution, in whole or in part, to the ongoing need for more single family, owner occupied, detached and attached homes being affordable to low and moderate income families NOW and on into the next century.

This most probable solution is being presented for your consideration as a "Congressionally authorized alternative use" for tax exempt housing subsidy bonds for owner occupied, single family, attached and detached homes. It is also being presented as a suggested use for such bonds in response to the challenge as seen in the "O. Miscellaneous" section of H. R. 3712. That is why copies of this correspondence are also going to representatives of the three agencies mentioned in "O. Miscellaneous". The prime basis for operation of my most probable solution is "you eat my bread (money), you sing my song (follow the rules)."

This most probable solution involves two concepts: (1) a controlled purchase and sale price and (2) the multiple usage of the same structure over time.

The basic principle of operation is as follows:

1. The City or its authorized agent purchases or constructs homes to be single family owner-occupied. These may be free-standing single family homes or condominiums.
2. The City or its authorized agent will then sell the homes to families whose income limits are presented in H.R. 3712. The great number of such sales will indirectly involve, at the time of the first sale, a monetary subsidy since the mortgage will not be equal to the original cost of the home.
3. As long as the family owns the home, they have all the

tax benefits of a regular homeowner.

4. When the time for resale occurs, the City or its authorized agent is the ONLY repurchaser.
5. The City or its authorized agent will then repurchase the home at a value calculated by a simple three part formula.
6. The same structure (home) is resold by the City or its authorized agent to low or moderate income families as defined AT THE TIME of the second and subsequent sales.

The first three attachments give the meaningful details of my suggested Congressionally authorized alternative use for monies created by the sale of tax exempt mortgage subsidy bonds. These three attachments do not consider, for sake of simplicity, the authorized use of such bond monies for rehabilitation or home improvement loans. Also, all attachments are presented in the order of their discussion in the text of this letter.

The first three attachments are described as follows:

1. My 5-12-79 personally submitted four page letter on the topic. The "shall" concepts numbered 3,5 and 6 cover the concept of sole repurchase and resale of the same structure. The concept in "shall" number 2 of limiting the difference in sale price to be at most $15,000.00 higher than the maximum affordable mortgage for the family was modified as will be seen in my second attachment.

   Note on page 3 that there is the concept of using a tax exempt charitable organization as the City's authorized agent. Note also the "should" requirements.

Note on page 1 the discussion about low ($500.00 and lower) and high ($5,000.00) denomination tax exempt bonds being proposed for use in the area of owner occupied, single family, attached and detached housing. Low denomination bonds, to my knowledge, are issued in a checkbook format with the checks being the bond interest payments and the very last check being the principal payment. According to the premier edition of E.P.O. magazine (Jan./Feb. 1979) on page 25, such low denomination bonds have been authorized by the Federal Reserve Board and have been issued by a Mr. L. Mason Neeley-township finance director for East Brunswick, New Jersey. Such bond issues are, in my opinion, valuable adjuncts to allow "small investors" a chance to invest in their own communities.

2. My 6-16-79 seven page letter to Congressman Al Ullman where two examples are given to show the feasibility of issuing tax exempt mortgage subsidy bonds and using the proceeds according to my suggested formula. Note that additional funds must be initially supplied by the City or its authorized agent to purchase or construct those homes and these amounts are in excess of $15,000.00. Note that the reserves increase as time passes. As the thirty year payoff period approaches, the City or its authorized agent will almost be able to pay off the principle and still own most of the mortgages on the homes. OR portions of the reserves can be used, as time progresses, according to the H.R. 3712 allowed rehabilitation and home improvement provisions.

3. My 6-25-79 two page mailgram to Congressmen Al Ullman and Barber B. Conable where more limitations and parameters are submitted for consideration. These additional limitations and parameters are most beneficial when used as a part of my suggested Congressionally authorized alternative use for tax exempt mortgage subsidy bonds used for the purchase or construction of single family, owner occupied, attached or detached homes. In item #5, the sixth word over is "BUILT" not "BUT".

This concept of a City forming (or accepting) an authorized agent to play the part in the issuance of tax exempt mortgage subsidy bonds and related bonds and overseeing the usage of the proceeds is seen in the one page attached August 10, 1979 article in the Los Angeles Times. Note there is mention of deed restrictions to prevent owners from selling their units at high profits. Also, Mr. John Jalili, Assistant Manager for the City of Santa Monica, California (213-393-9975) has already agreed with the general concept of a controlled resale and repurchase price. I will add right here that I am not a lobbyist, paid or unpaid, but I am a concerned citizen who would like to assist in solving housing problems. An example of this is seen in the attached one page declaration from the City of Santa Monica for my giving of the first funds to start the Santa Monica Bay Foundation, a community foundation.

I have attached a portion of a page from the August 17, 1979 edition of the Wall Street Journal. As the mortgage backed bonds presented in the article are for free market home purchases at free market interest rates, so should tax exempt mortgage subsidy

bond proceeds be for those unable to meet free market requirements.

In conclusion, I feel that the limitations put on tax exempt mortgage subsidy bonds as presented in the summary of H.R. 3712 are admirable and that the limitations of my suggested Congressionally authorized alternative use are complementary.

Sincerely Yours,

William R. Teachworth

William R. Teachworth

Santa Monica, California
5-12-79

SUBMISSION BY A PRIVATE INDIVIDUAL

Mr. Al Ullman--Chairman of the Ways and Means Committee
House of Representatives
Washington, D.C.
20515

Subject: H.R. 3712
Public Hearings: May 14 & 15, 1979
Presented at Rm. 1102 in person.

Dear Mr. Ullman:

I feel there is a proper use for low and high denomination tax exempt bonds in the area of owner-occupied, single-family attached and detached housing.

Before I proceed with my proposed limitations for usage, let me say that an immediate moratorium is indicated for the issuance of new such bonds for such a purpose AND on the distribution of the uncommitted portions of funds from already issued bonds. My understanding is that massive amounts of such bonds have been issued in the recent past. Such a distorted issuance of tax exempt bonds can adversely affect the general tax exempt bond marketplace if not checked. The uncommitted portions of the distribution of funds from issued bonds should, perhaps, be placed into various bank and S & L certificates to earn interest during the moratorium. This temporary depositing will earn more interest than the tax-exempt bonds require for their interest payments. This excess interest minus the costs of handling the transfers should go to the institution issuing the certificates. Such temporary deposit should be suitable until the final acceptable limitations are ironed out. I will discuss this topic later in my conclusion.

In my opinion, the limitations should have the following "shall"

and "should" requirements. Shalls are mandatory requirements. Shoulds are recommended requirements to assist the City in carrying out the intent of such bonds.

SHALL

1. There shall be no private first or secondary purchase mortgage usage.
2. Distribution of the funds shall be limited to $15,000.00 per unit for the differential in the original purchase cost or construction cost for the City AND the actual face value of the first mortgage held by the City upon sale of the unit to the first buyer. An example is as follows: A $50,000.00 purchase cost or construction cost for a unit means at least a $35,000.00 mortgage from the buyer.
3. The City has first and only right of repurchase of the unit.
4. Gross income levels of families eligible for loans to range up to and include the top of the Federal Government definition scale for the size of the low or moderate income family applying for the loan.
5. The repurchase cost to the City to be determined according to the following formula:
   A. The buyer's down payment, plus
   B. 8% simple interest on the down payment, plus
   C. The reduction in mortgage principal from the original amount at the time of sale back to the City.
6. The resale price to the second and subsequent buyers to be determined by the bond issuing municipality and/or the granting government agency(s) OR their authorized

agent or operator in charge by allowing the agent or operator in charge to use discretion in following the intent of the bond issue.

7. The purchasing or construction of the units under consideration shall be at various points in the City. The purchasing of entire existing multi-unit buildings or collections of units for such purposes is to be actively discouraged.

To ensure the proper insight into determining the most efficient distribution of the funds generated from tax exempt mortgage bonds, the following "should" requirements are recommended:

SHOULD

1. The funds should be distributed through a tax-exempt charitable organization formed by or acceptable to the City and other bond issuers or grantors.
2. The tax-exempt charitable organization should have the power of discretion in the usage of the generated funds within the framework of the terms of application as stated in the bond issue document.
3. The tax-exempt charitable organization SHALL BE BASED in the City. ALL of its corporate officers SHALL BE residents of the City at the time of incorporation. ALL FOUR corporate officer titles SHALL have a different person in each one of the titles. AT ALL TIMES, at least two-thirds of the Directors (Trustees) on the Board of Directors (or Trustees) SHALL BE residents of the City. AT ALL TIMES, the Chairman of the Board of Directors (Trustees) SHALL BE a resident of the City.
4. The tax-exempt charitable organization should have the

authority to determine the resale value of the properties involved as this pertains to the second and subsequent buyers.

In conclusion, I recommend that an immediate moratorium be placed on the issuance of tax exempt state and local municipal bonds that are used to finance mortgages on single family attached and detached dwellings. This moratorium is also recommended on the distribution of uncommitted funds generated by such bonds. The moratorium should last until a final set of acceptable limitations is fashioned. THEN, the already issued bonds or the initiated distribution of the funds therefrom be allowed to proceed under the terms of their issuance. The issuing municipalities SHOULD be encouraged to modify their operations in handling the bonds and funds to agree with the final acceptable set of limitations.

However, all bonds issued after the moratorium SHALL comply with with the acceptable set of limitations.

Sincerely Yours,

William R. Teachworth
P. O. Box 3157
Santa Monica, California
90403

Santa Monica, California
6-16-79

Congressman Al Ullman--Chairman of the Ways and Means Committee
House of Representatives
Washington, D.C.
20515

Dear Mr Ullman;

This letter presents two different examples of purchase-sale transaction involving single- family, owner occupied attached and detached homes originally purchased entirely by the proceeds from a sale of tax exempt mortgage subsidy bonds.

The following is a list of the parameters for these examples;

1. Average compounded annual increase in home prices over the next thirty years---10%.
2. Average compounded annual increase in gross median income for low and moderate income families over the next thirty years---7%.
3. Mortgage subsidy bond market interest rate over the next thirty years---8%.
4. Mortgage subsidy bond interest charge to borrowers over the next thirty years---9%.
5. The one percent difference in interest between mortgage interest to the borrower and the mortgage subsidy bond interest payment is sufficient to handle routine paperwork and pay operating expenses.
6. Term of mortgage subsidy bond issue is 30 years with payment in full at end of thirty years.
7. Four sales are made during length of bond term-one at the beginning when the City or its agent makes the initial purchase and then at the end of three separate seven year periods. Seven years is a fair average for length of home-

ownership of a certain unit.

8. Fifteen percent of the loan principal is paid off in seven years.
9. The Los Angeles local 1979 median income is $17,800.00.
10. Mortgage subsidy bond money loans are limited to families having up to 115% of the median income.
11. Upper limit on the mortgage amount is equal to 2.5 times the families annual gross income.
12. The Los Angeles local 1979 average home price was $100,000.00
13. The upper limit for the initial purchase price of the dwelling by the City or its authorized agent is 80% of the local average home price.
14. The down payment in all cases is $1,000.00.
15. The initial bond issue size is $10,000,000.00.
16. Two million of the initial ten million is set aside as a reserve.
17. The bond money in reserve should earn interest. However, interest on reserves is not included in this discussion.
18. Five hundred thousand of the initial ten million is for start-up and purchasing costs.
19. Thus, $7,500,000.00 is available for outright purchase.
20. The costs to the City or its authorized agent to handle the sales and repairs at the end of each seven year period is six (6.0) percent of the resale price.
21. This discussion does not include a method to handle the valuation of any improvements made by the private owner during occupancy when the time for repurchase comes.
22. The costs of repurchase by the City or its authorized agent are as follows:

    A. The buyer's down payment, plus

    B. Eight (8) percent annual interest on the

down payment amount only, plus

C. The reduction in mortgage principal from the original amount at the time of sale back to the City.

The two different purchase-sale arrangements are as follows:

A. The initial purchase by the City or its authorized agent is at 80% of the local average home price and resale is to families having 115% of the local median income. Second and subsequent sales are made at maximum mortgage levels affordable by families having 115% of the local media income at the time of purchase. This is Exhibit A.

B. The initial purchase by the City or its authorized agent is at 65% of the local average home price and resale is to families having 90% of the local median income. Second and subsequent sales are made at maximum mortgage levels affordable by families having 90% of the local median income at the time of purchase. This is Exhibit B.

In these arrangements, the fourth buyer sells at the end of 28 years. The City or its authorized agent shall have the power to decide how to liquidate some of the homes, either by free market sale or sale of mortgage, to pay off the principal due at the end of 30 years. This liquidation may or may not be necessary.

My caloulations are probably not precise but, hopefully, prove the feasibility of such a concept as the City being the first and only repurchaser of low and moderate income housing financed by tax-exempt mortgage subsidy bonds. This also pertains to the City's authorized agent. Thusly, low and moderate income housing of a single family attached and detached nature is available for ownership throughout this century and into the next.

Sincerely Yours,

William R. Teachworth

William R. Teachworth

EXHIBIT A

Initial purchase and resale to first buyer

A. Year---1979.
B. Average home price in local Los Angeles area---$101.000.00.
C. 80% of the average home price---$81,000.00.
D. Median income---$17,800.00.
E. 115% of the median income---$20,470.00.
F. Highest allowed mortgage at 115% of median income---$51,175.00.
G. Additional bond monies used to buy home---$28,825.00.
H. Down payment---$1,000.00.
I. Interest on down payment at time of repurchase from buyer---$714.00.
J. Reduction in mortgage at time of repurchase---$7,676.00.
K. Total interest paid out to bondholders from proceeds of the bond used to purchase homes and also in the amount in excess of the mortgage amount---$16,142.00 ($28,825.00 X .08 (8%) X 7 (years).
L. Total cost of carrying home through first seven years and repurchase from first buyer---$53,357.00 ($28,825.00 plus $7,676.00 plus $16,142.00 plus $714.00).

TOTAL NUMBER OF HOMES THAT CAN BE PURCHASED OUTRIGHT IS 92. This is $7,500,000.00 divided by the cost of each home.

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Resale to the second buyer

A. Year---1986.
B. Average home price in local Los Angeles area---N/A.
C. 80% of the average home price---N/A.
D. Median income---$28,480.00.
E. 115% of the median income---$32,752.00.
F. Highest allowed mortgage at 115% of median income---$81,880.00.
G. Mortgage given to second buyer---$80,000.00.
H. 6% handling costs---$4,800.00.
I. Down payment---$1,000.00.
J. Interest on down payment at the time of repurchase from buyer---$714.00.
K. Reduction in mortgage at the time of repurchase---$12,000.00.
L. Total cost to complete sale to second buyer---$58,157.00(initial L /
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$21,843.00 ($80,000,00 minus $58,157.00).
N. Total involved in repurchase from second buyer---$12,714.00.
O. Interest deposited in reserves during second buyer's ownership and earned on the differential in item M---$12,232.00.
P. Bond money from reserves to complete repurchasing from second buyer---$482.00 ($12,714.00 minus $12,232.00).

EXHIBIT A

Resale to the third buyer

A. Year---1993.
B. Average home price in local Los Angeles area---N/A.
C. 80% of the average home price---N/A.
D. Median income---$45,568.00.
E. 115% of the median income---$52,403.00.
F. Highest allowable mortgage at 115% of the median income---$131,000.00
G. Mortgage given to third buyer---$130,000.00.
H. 6% handling costs---$7,800.00.
I. Down payment---$1,000.00.
J. Interest on down payment at the time of repurchase from buyer---$714.00.
K. Reduction in mortgage at time of repurchase from buyer---$19,500.00.
L. Total expenses to complete resale to third buyer---$66,439.00 ($58,157.00 plus $482.00 plus $7,800.00).
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$63,561.00 ($131,000.00 minus $66,439.00).
N. Total involved in repurchase from third buyer---$20,214.00.
O. Interest deposited in reserves during third buyer's ownership and earned on the differential in M---$35,594.00.
P. Bond money from reserves to complete repurchase from third buyer ---none. Net increase in reserves is $15,380.00 ($35,594.00 minus $20,214.00).

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Resale to the fourth buyer

A. Year---2000.
B. Average home price in local Los Angeles area---N/A.
C. 80% of the average home price---N/A.
D. Median income---$72,908.00.
E. 115% of median income---$83,845.00.
F. Highest allowable mortgage at 115% of median income---$209,600.00.
G. Mortgage to fourth buyer---$208,600.00
H. 6% handling costs---$12,576.00.
I. Down payment---$1,000.00.
J. Interest on down payment at the time of repurchase from buyer-$714.00.
K. Reduction in mortgage at the time of repurchase---$31,200.00.
L. Total cost to complete resale to fourth buyer---$63,439.00 ($66,439.00 plus $12,576.00 minus $15,380.00).
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$144,251.00.
N. Total involved in repurchase from fourth buyer---$31,914.00
O. Interest deposited in reserves during fourth buyer's ownership and earned on the differential in M---$80,780.00.
P. Bond money from reserves to complete repurchase from fourth buyer---None. Net increase in reserves is $48,866.00. ($80,780.00 minus $31,914.00).

EXHIBIT B

Initial purchase and resale to first buyer

A. Year---1979.
B. Average home price in local Los Angeles area---$101,000.00.
C. 65% of the average home price---$65,000.00.
D. Median income---$17,800.00.
E. 90% of the median income---$16,020.00.
F. Highest allowed mortgage at 90% of median income---$40,050.00.
G. Additional bond monies used to buy home---$24,950.00.
H. Down payment---$1,000.00.
I. Interest on down payment at time of repurchase from buyer---$714.00.
J. Reduction in mortgage at the time of repurchase---$6,007.00.
K. Total interest paid out to bondholders from proceeds of the bond issue used to purchase homes and also in the amount in excess of the mortgage amount---$13,972.00 (seven years interest at 8%).
L. Total cost in carrying home through first seven years and repurchase from first buyer---$45,643.00($24,950.00 plus $6,007.00 plus $13,972.00 plus $714.00).

TOTAL NUMBER OF HOMES THAT CAN BE PURCHASED OUTRIGHT IS 115. This is $7,500,000.00 divided by the cost of each home.

Resale to the second buyer

A. Year---1986.
B. Average home price in local Los Angeles area---N/A (not applicable).
C. 65% of the average home price---N/A.
D. Median income---$28,480.00.
E. 90% of median income---$25,632.00.
F. Highest allowed mortgage at 90% of median income---$64,080.00.
G. Mortgage given to second buyer---$63,080.00.
H. 6% handling costs---$3,784.00.
I. Down payment---$1,000.00.
J. Interest on downpayment at the time of repurchase from buyer---$714.00
K. Reduction in mortgage at the time of repurchase---$9,462.00.
L. Total cost to complete resale to second buyer---$49,427.00 ($3,784.00 plus $45,643.00).
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$13,653.00 ($63,080.00 minus $49,427.00).
N. Total involved in repurchase from second buyer---$10,176.00 ($9,462.00 plus $714.00).
O. Interest deposited in reserves during second buyer's ownership and earned on the differential in item M---$7,645.00.
P. Bond money from reserves to complete repurchasing from second buyer ---$2,531.00 ($10,176.00 minus $7,645.00).

EXHIBIT B

Resale to the third buyer

A. Year---1993.
B. Average home price in local Los Angeles area---N/A.
C. 65% of the average home price---N/A.
D. Median income---$45,568.00.
E. 90% of the median income---$41,011.00.
F. Highest allowed mortgage at 90% of median income---$102,528.00.
G. Mortgage given to third buyer---$101,528.00.
H. 6% handling costs---$6,091.00.
I. Down payment---$1,000.00.
J. Interest on down payment at the time of repurchase from buyer---$714.00.
K. Reduction in mortgage at time of repurchase from buyer---$15,230.00
L. Total expenses to complete resale to third buyer---$58,049.00 ($49,427.00 plus $2,531.00 plus $6,091.00).
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$43,479.00.
N. Total involved in repurchase from third buyer---$15,944.00 ($714.00 plus $15,230.00).
O. Interest deposited in reserves during third buyer's ownership and earned on the differential in M---$24,348.00.
P. Bond money from reserves to complete repurchase from third buyer ---none. Net increase in reserves is $8,404.00 ($24,348.00 minus $15,944.00).

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Resale to the fourth buyer

A. Year---2000.
B. Average home price in local Los Angeles area---N/A.
C. 65% of the average home price---N/A.
D. Median income---$72,908.00.
E. 90% of median income---$65,617.00.
F. Highest allowed mortgage at 90% of median income---$164,043.00.
G. Mortgage to fourth buyer---$103,043.00.
H. 6% handling costs---$9,842.00.
I. Down payment---$1,000.00.
J. Interest on down payment at time of repurchase from buyer---$714.00
K. Reduction in mortgage at time of repurchase from buyer---$24,450.00
L. Total cost to complete resale to fourth buyer---$59,487.00 ($58,049.00 plus $9,842.00 minus $8,404.00).
M. Differential in bond funds demanding 8% interest and mortgage paying 8% (net)---$103,556.00.
N. Total involved in repurchase from fourth buyer---$26,170.00.
O. Interest deposited in reserves during fourth buyer's ownership and earned on the differential in M---$57,991.00
P. Bond money from reserves to complete repurchase from fourth buyer. None. Net increase in reserves is $31,827.00 ($57,991.00 minus $26,164.00).

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4-002727E176002 06/25/79 ICS IPMRNCZ CSP LSAB
1 2133944698 MGM TDRN SANTA MONICA CA 06-25 0231A EST

N TEACHWORTH
PO BOX 3157
SANTA MONICA CA 90403

THIS MAILGRAM IS A CONFIRMATION COPY OF THE FOLLOWING MESSAGE:

2133944698 TDRN SANTA MONICA CA 756 06-25 0231A EST
PMS CONGRESSMAN AL ULLMAN , COMMITTE ON WAYS AND MEANS
LONGWORTH HOUSE OFFICE BLDG ROOM 1136
WASHINGTON DC 20515
FOLLOWING MESSAGE SENT TO CONGRESSMAN BARBER B CONABLE AND
CONGRESSMAN AL ULLMAN:

DEAR MR ULLMAN

HERE ARE SOME ADDITIONAL LIMITATIONS AND PARRMETERS FOR YOUR
CONSIDERATION FOR INCLUSION INTO H.R. 3712:

1. SINGLE-FAMILY, OWNER-OCCUPIED, ATTACHED AND DETACHED HOMES BOUGHT
WITH TAX-EXEMPT MORTGAGE BOND MONIES CANNOT BE WILLED BUT MUST
REVERT TO THE CITY, AT ITS DISCRETION, UPON THE DEATH OF ONE OR MORE
OF THE ORIGINAL MORTGAGE SIGNERS.
2. THE DEATH OF ALL ORIGINAL MORTGAGE SIGNERS MEANS THE HOME SHALL
REVERT TO THE CITY WITHOUT DISCRETION BY THE CITY.
3. ONLY THE REPURCHASE PRICE AT THE TIME OF DEATH OF ONE OR MORE OF
THE MORTGAGE SIGNERS CAN BE WILLED.
4. THE CITY SHALL HAVE THE OPTION OF REPURCHASE OR NO REPURCHASE IN
THE CASE OF THE DEATH OF ONE LEGAL SPOUSE WITH THE SURVIVAL OF THE
OTHER SPOUSE.
5. SINGLE-FAMILY OWNER-OCCUPIED HOMES, BUT WITH TAX-EXEMPT MORTGAGE
BOND MONIES, SHALL NOT BE CONSIDERED COMMUNITY PROPERTY OR SEPARATE
PROPERTY. ONLY THE REPURCHASE PRICE AT THE TIME OF DIVORCE OR
DETERMINATION BY THE CITY OF PERMANENT SEPARATION SHALL BE
CONSIDERED COMMUNITY PROPERTY, THIS REPURCHASE PRICE SHALL NOT BE
CONSIDERED SEPARATE PROPERTY.
6. SUCH HOMES CANNOT BE USED AS SECURITY FOR SECONDARY FINANCING
SUCH AS SECOND TRUST DEEDS, HOME-OWNER LOANS, PRIVATE INDIVIDUAL
LOANS, PUBLIC-ENTITY LOANS, ETC.
7. IMPROVEMENTS FINANCED ENTIRELY BY THE HOMEOWNER'S FUNDS CANNOT BE
MADE IN AMOUNTS OVER $1,000 IN ANY THREE-YEAR PERIOD WITHOUT WRITTEN
PERMISSION FROM THE CITY. INCREASES IN THIS AMOUNT SHALL BE MADE AS
THE CITY DEEMS NECESSARY. ALL IMPROVEMENTS MUST BE APPROVED
BEFOREHAND BY THE CITY. THE CITY CAN JOINTLY COOPERATE WITH THE
HOMEOWNER IN MAKING AN IMPROVEMENT. IN THIS INSTANCE OF
CITY-HOMEOWNER COOPERATION, THE UPPER LIMIT OF IMPROVEMENT COST

WITHOUT WARRANTING A PUBLIC MEETING ON THE NECESSITY OF THE IMPROVEMENT IS THREE TIMES THE MAXIMUM-THEN-PERMITTED AMOUNT FOR A HOMEOWNER-FUNDED IMPROVEMENT.
8. THE DEPRECIATION SCHEDULE FOR IMPROVEMENTS SHALL BE 7 YEARS. AT THE END OF 7 YEARS, THE ORIGINAL COST OF THE IMPROVEMENTS WILL BE INCLUDED IN THE REPURCHASE PRICE.
9. SHOULD THE SALE OF THE HOME TAKE PLACE BEFORE THE DEPRECIATION HAS RUN OUT ON AN IMPROVEMENT, THEN THE CITY WILL PAY THE FORMER OWNER THE CASH VALUATION OF HIS PORTION (WHOLE OR PART) OF THE REMAINING DEPRECIATION AS DETERMINED BY A REVIEW OF THE FORMER OWNER'S TAX BRACKET (NOT HIS INCOME TAX FORMS).
10. THE REMAINING UNDEPRECIATED IMPROVEMENT VALUATION ATTRIBUTABLE, IN WHOLE OR IN PART, TO THE FORMER OWNER SHALL BE TRANSFERRED INTACT, UPON RESALE, TO THE NEW OWNER.
11. THE HOMEOWNER CAN DEDUCT ALL MORTGAGE INTEREST COSTS, PROPERTY TAX PAYMENTS, SPECIAL DISTRICT TAXES, DEPRECIATION ALLOWANCES, ETC, FROM HIS INCOME TAX.
12. NOTWITHSTANDING, THE CITY SHALL HAVE THE OPTION OF SELLING ITS HOMES ORIGINALLY PURCHASED IN AREAS WHERE THEY HAVE INCREASED IN VALUE AT A RATE OF AT LEAST 1-1/2 TIMES AS GREAT AS THE RATE OF LOCAL OPEN-MARKET MEDIAN-PRICED HOMES. IN THIS MANNER, THE CITY CAN USE THE ARBITRAGE CONCEPT TO ADVANTAGE AND PURCHASE MORE HOMES FOR THEIR INITIAL PURPOSE (SINGLE-FAMILY, OWNER-OCCUPIED ATTACHED AND DETACHED HOUSING FOR LOW- AND MODERATE-INCOME FAMILIES). CONSIDERATION OF SUCH A SALE SHALL BE PUBLICLY DISCUSSED AT AT LEAST TWO PUBLIC MEETINGS OF THE CITY. IN ADDITION, THESE SALES FOR THE PURPOSE OF USING UNUSUAL FINANCIAL GAIN SHALL BE MADE ONLY AT THE TIME OF NORMAL REPURCHASE BY THE CITY.
13. THE USAGE OF THE WORD "CITY" IN ALL OF THE ABOVE ALSO PERTAINS TO ITS AUTHORIZED AGENT.

THE RESALE PRICE OF THESE SINGLE-FAMILY, OWNER-OCCUPIED ATTACHED AND DETACHED HOUSES PURCHASED WITH TAX-EXEMPT BOND MONIES SHALL NOT BE DETERMINED BY OPEN-MARKET FORCES, TO WIT: THE HOMEOWNER OF SUCH HOMES CANNOT MAKE A "KILLING" WITH CHEAP MONEY.

SUCH A CONCEPT IS SIMILAR TO MY "WAY STATION" CONCEPT IN THE RECONSTRUCTION OF EARTHQUAKE-SUSPECT BUILDINGS IN LOS ANGELES. THE HOMEOWNER HAS THE ABILITY TO "OWN" A HOME AND LAY ASIDE DISCRETIONARY INCOME TO ADD TO WHAT THE CITY WILL REPURCHASE HIS HOME FOR AND COMBINE BOTH SUMS AS A DOWN PAYMENT ON AN "OPEN-MARKET" HOME WHEN HIS INCREASE IN INCOME IS SUFFICIENT TO HANDLE AN OPEN-MARKET HOME. THIS CONCEPT PERTAINS TO THE YOUNG FAMILIES STARTING OUT IN LIFE AND IS FURTHER IN KEEPING WITH MR JACOBS' COMMENTS ABOUT H.R. 3712.

A COPY OF THIS TELEGRAM HAS ALSO BEEN SENT TO BARBER B. CONABLE, SINCE YOU TWO GENTLEMEN WERE INVOLVED IN THE INITIAL COMPROMISE AND THE TIME IS SHORT BEFORE THE RECONSIDERATION OF H.R. 3712.
WILLIAM R TEACHWORTH, PO BOX 3157, SANTA MONICA CA 90403
02:32 EST

STANFORD UNIVERSITY
STANFORD, CALIFORNIA 94305

DEPARTMENT OF ECONOMICS

MICHAEL J. BOSKIN
PROFESSOR OF ECONOMICS

November 15, 1979

The Honorable Lloyd Bentsen
The United States Senate
240 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

Thank you very much for your letter soliciting my advice on your Individual Savings Act: S.246. Before I present my very favorable reaction to S. 246, let me first express my deep appreciation of your leadership in attempting to bring a more balanced approach to economic policymaking in this country. I am sure that we will all benefit in the long run from a concern with our continuing problems of declining productivity, high inflation, and sluggish economic growth by focusing some of our attention on the factors affecting the supply side of our economy instead of paying virtually exclusive attention to attempting to fine tune or manage aggregate demand.

There is no greater long-run problem facing the United States economy today than our extremely low rate of saving and closely related low rate of investment. This not only has been a major ingredient in our current inflation and productivity decline, declining international competitiveness and sluggish economic growth, but also has enormous long-run implications. Simply, if our low rate of personal saving continues for any foreseeable length of time, we will face a crisis in financing the retirement income of the current generation of workers and savers when they ultimately retire. At our current very low rate of saving, this group will be thrown even more than our current retirees into a dependency status in need of governmental, and hence future tax, support for financing their retirement.

As you well know, and have documented so forcefully, the tax treatment of saving in the United States is very different from that of other industrialized countries. Virtually all of those countries give substantial incentives to saving in the form of interest exemptions much larger than those provided through our IRA or Keough accounts, and usually on a broader range of savings instruments. Since the early 1970s, the growth of real GNP per worker in the United States is only one-tenth of 1% per year. This compares with growth rates of 3.2% in

Japan, of 3.0% in France and Germany, of 1.1% in Italy, and of 0.8% in the United Kingdom. By any sensible yardstick, our economic growth performance has been simply absymal.

For these and other reasons, I strongly favor tax legislation to remove the double taxation of savings inherent in our income tax. As you know, savings is taxed twice under an income tax: first when it is earned, as part of income; and again when it earns an interest return. While we have a few forms of exemption from taxation (for example, IRA and Keough accounts, certain types of life insurance, etc.), on balance our tax policies strongly discourage personal saving in the United States. I believe these disincentives are so strong that I personally hope we eventually will be able to provide a larger exemption on a broader class of assets than proposed in your bill. However, I believe your recommendations are a very good place to start.

It is important to note that there is an insidious interaction between inflation and income taxation on the one hand, and the after tax and inflation rate of return earned by savers on the other. This interaction is in the process of totally destroying the incentive to save in the United States.

Not too long ago, a passbook account yielding 5% in an era of relatively stable prices and moderate tax rates would still yield a positive after tax, after inflation rate of return. For example, at a 40% tax rate, 5% would be reduced to 3% after-tax return, and with the historical average inflation rate in the post-war period, through the late 1960s, of a little over 1½%, the saver at the end of the year would have after taxes and inflation 1½% more purchasing power than at the beginning of the year. While not enormous, this would enable an accumulation of real capital and purchasing power for the general population, including increased real purchasing power during retirement for those savers who are saving during their peak earning years in anticipation of retirement. But what situation do such people find themselves in now? In that same 5% passbook account at that same 40% tax rate (I ignore the fact that these rates have risen since the mid-1960s), the after tax return would still be 3%. However, now the inflation rate is 13%. After taxes and inflation, the rate of return on your savings is minus 10%! That is, at the end of the year, your savings is now worth only 90% of what it was worth at the beginning of the year.

Because of this, I would like to add that my own personal program to remove these enormous disincentives would involve gradually shifting away from taxing income to taxing expenditures or consumption in a personal expenditure tax (not a value-added tax). Since I assume that such a proposal would take too long to implement to achieve much tax relief for hard pressed savers at the present, I strongly favor some form of tax legislation to exempt some amount of interest income from taxation.

There is a substantial equity case for the type of saving relief proposed in your bill, as well as the beneficial long-term effects on our rate of saving and ultimately our rate of investment, productivity,

and future standard of living. While the limitation of the exclusion of interest to $500 for unrelated individuals and $1000 for husbands and wives filing jointly would provide substantial relief for many savers, it would only affect a minority of interest received (although a larger fraction of savers). For those earning less than the $500 (or $1000) exclusion limit, this bill would provide a very substantial incentive to save (or perhaps more appropriately, reduction in the enormous disincentive to save in our current tax and inflation situation). For these people, the net rate of return to saving after taxes and inflation would rise substantially on any incremental saving they might do. I believe, therefore, that a substantial amount of additional saving would be encouraged. My own estimates suggest that when the rate of return after taxes and inflation goes up by 10% (for example, from 3% to 3.3%) private saving increases by about 4%, a very substantial increase. Further, there is some evidence that saving out of an increase in interest income, such as that which your bill would provide, would be substantially greater than saving out of an increase in general income produced by general tax cuts.

For the substantial bulk of savings earning interest above the exclusion, there would still be an incentive to save out of the increase in that interest, although the extra incentive at the margin of an increased net rate of return would not exist for these people because of the exclusion limit in your bill.

Therefore, in deciding on an appropriate exclusion limit, there are two factors which must be weighed. The higher the exclusion, the more savers and proportionally more interest income that will be subject to an extra incentive at the margin for more savings, and hence the larger the impact on overall savings. But, of course, the larger the exclusion the greater the short-term reduction and tax revenue loss for the Treasury. The extra saving generated will ultimately lead to increased investment and increased productivity, wages, income and, hence, future tax base and revenues. The problem is that this will not occur so rapidly as to avoid a short-term falloff in tax revenues. In the current economic situation, I do not think it is sensible to enact legislation which would have an enormous exclusion of interest without a corresponding substitution of other revenue sources. That is, I believe it is prudent to start with the modest exemption you propose in order to keep from putting too much pressure on the deficit.

However, I believe it is important to start with a modest interest exclusion in providing a principle that ultimately we are going to unravel the disincentives to save which our tax system, inflation and other factors have created.

My best approximation is that your bill would increase personal saving in the United States by several billion dollars. Accumulated over a few years, this extra saving and the ultimate extra investment would increase income and future tax revenues and therefore recoup at least part of the short-term revenue loss such a move might entail.

Let me conclude by restating my support for your bill and my general support for legislation designed to remove the enormous disincentive that the interaction of this double taxation of savings and inflation have created for private saving in the United States. I believe there is no more urgent legislation than to gradually shift to a system that would promote, rather than destroy, the incentive to save. Your bill represents an important beginning in dealing with the saving issue as it effects low- and middle-income savers.

If I may be of any further assistance, please do not hesitate to call upon me.

Sincerely yours,

Michael J. Boskin

MJB:kq

GENERAL ARNOLD BROWN
INTERNATIONAL LEADER

WILLIAM BOOTH, FOUNDER

COMMISSIONER JOHN D. NEEDHAM
TERRITORIAL COMMANDER

The Salvation Army
(FOUNDED IN 1865)

COMMUNITY COUNSELING CENTER
SUBURBAN BRANCH
FAMILY SERVICE DIVISION
1616 NORTH ARLINGTON HEIGHTS ROAD
ARLINGTON HEIGHTS, ILLINOIS 60004
(AREA CODE 312) 392-0285

MR. IKUO YAMAGUCHI A.C.S.W.
DIRECTOR
FAMILY SERVICE DIVISION

MRS. BONNIE DEICH, ACSW
DISTRICT SUPERVISOR

Oct. 5, 1979

Senator Adlai Stevenson
219 South Dearborn
Chicago, Ill.

Dear Senator Stevenson:

The enclosed resolutions were passed at the last regular meeting of our Advisory Council.

We wish these resolutions to be placed in any written testimony in the appropriate committees, especially oversight, of both Houses who may be reviewing the Federal Revenue Sharing Act.

Yours truly,

Virginia B. Hayter

Virginia Hayter, Chairperson
The Salvation Army
Community Counseling Center
Advisory Council

VH;lg

Enc.

RESOLUTION OF SUPPORT

WHEREAS, the Salvation Army Community Counseling Centers have provided family counseling services for several years, and

WHEREAS, the Township of Wheeling has contracted for this service with the aforementioned agency for the residents of their geographic area and,

WHEREAS, these funds have been invested in human service programs that have been of great benefit to the community, and

WHEREAS, the United States Congress and the President of the United States are considering the need for targeting Federal Revenue Sharing funds to concentrated population centers and discontinuing the program to the Townships.

NOW, THEREFORE, BE IT RESOLVED by the Chairman and members of Advisory Council of the Salvation Army Community Counseling Centers of Illinois, as follows:

Section 1: That the Salvation Army Community Counseling Centers supports the present policy of distribution of Federal Revenue Sharing funds.

Section 2: That copies of this Resolution be forwarded to Congressman Philip Crane, Senators Charles Percy and Adlai Stevenson and President Jimmy Carter.

PASSED THIS 21st day of September, 1979

APPROVED THIS _____ day of _____, 1979

Virginia M. Hayter

Virginia Hayter, Chairman
The Salvation Army
Community Counseling Centers
Advisory Council

RESOLUTION OF SUPPORT

WHEREAS, the Salvation Army Community Counseling Centers have provided counseling services for several years, and

WHEREAS, the Township of Schaumburg has contracted for this service with the aforementioned agency for the residents of their geographic area and,

WHEREAS, these funds have been invested in human service programs that have been of great benefit to the community, and

WHEREAS, the United States Congress and the President of the United States are considering the need for targeting Federal Revenue Sharing funds to concentrated population centers and discontinuing the program to the Townships.

NOW, THEREFORE, BE IT RESOLVED by the Chairman and members of Advisory Council of the Salvation Army Community Counseling Centers of Illinois, as follows:

Section 1: That the Salvation Army Community Counseling Centers supports the present policy of distribution of Federal Revenue Sharing funds.

Section 2: That copies of this Resolution be forwarded to Congressman Philip Crane, Senators Charles Percy and Adlai Stevenson and President Jimmy Carter.

PASSED THIS 21st day of September, 1979

APPROVED THIS _____ day of _____, 1979

Virginia B. Hayter

Virginia Hayter, Chairman
The Salvation Army
Community Counseling Centers
Advisory Council

RESOLUTION OF SUPPORT

WHEREAS, the Salvation Army Community Counseling Centers have provided family counseling services for several years, and

WHEREAS, the Township of Palatine has contracted for this service with the aforementioned agency for the residents of their geographic area and,

WHEREAS, these funds have been invested in human service programs that have been of great benefit to the Community, and

WHEREAS, the United States Congress and the President of the United States are considering the need for targeting Federal Revenue Sharing funds to concentrated population centers and discontinuing the program to the Townships.

NOW, THEREFORE, BE IT RESOLVED by the Chairman and members of Advisory Council of the Salvation Army Community Counseling Centers of Illinois, as follows:

Section 1: That the Salvation Army Community Counseling Centers supports the present policy of distribution of Federal Revenue Sharing funds.

Section 2: That copies of this Resolution be forwarded to Congressman Philip Crane, Senators Charles Percy and Adlai Stevenson and President Jimmy Carter.

PASSED THIS 21st day of September, 1979

APPROVED THIS _____ day of _____, 1979

Virginia A. Hayter

Virginia Hayter, Chairman
The Salvation Army
Community Counseling Centers
Advisory Council

RESOLUTION NO. 367 -1979

A RESOLUTION SUPPORTING FEDERAL REVENUE SHARING PROGRAM FOR TOWNSHIPS

WHEREAS, the Township members of the Northwest Municipal Conference have received significant Federal Revenue Sharing funds for the past four fiscal years; and

WHEREAS, 86 percent of the funds have been invested in "human service programs" that have been of great benefit to the community; and

WHEREAS, the United States Congress and the President of the United States are considering the need for targeting Federal Revenue Sharing funds to concentrated population centers and discontinuing the program to the Townships.

NOW, THEREFORE, BE IT RESOLVED by the President and Board of Trustees of the Village of Hoffman Estates, Cook County, Illinois, as follows:

Section 1: That the Village of Hoffman Estates supports the present policy of distribution of Federal Revenue Sharing funds.

Section 2: That copies of this Resolution be forwarded to Congressman Philip Crane, Senators Charles Percy and Adlai Stevenson and President Jimmie Carter.

PASSED this 1st day of October, 1979

APPROVED this 1st day of October, 1979

VOTE: AYES 5 NAYS 0 ABSENT 1

APPROVED:

Virginia B. Haytes
Village President

ATTEST:

Helen Wyant
Village Clerk

RESOLUTION NO. 368 -1979

A RESOLUTION OPPOSING FEDERAL REVENUE SHARING FORMULA FOR FUNDING

WHEREAS, the present Federal Revenue Sharing formula for funding includes per capita income, population and local tax; and

WHEREAS, the primary factor of the formula is the local tax initiative and said initiative includes the sales tax; and

WHEREAS, the sales tax is not reflective of local initiative.

NOW, THEREFORE, BE IT RESOLVED by the President and Board of Trustees of the Village of Hoffman Estates, Cook County, Illinois, as follows:

Section 1: That the Village of Hoffman Estates opposes the continuation of the sales tax as a component of the local tax initiative portion of the Federal Revenue Sharing formula for funding.

Section 2: That copies of this Resolution be forwarded to Congressman Philip Crane, Senators Charles Percy and Adlai Stevenson and President Jimmie Carter.

PASSED this 1st day of October, 1979

APPROVED this 1st day of October, 1979

VOTE: AYES 5 NAYS 0 ABSENT 1

APPROVED:

Virginia B. Dayton
Village President

ATTEST:

Helen Vyzral
Village Clerk

LUTHERAN COUNCIL IN THE USA

475 L'Enfant Plaza West, S.W.
Suite 2720
Washington, DC 20024
202/484-3950

Testimony of Dr. Charles V. Bergstrom, Office for Governmental Affairs, Lutheran Council in the USA. Submitted to the Subcommittee on Taxation and Debt Management, Committee on Finance, United States Senate. November 21, 1979.

Mr. Chairman, I am appreciative of this opportunity to submit testimony on S. 1703, which amends the Internal Revenue Code of 1954 to allow overseas American employees of churches and other charitable organizations the option of using the $20,000 income tax exclusion now reserved for corporate employees working in remote camps. My name is Dr. Charles V. Bergstrom. I serve as Executive Director of the Office for Governmental Affairs, Lutheran Council in the USA, located here in Washington, D.C. My statement today is submitted on behalf of three member church bodies of the Lutheran Council:

The American Lutheran Church, headquartered in Minneapolis, Minnesota, composed of 4800 congregations having approximately 2.4 million U.S. members;

Lutheran Church in America, headquartered in New York City, composed of 6100 congregations having approximately 3.1 million members in the U.S. and Canada; and

The Association of Evangelical Lutheran Churches, headquartered in St. Louis, Missouri, composed of 260 congregations having approximately 110,000 U.S. members.

I want to state at the outset that we endorse the statement presented orally to this Subcommittee on behalf of the American Council of Voluntary Agencies for Foreign Service (ACVS), and its 44 member charitable organizations which provide services in less developed countries throughout the world. Lutheran Immigration and Refugee Services and Lutheran World Relief are members of ACVS.

S. 1703 has the strong support of the three Lutheran church bodies as well as their interchurch overseas aid agencies, Lutheran World Ministries and Lutheran World Relief.

In their work abroad, the U.S. Lutheran churches strive to address social and

economic injustice in order to alleviate human suffering. Our overseas aid efforts can be classified into four general categories of service: relief, rehabilitation, refugee assistance, and development. Within these broad categories, we perform diverse activities including water resource development, land reclamation, vocational training, education assistance, medical care, refugee resettlement, and disaster relief. For example, during the past month, in response to the intense suffering in Cambodia, the Lutheran church bodies through their interchurch aid agencies have allocated over one-half million dollars for hunger relief. It is our people abroad who administer these services who are affected by S. 1703 and who will benefit from its enactment.

Enactment of S. 1703 will abate the severe tax increases for charitable personnel caused by the Foreign Earned Income Act of 1978, which substituted the $20,000 exclusion for employees of qualified charitable organizations with a series of tax deductions. While the deductions serve the bulk of the American overseas corporate work force very well, they have the opposite effect on a great number of overseas employees of the church and other charitable organizations, especially our personnel serving in developing countries. In order to counteract the increased tax liability caused by the Foreign Earned Income Act of 1978, the church and other charitable organizations will be forced to make difficult budgetary decisions. Either we lose our most skilled and experienced workers--many of whom are already serving overseas at great personal and financial sacrifice--or we compensate for the tax increase by raising their salaries. Such salary increases must be offset by cutbacks in other areas through reductions in personnel or curtailment of necessary services. We are not in the position to pass on increased costs to the "customers," as is so often the case with many organizations in the private sector faced with a similar financial situation. Further the financial strain placed upon the church and other charitable organizations is exacerbated by the mounting effects of inflation on payroll costs and the declining value of the United States dollar abroad.

An additional comment which I would like to make on the U.S. foreign earned income tax system in general concerns its negative effect on the hiring of Americans by worldwide interchurch agencies. It is our understanding that it is highly unusual for a country to tax the income of its people working overseas and that the United States is one of the few countries to levy such a tax. Therefore, when an international interchurch agency, with headquarters often outside of the United States, wants to hire someone to fill one of its posts in various parts of the world, the American applicant will be penalized because of the increased tax liability attached to that person by the United States. This problem surfaced in discussions of S. 1703 and similar legislation related to foreign earned income tax and is one which we want to bring to the attention of Congress.

In conclusion, I want to thank and commend the Subcommittee for considering S. 1703 which addresses what we feel were unintended tax burdens on church and other charitable personnel working abroad. Passage of S. 1703 will, in essence, restore the tax policy which existed prior to the 1978 law with little impact on the U.S. Treasury. For example, ACVS has estimated that for all 44 of its members, the effect of S. 1703 will be a total revenue loss to the Federal government of no more than $2.5 million. This is a small price to pay for a viable charitable sector which performs necessary overseas services -- services which maintain the good will of America abroad and which, if curtailed, would have to be provided by the Federal government. We urge expeditious enactment of the legislation.

56-074 O - 80 - 37

LEVIN & TOOMEY
COUNSELLORS AND ATTORNEYS AT LAW
SUITE 240
1050 SEVENTEENTH STREET, N. W.
WASHINGTON, D. C. 20036

MORRIS J. LEVIN
DANIEL E. TOOMEY

TELEPHONE
(202) 872-0008

November 21, 1979

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

Re: The Independent Local Newspaper Act
S.555

Dear Chairman Long:

This letter is submitted for inclusion in the record of the hearings held on October 31, 1979, on The Independent Local Newspaper Act, S.555, and supplements testimony given at the hearing.

Suggested Technical Corrections to S.555

Two minor technical corrections should be made on page 29 of S.555. At line 8, "within 1 state", should be revised to read "within one State". Also, line 13 on page 29 should be revised to read as follows: "community, or metropolitan area or, on January 1, 1979, within one State, and..." This would also conform to the like bill in the House of Representatives, H.R.2770.

Correction to "Description of Tax Bills" Prepared by the Staff of the Joint Committee on Taxation

In reviewing the "Description of Tax Bills listed for a Hearing Before the Subcommittee on Taxation and Debt Management Generally, of the Committee on Finance, on October 31, 1979, prepared for the use of the Committee on Finance by the Staff of the Joint Committee on Taxation," we discovered an error on page 8. The second sentence in the fourth full paragraph under the heading "Explanation of the bill" should be revised to read, "A 'chain of newspaper publications' is defined as two or more newspaper publications under common control, and which are not published in a single city, community, or metropolitan area or, on January 1, 1979, within one State." This correction makes that sentence consistent with the first sentence of the fourth paragraph. The January 1, 1979, date of determination should apply only to the intra-state aspect of the definition of an independent local newspaper, and not to other aspects such as the location of its offices in a single metropolitan area.

Response to Statement Submitted by the Treasury before the Subcommittee on October 31, 1979

The Treasury Statement discusses at length the reported "violation" of "generally applicable tax law principles" furthered by S.555. As demonstrated in the submissions, examples, and testimony offered at the hearing by Joseph S. Iannucci, Esquire, and the undersigned, these criticisms ignore two significant aspects of the Bill.

First, the Treasury ignores the fact that the Bill provides for the prepayment of estate tax. Consistent with this approach, the Bill permits the Government to pay no interest on the estate tax prepayment trust fund sums. Because the Government will, therefore, have the use of money it would not normally be entitled to */ for long periods at no charge, the Government will realize substantial benefits from the interest-free use of this money. As our previous submissions have demonstrated, in most cases, this benefit more than offsets the alleged revenue loss due to the purported tax benefits which this Bill may provide the owners of independent local newspapers. The prepayment of taxes grants the Government material benefits, just as a deferral of taxes would give a taxpayer significant advantages.

Second, the Treasury Statement is misleading in arguing that, by excluding the trust corpus from the taxable estate, the Bill provides a tax benefit to the independent local newspaper proprietor. This alleged "benefit" is no more a benefit than that provided by the system of gift taxation in the United States. Gifts are not deemed to be given back to become part of the benefactor's estate. Further, it would be inconsistent to levy an additional estate tax on sums used in earlier years to prepay the estate tax. To tax the prepayments themselves would be to levy a tax on a tax.

The example on Page 5 of the Treasury Statement is incorrect. By excluding the trust corpus from the taxable estate, the hypothetical taxpayer is saved only the inequity of being assessed an additional estate tax upon sums used to prepay

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*/ Even with the deduction from income subject to corporate income tax available to the newspaper for contributions to the trust fund, the Government will nevertheless obtain 54 cents on every dollar of prepayment whose use it would not otherwise be entitled to.

his estate tax in previous years, possibly 20 to 30 years earlier. The hypothetical taxpayer, therefore, is not "saved $217,200, or 42 percent of the normal estate tax," and is not relieved of this portion of the burden a taxpayer who could not take advantage of the bill must bear.

Respectfully submitted,

Morris J. Levin

MJL:knr

Statement of
Robert M. White, II
in support of
The Independent Local Newspaper Act
S.555

I am Robert M. White, II, the Editor and Publisher of the Mexico Ledger, a daily newspaper published in Mexico, Missouri. The Mexico Ledger has been owned and operated by my family for three generations and over 100 years, beginning on September 21, 1876. My statement in support of S.535, The Independent Local Newspapers Act, may be interpreted as an expression of my desire and intent to see this newspaper remain in my family during future generations.

Since the close of World War II, while the number of daily newspapers has remained fairly constant, there has been a tremendous growth in the number of newspapers owned by chains, with a concomitant decrease in the number of locally owned newspapers. Today, the chains own over two-thirds of our daily newspapers, and have 72 percent of daily circulation and 76 percent of Sunday circulation. This trend continues, with chains now buying locally owned newspapers at a rate of one each week, and weekly newspapers at the rate of three to four each week.

My complaint is not with chain newspapers, or how they may be operated. Without question, there are good and bad chain newspapers, just as there are good and bad newspapers published by local owners. I do object to the fact that decisions as to the sale or maintenance of newspapers are taken out of the hands of local owners because of the estate and inheritance tax laws.

Newspapers are being purchased at remarkable price-earnings ratios. The newspaper chains and media conglomerates are paying 30, 40 and even over 60 times earnings. I do not know of any other industry where the prices paid approach these levels. The inflated values placed upon the remaining locally owned newspapers result in excessive estate taxes being levied upon the death of a publisher. The Internal Revenue Service values a property at the amount a willing buyer will pay a willing seller, or the amounts being paid for like properties. In the case of newspapers, the values for estate tax purposes are far beyond the abilities of the heirs to pay, since the newspaper's earnings are not sufficient to cover the interest costs of the sums required to be borrowed.

Not only are locally owned newspapers being sold in order to pay estate taxes, but publishers are inclined to sell in order to put their estates in order, rather than having a forced sale thereafter. It is my understanding that this was the situation with the recent sale of the Nashville Tennessean.

It seems to me a serious mistake for Government policy to favor sales of independent newspapers to chains. At the least, the Government should be neutral. That is definitely not the situation that faces us today.

As a member of the Government Affairs Committee of the American Newspaper Publishers Association, I recently heard Senator Robert Morgan, of North Carolina, discuss the purposes as well as the provisions of S.555. It is my understanding that this bill would permit owners of locally owned newspapers

to prepay their estate taxes during their lifetimes. Senator Morgan explained that there would be little if any cost to the Government, in that the Treasury would have the use of the prepaid sums before they were due and owing to the Government. He also made it clear that he, and the co-sponsors of S.555, were not particularly concerned about the individual owners, but were seeking enactment of the legislation in order to retain in the public interest independent, locally owned daily and weekly newspapers.

I strongly endorse these purposes. Although I recognize that the Family Farm Act of 1976 was enacted to provide estate tax relief for independent farmers, I have been reluctant to seek like relief for newspapers. I would prefer it for all small business. However, I do sincerely believe our shrinking, diverse press is such an important part of our democratic process, it must be protected soon - before it is further diminished. Further, I believe a locally owned newspaper has an important role to play in its community which usually cannot be filled as well by a chain newspaper. Lastly, in America, too much power - press power or any other kind of power - in too few hands, is unacceptable.

I urge that the Senate Finance Committee give favorable consideration to S.555, in order to save from extinction the species known as the locally owned newspaper.

AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

1725 DE SALES STREET, N.W., WASHINGTON, D.C. 20036 TEL 347-2315

OFFICE OF THE PRESIDENT

November 13, 1979

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation & Debt Management
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the nation's major manufacturers of aircraft, aircraft engines and related components and equipment, the Aerospace Industries Association of America, Inc., would like to take this opportunity to endorse S. 873, permitting the Secretary of the Treasury to waive the foreign residency requirements of Sections 911 and 913 of the U. S. Tax Code for citizens working in Iran.

Our member companies which have operations in Iran promised their employees that the additional living allowances they were offered in order to persuade them to accept employment in this relatively undesirable post would not result in additional income taxes, as guaranteed by Sections 911 and 913. Now, for obvious reasons, most of those employees will have to return to the United States prematurely, making them ineligible for the benefits of those tax provisions. Instead, their employers will have to assume the additional tax burdens, putting these companies at a further competitive disadvantage with companies of other industrialized countries, which levy no income tax whatsoever on their citizens who work abroad.

For reasons of equity, and to compensate these employees and companies for conditions over which they had no control, we feel that S. 873 should be passed as expeditiously as possible. It is hoped that our views can be included in the record of your Subcommittee's hearings on this legislation.

Yours very truly,

Karl G. Harr, Jr.

Price Waterhouse & Co.

OFFICE OF GOVERNMENT SERVICES
1801 K STREET, N.W
WASHINGTON, D.C. 20006
202-296-0800

November 14, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management Generally
2227 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

We are pleased to have the opportunity to express our support for passage of S.1638 which proposes to amend the Internal Revenue Code of 1954 to provide for the amortization of startup expenditures paid or incurred in starting a new trade or business. This bill is directed to expenditures which are not presently deductible resulting in inequities between taxpayers.

S.1638 would allow taxpayers--whether or not incorporated--to elect to amortize expenditures paid or incurred prior to the start of business. The taxpayer would be permitted to elect amortization for a period of not less than 60 months. Expenditures falling into this category, usually referred to as "preopening" or "startup" costs, are defined in the bill as:

"(1) an ordinary and necessary expense incident to the investigation, formation, and creation of the trade or business;

(2) chargeable to capital account; and

(3) of a character which, if expended incident to the investigation, formation, and creation of the trade or business having a determinable life, would be amortizable over such life."

Typical examples of such expenditures are those incurred for investigating the new business venture, as well as advertising, training, administration and other similar items incurred prior to actual commencement of the trade or business. Current law renders these expenditures nondeductible if they are incurred prior to commencement of the business. It is significant to note that the taxpayer expenditures referred to by this bill are such that they normally would be fully deductible if they were incurred after the commencement of business.

In our opinion, S.1638 provides for a necessary and proper expansion of the deductible items under the Internal Revenue Code. In addition, enactment of S.1638 would add incentives to taxpayers starting businesses or expanding businesses into new areas. Further the bill would reduce much of the disparity in tax treatment given expenditures incurred in connection with the expansion of an existing business and the formation of a new business by allowing deductions for similar expenditures in each case.

One of the significant benefits to be derived from the passage of S.1638 would be the elimination of continued controversy which presently exists between taxpayers and the Internal Revenue Service. This controversy involves the definition as well as the deductibility of startup expenses. Under current law, the IRS treats preopening or startup costs incurred by new business ventures as nondeductible capital expenditures, based on the theory they are not ordinary and necessary expenses incurred in a trade or business inasmuch as the business does not exist. Once the business has been started, subsequent similar expenditures are deductible. Since the question of when a business actually begins is one of fact with no clear cut guidelines or rules, considerable differences occur between taxpayers and the IRS resulting in time consuming and costly negotiations sometimes leading to litigation. Enactment of S.1638 would constitute a major step in reducing such controversy since it would provide a deduction for all such costs through amortization without regard to the date a trade or business began.

The Bill, as drafted, makes provision for the taxpayer to treat the startup expenditures as deferred expenses amortizable over a period not less than 60 months. S.1638 leaves the method of making such an election to the Secretary by requiring that regulations are to be issued prescribing the manner in which the election should be made. It is our opinion that the election procedures should not be overly restrictive. To be overly restrictive would not be in keeping with a key feature of the bill, that being a desire to eliminate unnecessary and costly controversy.

For example, if the Secretary should prescribe that an election to amortize startup expenditures may be made only with a timely filed tax return and would cover only the specific expenditures itemized in the election, the effectiveness of the provision would be seriously impaired. This is because controversy surrounding other items which the taxpayer may have regarded as ordinary and necessary nonstartup expenses will continue. Under these circumstances, taxpayers would not have available the

opportunity to yield to an IRS disallowance on the basis that amortization would be available. With a highly circumscribed election procedure, taxpayers would still face the risk of having to capialize permanently borderline items that were initially deducted, without the opportunity to bring those items under an amortization election if they are disallowed as current deductions.

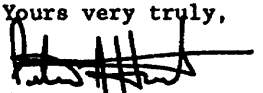
In summary, we feel the proposal to provide for amortization of startup expenses as set forth in S.1638 presents an effective approach toward the elimination of unwarranted controversy between taxpayers and the Internal Revenue Service. Perhaps more important is the proposed elimination of disparity which presently exists between those seeking to expand their businesses and those seeking to start a new business.

In addition to the merits of S.1638 we feel the timing of taxpayer election to amortize startup expenses should not be so restrictive as to force existing businesses to elect to amortize startup expenses, incurred in connection with an existing business, merely as the result of concern that failure to do so will result in permanent loss of a legitimate deduction. In our opinion the Legislation should make this clear.

* * * * *

We hope our comments are helpful to you. If you, your staff or other members of the Subcommittee wish to discuss this matter with us feel free to contact me.

Yours very truly,



Peter J. Hart
National Director of
Tax Policy

Price Waterhouse & Co.

Statement of
ROBERT B. ATWOOD
before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
in support of
THE INDEPENDENT LOCAL NEWSPAPER ACT
S.555

My name is Robert B. Atwood, and I am the Publisher and Editor of The Anchorage Times, the largest daily newspaper serving the State of Alaska. The Anchorage Times is locally owned and managed, with allegiance only to the community and state which we serve.

A generation ago, most newspapers were locally owned in the communities they served. The owners were vitally interested in all parts of community life, and deeply involved with community problems.

The Anchorage Times is involved with and a part of all things pertaining to Anchorage and Alaska. We are a real part of the greater community we serve. We want to continue this relationship, and to be sure that our successors will be like us, a part of this community. While we can sell our newspaper for a very handsome price, we have no intention of doing so, now or in the foreseeable future.

The problem is how to pay the Federal and state taxes that fall due when there is a death in the family. The laws encourage chains to keep buying more papers, and for individuals to sell for estate planning purposes.

There can be no doubt that the effect of the inheritance laws is the greatest single factor leading to many of the sales

of individually-owned newspapers. It is often the case that, when a publisher declines to sell out, his heirs are forced to sell in order to pay the estate taxes. There is sometimes no way a publisher can be certain that control of a newspaper can be retained after his demise.

In our own case, my wife and I believe that our newspaper can successfully be passed on to our children, but, because of the estate tax laws, it would appear that they must be the last in our line to control our publication. The estate tax laws seem to mandate a sale, which decisions should rightfully be left to my family.

I urge the Finance Committee to give favorable consideration to legislation to alleviate this problem.

UNIVERSITY OF MASSACHUSETTS
AMHERST · BOSTON · WORCESTER

DEPARTMENT OF GENERAL BUSINESS & FINANCE
SCHOOL OF BUSINESS ADMINISTRATION
AMHERST, MASSACHUSETTS 01003

October 23, 1979

Mr. Michael Stern, Staff Director
Senate Committee on Finance
Room 222 Dirkson Senate Office Building
Washington, DC 20510

Dear Mr. Stern:

I understand that hearings are being held and consideration being given to the Nelson Bensen Bill S 1543 to defer taxes on newly issued dividends used to purchase stock through a dividend reinvestment plan. While I can not make the hearing, I would like to offer as input my article on the subject. A copy if enclosed. If I can be of further assistance, please let me know.

Sincerely,

Ben Branch
Professor

Enclosure

bl/3925

CAPITAL SHORTAGE, DIVIDEND REINVESTMENT AND TAXES

by
BEN BRANCH(*)

Abstract

There appears to be general agreement that not enough capital is being generated to meet the ever increasing demands placed on the economy. Various ways of stimulating capital formulation have been proposed (elimination of the double taxation of dividends, increasing the investment tax credit, reducing corporate tax rates, etc). Unfortunately, most of the proposed methods are quite costly in the sense that they would require a large tax loss or subsidy to obtain no more than a modest amount of additional capital formation. Moreover many of the proposals would also either be inequitable or lead to an undesirable distortion of the capital allocation process. There is, however, one way of increasing capital formation which appears to be cost effective, equitable and would improve capital allocation. By simply eliminating the double taxation on funds reinvested through dividend reinvestment plans, large sums of additional capital would be raised. The likely tax losses would be modest. Moreover a current inequity in the tax system would be favorably modified and stockholders would be given more power over the capital allocation process. It is an idea well worth considering.

In two earlier articles in this *Review* Sufrin and Moore(1) and later Sufrin and Anderson(2) discussed the capital allocation problem. Both

(*) University of Massachusetts, Dept. of General Business and Finance. Amherst, Mass.

(1) S. SUFRIN and C. MOORE, « Retained Earnings, Capital Gains and Progress », *Rivista internazionale di Scienze Economiche e Commerciali*, 1974, No. 2, pp. 137-145.

(2) S. SUFRIN and P. ANDERSON, « Undistributed Profits in a Mature Economy », *Rivista internazionale di Scienze Economiche e Commerciali*, 1976, No. 1, pp. 6-22.

articles were concerned with the role of retained earnings in the capital allocation process. It was argued that many large firms have access to substantial sums of internal capital. Thus a significant amount of capital does not get allocated through the market. Following Logue and Merville (3), Sufrin and Anderson advocate a system whereby profits are fully paid out to stockholders and all new equity is raised through the capital market. The two groups of authors both point out that such a procedure would significantly increase smaller firms' access to capital. They further note that it is the larger firms which are generally able to obtain so much funding internally and they often invest it where the return is quite low.

Any proposal to prohibit or greatly restrict a firm's ability to retain and reinvest its own earnings, is certain to be fiercely opposed by powerful and entrenched interest groups. Moreover, such proposals deal only with the micro aspect of capital allocation while leaving the macro aspect largely unaffected. That is, the forced disgorgement of retained earnings would quite possibly lead to a better allocation of capital but almost certainly would not produce any increase in the amount of capital formation.

The Capital Shortage

The increasing burdens placed on our economy have lead to ever greater demands for results. In the past capital has been needed for such traditional uses as providing for an expanding labor force and a growing standard of living. Now, however, expectations appear totally unrealistic. For example, society would like: 1) A cleaner environment with no reduction in the rate of economic growth; 2) Increasing amounts of energy from sources which continue to be depleated; 3) More energy efficient technologies which also are less polluting; 4) An improved public transportation system without sacrificing any of the convenience of the private transportation system; 5) A revitalization of the urban areas without increasing the burden on suburbia; 6) Products and processes which are safer to produce and consume and yet no more costly to purchase; 7) More and better jobs for women and minorities without any adverse employment impacts on white males; and 8) A reduction in military exports without any reduction in the imports that they finance.

While our sophisticated industrial economy is capable of making progress with each of these tasks, its efforts may be severely limited by

(3) D. Logue and L. Merville, « Capital Allocation in a Mature Economy », *MSU Business Topics Winter 1974*, pp. 57-61.

the availability of capital. Dealing with problems like pollution, energy and growth will take hundreds of billions of dollars. These funds must come from somewhere. In essence they are generated from that portion of our output which is produced but not consumed. Thus, society's decision to save will provide the amount that is available for investment in the physical assets which provide for such things as jobs, environmental clean up and energy.

The Allocation Process

While the spending-savings decisions of households establishes how much is available, the allocation of the funds is accomplished in other ways. A significant portion of the allocation takes place within firms as they decide how to spend the sums released through depreciation allowances and retained earnings. Sufrin and Anderson would like to see the retained earnings portion of these funds flow to the shareholders. Such funds would then be available for reinvestment through the other principal method of allocation: the capital market.

In its broadest sense the capital market consists of the set of places and procedures where short term debt, long term debt and equity capital are raised and allocated. In essence all those, who wish to seek funds in excess of the amount generated internally, must compete by bidding against others who also seek funding. That is corporations, governments and individuals offer prospective rates of returns (4) to those who have capital to rent or sell. The amount available goes to the highest bidders. Those who can not match the market bid are frozen out of the allocation.

It is in a sense erroneous to speak of a capital shortage as there will by definition always be enough capital at the market clearing price. And yet there is the very real possibility that the available amount will not be sufficient to meet the needs and expectations of society. Large governmental deficits coupled with modest savings rates could easily lead to some rather unpleasant situations such as insufficient fuel to meet the demand for home heating, failure to install mandated pollution abatement equipment, failure to develop automobiles which are sufficiently energy efficient, etc. All of this could happen if industry is unsuccessful in its effort to raise the capital it needs to carry out such tasks.

(4) When funds are borrowed the terms are specified precisely and the borrower is expected to fulfill them. When, however, equity capital is raised, the return which is offered is only an expectation depending on future events.

Clearly there is a need both for better allocation of capital and better ways of insuring that sufficient capital is available to meet our expectations. Currently there is a great deal of debate over how to encourage capital formation. This stems in part from the very depressed capital markets of the 1974-75 period and the fact that even now it is relatively difficult for many firms to raise capital (5). Interest also arises because of the debate over how to reform our corporate tax system so as to make it more equitable and incidentally more efficient at encouraging capital formation (6). While the somewhat better capital market conditions of 1975, 76 and 77 have eliminated the crisis aspects of the problem, the scarcity aspects continue.

Encouraging Capital Formation

Let us move to a more specific consideration of how capital is allocated and how taxes affect that allocation. The bulk of equity capital is raised internally through retained earnings while most of the amount raised externally is in the form of debt (7). And yet it is the sale of external equity that is the key to the capital formation process. Debt can only be raised to the extent that there is enough equity to support it (8). Retained earnings are a residual which may or may not be sufficient to meet funding needs. External equity funding, at the margin, is the primary determinant of capital formation. If firms find it easier to raise external equity capital, they will then be able to borrow more freely. Therefore, such firms would be able to supplement their equity capital with additional debt and thus maintain a proper balance between their debt and equity. Clearly anything that encouraged the raising of equity capital would also be likely to stimulate

(5) R. SWINARTON, « Our Capital Markets and Their Outlook », Paper presented to Seminar for NASDAQ Company executives, December 8, 1975.

(6) D. FARNEY, « Carter Favors Eliminate Preferences for Capital Gains in Tax Revision Plan », *Wall Street Journal*, July 6, 1977, p. 3; L. THUROW, « Abolish the Corporate Income Tax », *Wall Street Journal*, July 6, 1977, p. 16.

(7) In 1976 for example retained earnings equaled $18.8 billion while net increases in borrowing amounted to $20 billion. Equity sales only amounted to $13 billion. Thus, of the total amount of new capital raised, only 25% came from external equity sales while 36% came from internal equity and 37% came from new debt.

(8) For example, one of the first things firms began to do after returning to modest profitability in 1975 and 76 was to reduce some of their outstanding debt - particularly their short term debt.

additional borrowing as well. Thus total capital formation is likely to be increased by more than the increase in equity sales taken alone.

It is relatively easy to think of ways to encourage more capital formation. Formulating cost effective incentives is, however, much more difficult. To see this let us first consider the various ways that equity capital is raised. As already noted large sums of equity are retained from profits. Among the methods of raising external equity capital are: sale of common and preferred stock through rights offering and public sales; conversion of convertible bonds; exercise of warrants; and participation in dividend reinvestment plans.

An unlimited number of tax incentives could be devised to encourage one or more of these methods of raising equity. For example, there has been a good deal of talk of eliminating the double taxation of dividends. Currently in the US, profits are taxed at the corporate level and taxed again when paid out as dividends. Income from proprietorships and partnerships, however, is taxed only once. Eliminating this inequity would make stock more attractive to stockholders while providing investors with more funds to invest. Similarly an increase in the investment tax credit, a reduction in corporate tax rates, allowing price level depreciation, expanding the dividend exclusion and a host of other proposals would encourage capital formation. The problem with these various approaches is that they are not particularly cost effective. For every dollar of new equity raised, several dollars in tax revenues are likely to be lost. Such revenues would have to be made up somewhere else([9]). Moreover, a significant part of the tax benefit would likely accrue to those in the higher income brackets.

The ideal reform would simultaneously improve capital allocation, encourage capital formation and do so in an equitable and cost effective manner. It is a tall order but perhaps there is a way. The traditional methods of raising equity capital are rather well developed and would probably be costly to stimulate. The dividend reinvestment plans are, however, a relatively new and promising concept([10]). Possibly such plans could provide the vehicle for accomplishing the desired goals.

([9]) That is the Federal government has to raise a given amount of tax revenues to accomplish its spending goals and avoid an unduly inflationary deficit. To the extent that tax breaks are given to one group, something tends to have to be done elsewhere to offset the revenue loss.

([10]) R. PETTWAY and R. MALONE, « Automatic Dividend Reinvestment Plans and Non-Financial Corporations », *Financial Management*, Winter, 1973, pp. 11-18.

Dividend Reinvestment Plans

A growing number of firms offer their stockholders the opportunity to reinvest their dividends in additional shares of the company (11). The plans generally offer reduced commissions and in the case of a few firms (AT&T for example) a discount from the market price. Some firms purchase shares for their plans in the open market while others issue new shares to their participating stockholders. Only in the latter case is any additional equity actually raised.

The incentive of reduced commissions has thus far only encouraged modest participation in these plans (12). The discount offered by a few firms has led to increased participation (13). Still the vast bulk of dividends are paid out in cash.

There is currently no tax advantage to dividend reinvestment. Whether the dividends are received in cash or used to purchase additional shares, the amount is taxed as ordinary income to the investor (14). This double taxation of dividends makes firms reluctant to establish a high payout ratio (ratio of dividends to profits).

If the firm simply retains and reinvested its earnings directly, only one tax is due on the income (15). If the retained earnings produce growth in profits and ultimately an increase in the market price of the stock, the investor is able to reap his or her reward through tax preferred capital gains (16). This advantage is lost when the dividends are declared and

(11) « Compound Your Holdings », *Forbes*, April 1, 1977, p. 72.

(12) Most plans are able to offer significantly lower transactions costs than if the dividends were used to buy stock on the open market. This results from a commission structure which offers large discounts for volume trades.

(13) AT&T reports that 22% of its shareholders reinvested a total of $432 million in 1976. American Telephone and Telegraph Company, *Annual Report*, p. 6, 1976.

(14) A minor exception is the dividend exclusion. Each stockholder may exclude from taxable income $100 annually. This exclusion applies whether the dividends are reinvested or not.

(15) Indeed, many firms follow a no or low dividend policy in large part to avoid this double taxation of dividends. Some of these firms pay dividends in the form of additional shares (stock dividends) in an attempt to substitute for the lack of a cash dividend. There is relatively little difference between stocks dividends coupled with a low payout, versus a higher payout and substantial dividend retention. The firm would end up with about the same amount of additional equity. Shareholders in the aggregate would own a firm worth about the same amount in either case. The principal difference is that the cash dividend is fully taxed while there is no current tax on the stock dividend.

(16) When a capital asset is held long enough (nine months in 1977 and twelve months in 1978 and thereafter), only half of the gain on its sale is taxed.

reinvested. There are, however, two good reasons for encouraging the firm to pay dividends and then seek their reinvestment. First, a firm's stockholders are a heterogenous group with diverse needs. By paying out a generous dividend, the firm can satisfy the needs of those stockholders seeking a steady source of income. Those who do not need the income can simply return it to the firm in exchange for additional shares. Second, the stockholders' right to participate or not participate in the dividend plan could become an important check on management. Firms with bright prospects and good records are likely to attract significantly greater participation than those with less attractive prospects. This should cause managers to place a higher value on reinvested dividends and lead to a better allocation of capital than is presently the case.

A Tax Incentive for Dividend Reinvestment

Encouraging the growth and development of dividend reinvestment plans should be rather easy to do by eliminating the double taxation of those reinvested dividends which supply the firm with additional capital. Thus, those plans which provide for reinvestment of dividends in newly issued stock would qualify for a special dividend exclusion. Thus those who took advantage of such plans would incur no immediate tax liability as a result of their participation. Now a few loopholes would have to be plugged so the law's purpose would not be thwarted. First, in order for a plan to qualify the firm must not be allowed to make any offsetting purchase of shares in the open market. The money it raised through reinvestment would have to be used by the firm. Second, the stockholders would not be allowed to make any offsetting sales. That is, the tax benefit of reinvestment would be lost if the shareholder turned around and sold shares equivalent to the amount of shares it received through reinvestment ([17]). Finally, reinvested dividends could be made a tax preference item so that the benefit to the very wealthy would be limited ([18]).

([17]) This could be accomplished in a rather straightforward fashion. Any sale of shares by a participator in a dividend reinvestment plan would be treated on a Last In First Out basis. Thus the gain on any recently purchased shares would generally be short term.

([18]) A minimum tax of 15% is now applied to certain types of tax sheltered income to the extent the total exceeds $10,000. Included in this group of tax preference items subject to the minimum tax are the otherwise untaxed half of long term capital gains; depreciation, amortization and depletion which exceed the straight line value; bad debt loss reserves which exceed experience, etc. Making dividend reinvestments subject to the minimum tax would cause many wealthy individuals to pay a tax of 15% on the amount reinvested.

The Proposals' Impact

Now let us consider the proposal's impact on capital formation, tax receipts, capital allocation and income distribution. Currently about $ 38 billion is paid out in dividends annually. How much of this would be reinvested can only be guessed at. AT & T has been able to obtain a 22% participation rate by offering a 5% discount. Since the tax advantage would probably be worth more than 5% to most individual stockholders, somewhat better participation might be anticipated. Perhaps 30% of dividends would eventually be reinvested if the proposed tax incentive were passed. This is no more than a « guesstimate », as the actual participation would depend first on how many corporations offered qualifying plans and then what the preferences of their stockholders turned out to be. It should be clear that stockholders now able to avoid taxes on their dividend income would have little incentive to participate([19]). There are also many investors who depend on their dividend income as a source of spendable funds. Still others may prefer to receive the dividends in cash so that they could reinvest the funds elsewhere. Finally, many firms would not need to raise additional capital and therefore would not offer qualifying plans.

A 30% participation rate would amount to new equity sales of $ 11.4 billion at current rates. The net increase is more difficult to estimate. The amount of new equity raised through dividend plans might offset some other types of equity sales. Estimating this offset is quite tricky. In the 1973-76 period annual equity sales of both common and preferred stock amounted to $ 11.0, $ 6.2, $ 10.9 and $ 13 billion. By selling additional equity through reinvestment plans, some firms would have less need to sell stock through rights offering and underwritings. Moreover some firms might raise their dividend rates so that they could offer the plan and yet avoid raising more capital than they needed.

Still many stock offerings would continue to be made as dividend reinvestment could not provide sufficient new equity for many types of

([19]) Through various devices a substantial amount of dividend payments goes untaxed. Each individual can exclude up to $100 annually from taxable income. Corporations pay taxes on only 15% of dividends from firms that they own less than 85% of and no tax at all on the dividends of firms which they own more than 85% of. Dividends paid to pension funds and non profit institutions are not taxed. Capital distribution dividends are not taxed (though they have the effect of reducing the basis on the stock). Individuals whose deductions exceed their income would pay no taxes on any dividend income they might receive. These various devices probably exclude about half of dividend payments from any tax liability.

firms (those which paid no dividends needed more equity than could be raised from dividend reinvestment or were just beginning operations). Other firms might find that they were able to raise sufficient funds from their common shareholders but still needed to go outside to raise preferred equity([20]).

Moreover, there would be offsets to the offset. Some firms including AT&T use their dividend reinvestment plans as a mechanism for making additional sales to their stockholders. AT&T stockholders may invest up to $3,000 per quarter over and above their dividend reinvestment. If the tax incentive were enacted, more firms might offer optional additional investment plans like AT&T's. Also the tax incentive would tend to make stock ownership more attractive relative to other types of investments. This would make it easier for firms to market their equity issues and therefore might encourage more offerings. Taking all this into account, a ballpark estimate is a decline in traditional stock sales of $2 to $4 billion and thus a net increase in equity sales in the neighborhood of $7 to $9 billion. Additional debt to go along with this equity might raise the total of the added capital formation to $10 to $14 billion. This is compared with a total capital formation of $51.8 billion in 1976. Even if the actual figure were less than half the estimated range, it would amount to more than a 10% increase in the total amount raised. Such an increase could make a significant difference in our ability to meet our future needs.

It is also likely that dividend reinvestment would hold up somewhat better in a downturn than would other types of equity sales. Thus, the 45% decline in equity sales from 1973 to 1974 would probably have been significantly less severe had dividend reinvestment been more widespread. Since the need for equity capital continues in a downturn, this support would be quite worthwhile. In the 1974-75 recession most firms were forced to borrow large sums of money short term since this was the only source of external funding available. The very high market rates of the time (prime rate of up to 12%) no doubt discouraged much business activity that would have otherwise taken place. Such a discouragement had the effect of deepening and prolonging the recession. With capital easier to raise in recessionary periods, downturns might well be shorter and less severe.

([20]) Even if firms offered a dividend reinvestment plan to their preferred stockholders, relatively few would be likely to accept. Most preferred stockholders have purchased the generally higher yielding stock for its dividend. Many owners of preferreds are corporations who are therefore able to avoid paying taxes on 85% of the amount received.

Now let us consider what the impact on tax revenues would likely be. A 30% participation rate amounts to $11.4 billion in reinvested dividends. Some of this amount would have escaped taxation anyway but the vast bulk would be removed from taxable income. Assuming a 30% marginal tax rate implies that the immediate tax loss would be in the order of $3.4 billion. Various factors would reduce the net loss. First, a small portion would be subject to the tax on tax preference items. Second, stockholders would eventually have to pay capital gains taxes on the value represented by the reinvestment. This should reduce the tax loss by about half the $3.4 billion. Finally, the additional economic activity stimulated by the equity sales would be expected to create taxable income. Thus, the net tax loss to the Treasury would be no more than $1.7 billion and could well be much less.

Potential Drawbacks

Two arguments that one might raise against this proposal are that it would tend to favor large established firms and it would open a tax loophole for the wealthy. Let us consider both points.

It is true that a tax incentive for dividend reinvestment would give disproportionate benefits to those businesses that are established and stable enough to pay dividends. By no means would this limit the advantage to large firms, as there are many smaller businesses that also pay dividends and seek capital. Companies which are not profitable enough to pay dividends would not be helped, but such firms would have difficulty raising capital in any case. The principal group that might be harmed by this proposal would be the new firms trying to raise venture capital. To the extent that the tax incentive made it more attractive to invest in dividend paying stocks, funds would be drawn away from other investment outlets. Among the investment outlets likely to be affected are the newly formed firms trying to tap the venture capital market. Since the boom-bust period of the late 1960's, however, there has been relatively little interest in the new issues market([21]). Thus, any further discouragement would be likely to have very little actual impact — at least in the short run. If, however, the new issues market is ever to come back, a tax incentive which discriminates against it would not be helpful.

([21]) P. REVZIN, « Fledgly Firms Find Risk Capital Still Flies Far Out of Their Reach », *Wall Street Journal*, November 9, 1976, p. 1.

The venture capital market plays an important role in our economy. Most large established firms start out as small untested companies looking for venture capital. The opportunity to raise such capital should not be cut off or lessened. Thus, some sort of offsetting incentive (such as a tax credit for purchasing new issues) would be needed to stimulate this market.

There is also some truth to the second objection. Those who could profit most from the tax incentive would tend to be the individuals in the highest tax brackets. And yet the benefit to those in the highest tax bracket would not be all that great. First, they would have to pay a tax on the tax preference dividend reinvestments. Then they would have to pay a tax on half the capital gain that the reinvested dividend represented. Finally the other half of the capital gain would be subject to the tax preference tax. All in all those subject to the tax preference items would not escape taxation by much more than under the current system. Those in the upper middle income brackets with less than $10,000 in tax preference income would receive it more favorably. But even they would still find the tax advantage substantially less than that offered by tax free municipal bonds. Furthermore the total estimated tax benefit is less than $2 billion and much of this would go to people in middle income brackets. It should also be borne in mind that this tax incentive would actually be designed to alter the present inequity which produces a double taxation of dividends. Thus, it is quite possible to argue that this proposal would actually make the tax system more equitable. Even if it is viewed as inequitable, the impact would be quite modest.

Conclusion

Improving capital allocation is but one part of the overall capital problem. Increasing capital formation so that our economy's full potential can be realized, is at least as important. Various ways are available but the proposed tax incentive for reinvested dividends has much to recommend it. Deferring the current tax liability for qualifying dividend reinvestment plans would encourage a significant increase of capital formation. Unlike most of the other proposals, there would only be a modest tax loss. Moreover encouraging firms to raise more capital from their stockholders might well improve the capital allocation process. It is a proposal well worth careful consideration.

SCARSITA' DI CAPITALE, REINVESTIMENTO DEI DIVIDENDI E IMPOSTE

In due articoli apparsi su questa rivista Sufrin e Moore e poi Sufrin e Anderson hanno discusso il problema dell'allocazione del capitale. Entrambi gli articoli erano interessati al ruolo degli utili non distribuiti nel processo di allocazione del capitale, e sostenevano che molte grandi imprese hanno accesso a somme notevoli di capitale interno. Così una quota considerevole del capitale non viene investita attraverso il mercato. Seguendo Logue e Merville, Sufrin e Anderson proponevano un sistema in cui i profitti fossero completamente distribuiti agli azionisti e tutte le nuove emissioni fatte attraverso il mercato dei capitali. Opinione dei due gruppi di autori è che una procedura siffatta aumenterebbe in misura significativa l'accesso delle imprese minori al mercato dei capitali, giacché in generale sono le grandi imprese a finanziarsi internamente per poi investire dove spesso il rendimento è assai basso.

Qualsiasi proposta intesa a proibire o a limitare drasticamente la possibilità di non distribuire e reinvestire gli utili incontrerebbe certamente la fiera opposizione di potenti gruppi d'interessi. Queste proposte considerano inoltre soltanto l'aspetto micro dell'allocazione del capitale e lasciano quello macro pressoché fuori discussione. Difatti uno scoraggiamento forzato degli utili non distribuiti potrebbe sì portare a una migliore allocazione del capitale, ma quasi certamente non contribuirebbe ad incrementarne la formazione.

La scarsità di capitale. I crescenti oneri imposti all'economia hanno reso più esigenti in materia di risultati. In passato il capitale era richiesto per usi tradizionali come quello di provvedere a una forza lavoro in espansione e a un crescente tenore di vita. Ora le pretese sembrano addirittura fantastiche. La gente vorrebbe ad esempio: 1) un ambiente più pulito senza ridurre il tasso di sviluppo economico; 2) crescenti ammontari di energia da fonti in via di esaurimento; 3) tecnologie energetiche più efficienti e meno inquinanti; 4) migliori trasporti pubblici senza sacrificio del trasporto privato; 5) rivitalizzazione delle aree urbane senza accrescere gli oneri dei sobborghi; 6) prodotti e processi più sicuri per la produzione e per il consumo e tuttavia non più cari; 7) maggiori e migliori impieghi per le donne e le minoranze senza influire sull'occupazione dei maschi bianchi; 8) riduzione delle esportazioni militari senza nessuna riduzione nelle importazioni ch'esse finanziano.

Mentre la moderna economia è in grado di affrontare tutti questi compiti, i suoi sforzi possono essere grandemente pregiudicati dalla mancanza di capitale. Problemi come l'inquinamento, l'energia e la crescita richiedono centinaia di miliardi di dollari. Questi fondi devono venire da qualche parte. Essenzialmente essi sono generati dalla porzione di prodotto non consumato.

Il processo allocativo. Mentre le decisioni spesa-risparmio delle famiglie stabilisce quanto è disponibile, l'allocazione dei fondi si realizza in altri modi. Una parte importante dell'allocazione avviene entro le imprese, che decidono

come spendere le somme rese disponibili dalle quote d'ammortamento e dagli utili non distribuiti. Sufrin e Anderson vorrebbero che questa porzione di utili non distribuiti andasse agli azionisti. Tali fondi sarebbero allora disponibili per l'investimento attraverso l'altro principale metodo di allocazione: il mercato dei capitali.

In certo senso è sbagliato parlare di scarsità di capitale quando per definizione vi sarà sempre capitale sufficiente a quel prezzo che uguaglia la domanda all'offerta. V'è peraltro la prospettiva reale che l'ammontare disponibile non sia sufficiente ai bisogni della società. Grossi disavanzi governativi con modesti tassi di risparmio potrebbero facilmente condurre a situazioni spiacevoli come combustibile insufficiente alla domanda familiare, impossibilità di installare attrezzature essenziali antiinquinamento, e così via. Tutto questo se l'industria non riesce a raccogliere il capitale necessario.

Incoraggiare la formazione del capitale. Negli S. U. la maggior parte del capitale d'impresa è raccolto all'interno mediante gli utili non distribuiti; mentre la maggior parte del capitale ottenuto fuori dall'impresa è sotto forma di debito. E tuttavia è la vendita di titoli a terzi la chiave del processo di formazione del capitale. Ci si può indebitare soltanto nella misura in cui vi è sufficiente capitale aziendale a garanzia. Gli utili non distribuiti servono certamente allo scopo, ma in misura insufficiente. Il finanziamento attraverso nuove emissioni resta, al limite, il momento principale della formazione del capitale. Se le imprese trovano agevole l'accesso a nuovo capitale di rischio, saranno anche in grado di prendere a prestito con maggiore facilità. Potranno quindi integrare il capitale di rischio col prestito mantenendo tuttavia un rapporto adeguato tra mezzi propri e mezzi di terzi.

E' relativamente facile immaginare modi per incrementare la formazione del capitale. Più difficile è trovare incentivi efficaci. Metodi consueti per la raccolta di nuovo capitale sono: la vendita di azioni ordinarie e preferenziali; la conversione di obbligazioni convertibili; l'esercizio dell'opzione; la partecipazione ai piani di reinvestimento dei dividendi.

Il successo di questi metodi potrebbe essere assicurato da incentivi fiscali. Per esempio abolendo la doppia tassazione dei dividendi. Attualmente negli Stati Uniti i profitti sono tassati a livello d'impresa e nuovamente quando vengono erogati sotto forma di dividendo. Il reddito della proprietà e delle partecipazioni è invece tassato una volta soltanto. L'eliminazione di queste sperequazioni renderebbe le azioni più appetite all'investitore e metterebbe maggiori fondi a disposizione delle imprese. Nello stesso modo agirebbero i crediti d'imposta sull'investimento, la riduzione delle imposte societarie, gli ammortamenti consentiti sui valori reali e così via.

L'autore considera in dettaglio la soluzione da lui preferita, che è il reinvestimento del dividendo con piani appropriati da parte delle imprese.

La migliorata allocazione del capitale è soltanto una parte del problema generale. Almeno altrettanto importante è l'incremento della formazione del capitale, in modo che l'economia possa assolvere ai suoi compiti. Tra i molti modi di promuovere questo incremento, l'incentivo fiscale sembra da preferirsi.

LONG ISLAND LIGHTING COMPANY
EXECUTIVE OFFICES 250 OLD COUNTRY ROAD · MINEOLA, NEW YORK 11501

THOMAS H. O'BRIEN
SENIOR VICE PRESIDENT

November 20, 1979

Mr. Michael Stern,
Staff Director
Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

I am Thomas H. O'Brien, Senior Vice President - Finance of the Long Island Lighting Company and the Treasurer of the Committee for Capital Formation Through Dividend Reinvestment.

I strongly urge adoption of S.1543 as a direct and cost-effective step towards reduction of double taxation on dividend reinvestment and towards providing additional capital to finance essential energy facilities.

In 1972, the Long Island Lighting Company instituted the first New Capital Dividend Reinvestment Plan. By 1978, there were seventy utilities with such plans. Adoption of S.1543 would not only encourage adoption of even more New Capital Dividend Reinvestment Plans, but would widen the participation in existing programs. While these are essentially small investor programs, approximately 22% of LILCO's shareowners have elected to participate in this Plan. The shareowners have generally been those with share holdings of less than $4,000 at current market value providing annual dividends of under $600. Since the proposed dividend exclusions under S.1543 are $1,500 for a single taxpayer and $3,000 if a joint return is filed, these are the small investors who would benefit most.

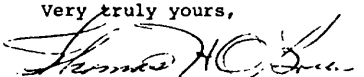
The small investor who is being most severely impacted by inflation would have an incentive for capital investment in common stocks rather than the purchase of gold, works of art, or gems as a hedge against inflation. Such non-productive investments are subject only to single taxation, while under the current system productive investment in common stocks is taxed twice.

Consultants for the Committee have estimated that adoption of S.1543 would lead to the creation of 50,000 new jobs per year through increased business fixed investments of about one billion dollars a year. This is particularly desirable when many economists are predicting a long recession.

The adoption of S.1543 would lead to new investments since its provisions are applicable only to dividends reinvested in the original issue stock of a company. This is especially important to investor-owned utilities. As the most capital intensive industry in the nation, utilities are in an adverse position when the price of money skyrockets. The high cost of money leads to higher utility rates without adding jobs or environmental benefit. In addition to requiring equity capital to build new facilities to meet increased energy demands, utilities are going to require capital to convert and replace oil-fired generating facilities.

The only significant objection raised to this bill has been that revenue would be lost to the Federal government. The opponents have failed to include in their projections the new revenue that would be received. Studies show that by the third year after adoption of the proposal, there would be a net revenue gain of six hundred million dollars. This would be in addition to the benefits derived from the creation of new jobs, the capital available for investment to increase productivity, and the anti-inflationary effect of increased reinvestment.

Very truly yours,



Thomas H. O'Brien
Senior Vice President - Finance

THO:tg

William E. Scott
Executive Vice President
Finance

Public Service Electric and Gas Company 80 Park Place Newark, N J 07101 201/430-5620

November 20, 1979

Mr. Michael Stern, Staff Director
Senate Finance Committee
Room 2727
Dirksen Senate Office Building
Washington, D. C. 20510

Sir:

Public Service Electric and Gas Company (PSE&G) fully supports Senate Bill 1543 that would defer current tax on dividends reinvested in new issue stock. We believe that the change in tax treatment proposed under the Bill would (1) help to improve the efficiency of raising capital by our Company, (2) provide our current shareholders with a more attractive incentive to invest current income, and (3) encourage additional individual investors in common stock. Stimulating capital formation and encouraging investment by individuals should be important fiscal goals in these turbulent economic times.

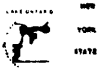
PSE&G has operated a new issue dividend reinvestment plan (DRP) since 1974. In that time the Company has been able to raise over $80 million (3.7 million shares) in new equity through the plan. This has saved us at least one full-scale sale of common stock to the public. Although the capital we currently raise through the plan amounts to only one third of our common stock requirements and just under 10% of our total new capital needs, we believe that the proposed legislation would go a long-way in making the DRP a more important mechanism for obtaining necessary new capital.

PSE&G has found its DRP to be a cost effective means of raising capital compared to a public offering of stock. Such savings realized in the cost of raising capital is beneficial to our customers as well as our shareholders.

That our current shareholders see merit in the DRP as presently established is evidenced by the participation in the plan. We now have enrolled in the plan 41,000 shareholders out of a total of 220,000 shareholders. If the individual taxes on reinvested dividends paid to shareholders were deferred, we believe that the number of participants in the plan and the extent of reinvestment would increase significantly.

The long-term benefits of capital formation encouraged by this Bill would far outweigh any near-term loss of tax revenues. As a member of the Committee for Capital Formation through Dividend Reinvestment, PSE&G endorses the Bill and fully supports the testimony of Herbert B. Cohn on behalf of the Committee.

Very truly yours,



ROCHESTER GAS AND ELECTRIC CORPORATION • 89 EAST AVENUE, ROCHESTER, N.Y. 14649

PAUL W. BRIGGS
PRESIDENT

TELEPHONE
AREA CODE 716 546-2700

November 21, 1979

Mr. Michael Stern, Staff Director
Senate Committee on Finance
Room 2227 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Stern:

This statement is submitted in support of S.1543 by Rochester Gas and Electric Corporation (RG&E), an investor-owned public utility supplying electricity, gas and steam to nearly 500,000 customers in western New York State. The corporation has outstanding approximately 15,368,000 shares and has over 48,000 shareholders.

S.1543 would defer current Federal income tax on up to $1,500 ($3,000 on a joint return) of dividends reinvested in original issue stock of a company. Such stock, if held at least a year, would be taxed at capital gains rates upon disposition.

We support this legislation because it will encourage much needed capital formation by adjusting, to some extent, a tax system which, particularly in an inflationary economy, discourages capital investment.

RG&E, like most similar utilities, has been seriously affected by the increased costs of capital. Gas and electric companies represent the most capital-intensive industry in the economy. While the average manufacturing concern has a capital investment of approximately three quarters of its annual gross income, RG&E has a capital investment equal to three times its annaul gross income. Such investment will continue to be necessary if we are to provide adequate and efficient energy service.

In 1978, our capital expenditures for new facilities amounted to over $112,000,000. We have developed an enourmous construction program for the next five years in order to enable us to continue to provide needed capacity for our customers. However, internal generation of funds to finance capital expenditures has fallen to between thirty and forty percent. As a result it has been necessary for us to go to the capital

markets more and more often. Over the past five years, RG&E has borrowed $180,000,000 and is currently negotiating to borrow another $50,000,000. Future projections indicate additional external financing over the next five years to be approximately $300,000,000. At the same time, the cost of raising funds in the market place has been rising rapidly. In March 1979, for example, RG&E replaced a maturing $16,700,000 three percent bond with short-term notes at more than eleven percent.

Ultimately, the burden of these rising costs falls on our customers. Because our services are so essential to the lives of our customers, these increasing costs are particularly troublesome.

RG&E currently has a dividend reinvestment program in which more than 9,000 of our shareholders (19%) are participating. By enabling investors to defer the income tax on dividends and to convert that tax to capital gain, we feel that many more shareholders will be encouraged to participate, thus providing us with more capital at a reasonable cost. In addition, future public equity offerings by RG&E would be more attractive to investors and, therefore, less expensive.

This legislation will also encourage capital formation by corporations in that it will be a step toward the elimination of the double tax on corporate income.

Since this proposal is aimed primarily at encouraging capital formation, reinvestments in previously existing shares of a company's stock will not qualify. Only original issue shares will qualify under this legislation. Therefore, revenue losses will be kept to a minimum. According to a study prepared by Robert R. Nathan Associates, first year revenue loss would be about $300 million, year two would be a wash, and year three would be a net gain of about $500 million (due to increased construction activity, productivity, and employment).

The deferral of current taxes on reinvested dividends will assist us and other investor-owned utilities in raising the equity needed for new plant and equipment while reducing our need to go to the expensive capital markets -- all without long-term cost to the Government. This reduction in the cost of capital formation would represent a significant savings which would be passed along to our customers.

Sincerely,

Paul W. Briggs
President

PUGET POWER

November 21, 1979

Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Attention: Michael Stern, Staff Director

Re: S.1543

Gentlemen:

This is to advise you that we support S.1543.

We are an investor-owned electrical utility serving approximately 508,000 customers in the western part of the State of Washington. As we plan for the future, virtually all indicators suggest continued strong growth in (1) the number of people who will live in our service areas, (2) the amount of business enterprise that will be generated to provide for them, and (3) the amount of energy that will be required to meet these growth needs.

In our efforts to meet our responsibilities in providing for the electrical energy needs of many of these people, one of the major challenges we face is being able to obtain sufficient capital to develop the facilities required to do the job.

One excellent source of capital that has fairly recently come upon the scene is investment in new stock by existing shareholders through Dividend Reinvestment Plans. A great deal of interest in such plans is

being shown by a substantial and growing number of shareholders. In the case of Puget Power, for instance, over 16% of our shareholders are now enrolled in our Plan. There is one area in these programs, though, which could be substantailly improved; namely, the tax treatment of reinvested dividends under such Plans. S.1543 would meet the need by giving participants in dividend reinvestment plans, such as Puget Power's, the opportunity of deferring federal income taxes on dividends reinvested through the plan.

We feel that adoption of this proposal would serve as a strong inducement to even more of our existing and future shareholders to take part in the Plan and, thus, be of special help in accomplishing the challenging task that lies ahead. We hope that the Committee will take favorable action on S.1543.

Very truly yours,

W. E. Watson
Secretary

LIFEMARK Corporation

Lifemark Building
3800 Buffalo Speedway
Houston,Texas 77098
713/621 8131

November 15, 1979

Mr. Michael Stern, Staff Director
Senate Committee on Finance
Room 2227, Dirksen Senate Office Bldg.
Washington, D.C. 20510

RE: Statement in Support of S. 1543

Dear Mr. Stern:

This statement in support of S. 1543 is being submitted on behalf of LIFEMARK Corporation, an investor-owned health care management company headquartered in Houston, Texas. LIFEMARK owns and operates hospitals and professional dental laboratories, manages hospitals for others under contract, and provides ancillary services to hospitals in areas of cardiopulmonary care, pharmacy and physical therapy management. The company's shares are traded on the New York Stock Exchange (NYSE: LMK).

Similar to other types of businesses, the investor-owned hospital management companies are capital intensive and have a continued need to obtain additional common stock capital to finance their business. They find it more and more difficult and expensive to attract the necessary capital through large public offerings in the market place.

S. 1543 has as its primary purpose the encouragement of capital formation and the provision of a stimulus to construction of essential capital facilities, employment opportunities, and a stronger economy. It would encourage increased reinvestment of dividends in original issue (OI) stock by deferring current taxes on dividends which are reinvested.

It is important to emphasize that this proposal applies only to qualified dividend reinvestment plans wherein the pool of reinvested dividends is used to purchase original issue stock from the corporation at prices related to the then current market price and generally without brokerage or acquisition costs to the participating stockholder.

Under existing tax law, Federal income tax is imposed currently on the value of the stock received by a stockholder who opts to participate in a dividend reinvestment plan. It is clear that this discourages participation by stockholders who may be pressed to use the cash dividends to pay the current tax. It is equally clear that deferral of the current tax would greatly encourage increased participation.

S. 1543 provides that a stockholder purchasing stock with reinvested dividends would be required to hold the stock for at least one year and would then be treated when sold as a capital gain. Any sale of the stock so acquired within one year of acquisition would be taxed as ordinary

rather than at capital gains rates. Suitable provisions are incorporated in the proposal to prevent abuse of the tax deferral privilege.

In 1978, the Committee for Capital Formation through Dividend Reinvestment, comprised of over twenty-one member companies of various sizes but similar in that they are capital intensive, retained the firm of Robert R. Nathan Associates to conduct a study of the economic impact of this proposal. The Nathan firm concluded that adoption of the proposal would:

1. Increase dividend reinvestment by more than 500% to some $6 billion;
2. Increase national output on the order of $10 billion annually;
3. Stimulate business-fixed investment by close to $3.5 billion annually;
4. Add the equivalent of 200,000 jobs per year; and
5. Considering the annual cap of $1,500 ($3,000 for a joint return) included in S. 1543, the proposal would involve, on a dynamic basis, a first-year revenue loss of about $300 million, result in a wash in the second year, and produce a net revenue gain of about $500 million in the third and each successive year.

The Nathan revised estimate of revenue effects, based upon the bills introduced in the 96th Congress (S. 1543 and H.R. 654), as noted in point 5 above, is almost identical to subsequent estimates by members of the staff of the Joint Committee on Taxation.

Increased participation by stockholders, as predicted by the Nathan report, would obviously be of major help in capital formation. It would help a large number of stockholders to participate in a simple, convenient and economical way to invest relatively small amounts which might otherwise be dissipated; and to obtain the advantages associated with a periodic savings plan, the principles of "dollar averaging" and the compounding effect to assist in building an investment which can provide larger cash dividends when the stockholder has need for such income.

The passage of S. 1543 may be expected to further important and desirable national policies in at least six areas:

1. It would provide substantial, direct and immediate help in the formation of new capital--a highly desirable national objective--and in the most capital-intensive companies where it is urgently needed.
2. It would eliminate, in whole or in part, the double tax on corporate dividends at the stockholder level.

Dividends reinvested in the corporation can lead to additional taxable earnings at the corporate level.

3. It would provide fairness and equity for the participating stockholder as compared with the recipient of a conventional stock dividend. Recipients of stock dividends pay not current tax, while recipients of cash dividends do. S. 1543 will assure equitable consideration to participants in qualified dividend reinvestment plans.
4. It would encourage individual savings to provide supplemental income for retirement. In this respect, the proposed program is analogous to Keogh and IRA programs which have been fostered by favorable tax treatment.
5. It would help materially in financing essentially needed energy facilities. Out of about 1,000 corporate dividend reinvestment plans today, 132 now involve the issuance of new shares, and these are primarily capital-intense public utility companies.
6. It would act as an anti-inflationary measure since it would encourage reinvestment of cash dividends which would otherwise add to consumer demands.

In summary, the proposal embodied in S. 1543 would make a substantial contribution to a healthier economy, would further several desirable national objectives, and would do so with a positive growth effect upon the national treasury. Passage of S. 1543 will provide multiple benefits for investors, for business and for the government.

Respectfully,

Robert W. Carithers

Robert W. Carithers
Vice President, Public Affairs

RWC/sh

MINNESOTA POWER & LIGHT COMPANY
30 WEST SUPERIOR STREET, DULUTH, MINNESOTA 55802
PHONE (AREA 218) 722-2641

A. J. SANDBULTE
Senior Vice President
Finance & Administration

November 21, 1979

Mr. Michael Stern
Staff Director
Senate Finance Committee
Room 2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Stern:

I submit the following comments on behalf of Minnesota Power & Light Company in full support of S. 1543 sponsored by Senators Nelson, Bentsen, Schmitt, Tower and Hollings. Minnesota Power & Light urges the Senate Finance Subcommittee on Taxation and Debt Management to report favorably on the proposed legislation to allow stockholders to defer the current income tax liability on cash dividends reinvested in original issue common stock pursuant to a qualified dividend reinvestment plan. If this legislation is passed by Congress, the benefits of such legislation will accrue to small corporate shareholders, capital intensive industries and the U. S. economy. Shareholders will be allowed to defer and in all probability decrease their income tax liability while receiving an incentive to invest for retirement needs. Certain corporations which are capital intensive, such as Minnesota Power & Light, would be provided with an alternative source of capital which in our industry would be used to construct increasingly vital energy facilities. Finally, this legislation would impact positively on the U. S. economy. Fostering investment in capital assets will discourage spending on consumer goods which, of course, is a primary cause of inflation. Furthermore, in the relative short run it is projected that increased corporate income taxes generated as a result of this legislation will easily offset any decreases in the revenue generated by the individual income tax.

Minnesota Power & Light has an ongoing need to acquire large sums of capital for the construction of energy facilities. For example, our construction budget for the period 1979-1988 will require the expenditure of $1.2 billion. By comparison this amount is approximately double our utility plant in service and under construction as of 1978. In recognition of the increasing difficulty in raising the large amount of funds needed for construction purposes, MP&L has utilized all available financing tools. In 1976 the Company initiated an original issue common stock dividend reinvestment program as a partial alternative to the typically used large public offerings of equity and long-term debt. Since that time over $3.7 million has been raised by the reinvestment of common stock dividends. Presently, twenty percent of the Company's common shareholders, representing ten percent of its outstanding common stock of 10.5 million shares, are participating in the reinvestment plan. The plan for

common stockholders, together with the Dividend Reinvestment of Preferred Stock Dividends Plan and optional cash payments by all shareholders, has generated over $8.4 million since 1976. Even though this sum is modest when compared to the Company's total capital needs in the past three years, it does become significant when one considers that without this source of capital the Company could have raised the needed funds only by further raising its rates or increasing the size of its equity or debt offerings. Our customers obviously benefited from keeping electric rates as low as possible and the Company benefits by being able to forego increased administrative and underwriting expenses and market pressure resulting from larger equity or debt offerings.

If twenty percent of our common shareholders currently view MP&L's Dividend Reinvestment Plan as a sound and prudent investment, I am confident that the tax benefits created by passage of this legislation will result in this figure increasing substantially. Any shareholder not relying on common stock dividends as a current source of income would surely take advantage of the long-term capital gains treatment of common stock dividends afforded by S. 1543. Passage of the DRIP tax deferral legislation will result in larger sums being made available for capital investment through this source of funds, thus easing the pressure to acquire capital by the more traditional means.

As mentioned before the infusion of capital which is expected to occur if this measure is passed will provide funds for the construction of capital assets. The direct impact of this measure on Minnesota Power & Light and the residents of central and northeastern Minnesota served by MP&L would be twofold. First, the additional capital raised by the DRIP tax deferral would be used to construct modern efficient electric generating and transmission facilities at a time when our country must use its domestic energy resources as efficiently as possible. Secondly, our area of the country is labor intensive and consequently, is more severely impacted by economic downturns such as the one this country is currently experiencing. Additional funds provided by this measure would help moderate the severity of any recession in northeastern Minnesota by creating jobs. Investment in additional utility plant by MP&L would provide a stimulus to the construction industry which is particularly susceptible to recessions.

I would also like to discuss the tax benefits to both the federal government and Minnesota Power & Light's shareholders. Although the estimates vary, there is little doubt that the increased corporate income taxes paid by corporations on income generated by increased capital expenditures will far outstrip any revenue shortfall in individual income taxes occurring as a result of this legislation. DRIP tax deferral will also at least partially eliminate the inequitable double taxation of corporate dividends by taxing dividends reinvested in a qualified plan and held for one year at the lower long-term capital gains rate. The effect would be to provide a tax cut to MP&L's small shareholders while at the same time increasing federal revenues. Although the amounts deferred by each shareholder would be small in amount, surely any relief from the ravaging effects of double digit inflation and ever increasing tax burden would be welcomed by the

average small investor. MP&L's records indicate that shareholders currently participating in its Dividend Reinvestment plan own an average of 304 shares. With MP&L's 1979 dividend on common stock of $1.94, the average shareholder would be allowed to defer $590 of income this year. This is well within the proposed "cap" of $1,500 for individual returns and $3,000 for joint returns.

The small investor would also reap other benefits as a result of the passage of S. 1543. The proposed legislation would encourage the small investor to use this plan as a vehicle for building a retirement fund similar to an IRA or KEOGH. At retirement the shareholder could either sell the stock received through the DRIP and pay the lower capital gains rates or start taking dividends in cash which in most instances will be taxable at lower ordinary income tax rates. As mentioned earlier, investing money rather than spending it for consumer goods will have an anti-inflationary impact. Consequently, dollars that are spent on consumer goods should purchase proportionately more than if no investment were made. DRIP also makes it easier for the small investor to compete in a marketplace dominated by institutional investors. Large investors typically have the bargaining power to negotiate favorable brokerage commissions where the single investor has no leverage. DRIP allows the small investor to forego the brokerage commission which might otherwise dissuade a person from getting into the market.

Passage of this bill will also rightfully equate dividends invested in DRIP's with stock dividends which are not taxed at the time of distribution. To treat cash dividends immediately reinvested in stock different than stock dividends, cannot be justified when the impact on the corporation is the same. It would also allow shareholders the option of taking either a cash or the equivalent of a stock dividend depending on their present income tax status.

MP&L's Dividend Reinvestment Plan has allowed the Company to decrease its effective payout ratio while simultaneously increasing the dividends declared for each share. Tax deferral of reinvested dividends would facilitate the continuation of this trend. This is important because it has allowed the Company to periodically raise the dividend rates to attract and retain investors, while paying out proportionately less cash in the form of dividends. The result has been a positive cash flow to the Company. Data for the past three years documents this claim.

	Payout Ratio (%)	Payout Raito Less DRIP (%)	Dividends Paid Per Share
1979 (Est.)	63.4	57.0	$1.94
1978	66.5	61.1	$1.84
1977	76.9	71.8	$1.76

As demonstrated by my discussion, I firmly believe that all parties concerned will be benefited by passage of the bill currently being considered by this committee. For these reasons Minnesota Power & Light Company strongly supports adoption of S. 1543 and urges favorable consideration by this committee.

Very truly yours,

A. J. Sandbulte

AJS:mkw

PHILADELPHIA ELECTRIC COMPANY

2301 MARKET STREET

PHILADELPHIA, PA. 19101

(215) 841-4000

R. F. GILKESON
CHAIRMAN OF THE BOARD

STATEMENT OF

ROBERT F. GILKESON

CHAIRMAN OF THE BOARD

PHILADELPHIA ELECTRIC COMPANY

IN SUPPORT OF

S. 1543

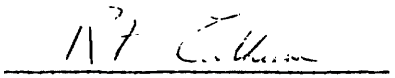
FOR

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

NOVEMBER 21, 1979



ROBERT F. GILKESON

PHILADELPHIA ELECTRIC COMPANY

2301 MARKET STREET

PHILADELPHIA, PA. 19101

(215) 841-4000

R. F. GILKESON
CHAIRMAN OF THE BOARD

Philadelphia Electric Company, an investor owned public utility having 250,000 shareholders, strongly urges your favorable consideration of S. 1543 which provides for a deferral of current taxes on dividends which are reinvested under original issue dividend reinvestment plans (with an annual limitation of $1,500 for an individual taxpayer and $3,000 for a joint return).

Philadelphia Electric Company depends on new private capital for investment in the increasingly expensive facilities on which our more than 1.2 million customers will depend for adequate and reliable electric energy and which on a national scale are needed to reduce our country's dependence on foreign oil. It has become increasingly difficult and expensive to attract the necessary capital through large public offerings and our Dividend Reinvestment Plan has proven to be an effective, less expensive means for obtaining new common stock capital.

At present, about 40,000 (15%) of our shareholders participate in our original issue dividend reinvestment plan. But it is clear that current tax law discourages participation since reinvested dividends, which participants do not receive as cash, are taxed currently. S. 1543 would at least partially offset this negative feature of current tax law and serve as an incentive to all investors, both large and small, to participate in the Dividend Reinvestment Plan, thus providing increased common stock capital where it is urgently needed. This, in turn permits the issuance of additional debt securities thus "leveraging" the benefits of capital formation.

In summary, S. 1543 would benefit both the utility industry's customers and investors, contribute to a healthier economy, and is consistent with our stated national objectives.

AT&T

Robert N. Flint
Vice President and Comptroller

American Telephone and
Telegraph Company
195 Broadway
New York, N Y 10007
Phone (212) 393-5183

November 21, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management Generally
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This statement is made on behalf of the American Telephone and Telegraph Company and associated Bell System Companies, which are listed in Appendix A, with respect to S. 1543, relating to tax treatment of qualified dividend reinvestment plans.

The Bell System has often stated its support of moves to encourage capital formation and to provide new incentives for equity investment. In our judgment, S. 1543 would help to accomplish these important objectives and would be a positive stimulus to a healthy business and economic environment. Accordingly, we are happy to endorse this bill.

On numerous occasions, distinguished scholars, economists and members of Congress -- including members of your own Subcommittee -- have acknowledged the importance of adequate capital formation in our nation's economy. Investment capital is essential for basic research and technological development, improving productivity, controlling inflation, reducing unemployment and enhancing America's international trade posture. Yet current tax law discourages equity investment and thus slows the rate of capital formation. Furthermore, it tilts the scales in favor of debt financing. The disincentives for equity investment are certainly among the reasons why the rates of individual investment and productivity growth in the United States today lag appreciably behind the rates of other major industrial countries throughout the world. Also, since the mid-1960's, debt ratios of the nation's leading industrial companies have increased sharply -- from the 20% range to the 30% range -- and the credit ratings of a number of utilities have been downgraded because of sharply higher debt ratios.

By providing tax relief directly to the shareholder, S. 1543 constitutes an important step toward eliminating the present tax law bias against equity investment.

We believe our experience with dividend reinvestment may be helpful to the Subcommittee in its consideration of this bill. The Bell System has had a dividend reinvestment plan since 1969, when the plan shares were purchased in the open market; in 1973, AT&T began to issue new shares at market price to plan participants; and, in 1975, AT&T became one of the first corporations in the country to offer stock purchased with reinvested dividends at a discounted price.

Our dividend reinvestment plan has proven to be an effective means of both raising necessary capital and enabling many of our small shareholders, who might otherwise not be able to do so, to add to their investments. Currently, for example, the plan is adding new common equity capital for the Bell System at an annual rate of just over a billion dollars, up from $786,000,000 last year. At present, AT&T has 2,974,000 shareowner accounts. Our shareholders reside in all fifty states and the vast majority are individuals of modest holdings. Some 752,000 AT&T shareowners participate in the dividend reinvestment plan, representing 25% of all our shareholders. Moreover, some three-fourths of all participants in our dividend reinvestment plan own fewer than 100 shares of AT&T stock and approximately 50% of plan participants own 35 shares of fewer. As these figures indicate, our dividend reinvestment plan has proven most attractive to the smaller investor.

Dividend reinvestment plans for new shares provide a convenient means of investment without market fees. Additionally, the tax deferral offered in this bill would be a forceful incentive for the smaller investor to reinvest dividends and, for an individual with modest means who owns no stock, a persuasive reason for purchasing a few shares. The $1,500 ceiling ($3,000 for joint returns) on reinvested dividends does limit the benefit to be realized by the individual shareholder.

S. 1543, then, would enhance dividend reinvestment programs and encourage shareholders to take advantage of this simple, convenient and economical way to build up their investments. With the added incentive of deferred tax, shareholder participation in dividend reinvestment plans would increase -- a development that should help stem the exodus of the individual investor from the stock market. In the years 1970-75 (the last years for which statistics are available), the market lost over five and a half million individual shareholders. Obviously the disenchantment with stock holdings stems from a variety of reasons, but certainly one of them has been the unfavorable tax treatment of dividend income. As this is corrected, it should widen the stream of capital available to business and make new offerings of equity more attractive.

Dividends which are reinvested in original issue reinvestment plans become immediately available to a corporation to help meet its capital needs. Accordingly, they provide a stimulus to construction, productivity and employment and contribute to a healthy economy. The equity capital that is produced reduces reliance on debt capital and provides for more stable capital structures.

There are two changes that we suggest be made in S. 1543. The bill, as it is now written, stipulates that for a plan to be qualified, stock purchased with reinvested dividends must be priced at not less than 95% of its fair market value on the date of distribution. Under some existing reinvestment plans (including the Bell System's), however, the price of shares purchased with reinvested dividends is determined by an average daily price over several consecutive trading days ending on the date of distribution. The purpose of this multi-day average is to protect both shareholders and the corporation from abrupt market fluctuations. We believe this to be a sound procedure and would suggest that the language of S. 1543 be broadened to permit such a multi-day average pricing procedure. To this end, we have suggested specific modifications to the text of the bill in Appendix B of this letter. Another more technical matter is addressed in Appendix C.

In conclusion, the Bell System believes that S. 1543 would aid small investors, make a positive contribution to capital investment in our country today and, in so doing, would provide vital aid to the economy as well.

We appreciate this opportunity to comment on the legislation.

Very truly yours,

R. Flint

APPENDIX A

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell Inc.
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

APPENDIX B

Section 305(e)(5) of the proposed bill provides that the price of shares purchased with reinvested dividends may not be less than "95 per centum of fair market value as of the date of distribution." AT&T's dividend reinvestment plan, among others, would not be a qualified plan under this criterion. In order to mitigate the effects of market fluctuations, the AT&T plan provides for the use of a 5-day average price, rather than the fair market value solely on the distribution date. We believe that this policy protects the interests of both the investor and the company. Thus we suggest the bill be amended to permit companies to utilize an averaging approach. The following language could be used to accomplish our suggestion.

Add to section 305(e)(5):

> "For purposes of this paragraph, in the case of securities listed on a national exchange, fair market value may be computed by using the average of the daily high and low price for the shares on a national exchange for a period of 5 or fewer consecutive trading days, ending on the date of distribution. In the case of securities not listed on a national exchange, the fair market value shall be determined in accordance with regulations prescribed by the Secretary."

APPENDIX C

Under the proposed legislation, a corporation any of whose shareholders elect to have the benefits of section 305(e)(1) apply with respect to one or more of its distributions will be unable to compute its earnings and profits accurately. Normally, a corporation must reduce earnings and profits by the amount of a dividend distribution. However, when a shareholder elects the benefits of section 305(e)(1), the shareholder's reinvested dividends are to be treated as a stock distribution under section 305(a). Pursuant to section 312(d)(1), the distributing corporation may not reduce its earnings and profits by the amount of the distribution treated as a stock dividend under section 305(a). However, the corporation has no way of knowing whether its shareholders will have made the election provided by section 305(e)(7) so it cannot determine the appropriate adjustment to its earnings and profits.

This problem may be solved by adding legislative language providing that the entire amount of the distribution shall reduce earnings and profits. (Proposed language is offered below.) Such an approach has the virtue of administrative simplicity and does not diminish tax revenues.

> "Section 312(d)(2) Distributions under qualified dividend reinvestment plans. - Notwithstanding paragraph (1), a distribution of stock pursuant to a qualified dividend reinvestment plan (as defined in section 305(e)(5)) shall be considered a distribution of the earnings and profits of a corporation to the extent of the fair market value of such stock on the date of distribution.
>
> "Renumber present sections (d)(2) and (3), as (d)(3) and (4), respectively."

Supplemental Statement of
UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION
on S. 1543
submitted to the
Subcommittee on Taxation and Debt Management
of the
Senate Committee on Finance
November 23, 1979

The United States Independent Telephone Association (USITA) supports the concept of deferring taxes on reinvested dividends as embodied in S. 1543, H.R. 654, and H.R. 5665. Deferral would offer an important incentive to increased investment in the American economy and would help reduce inflation.

The Need for Increased Investment

There is little dispute that the current flow of investment funds into United States industry is inadequate -- whether measured by comparison to the savings rate in other industrialized nations such as Japan or measured by the historical percentage of GNP or measured in any other way. The current inadequate flow of new investment is of particular concern to utilities, since they are the most capital-intensive sector of our economy[1/] and continually bring to market a large percentage (42 percent) of all corporate security issues and nearly two-thirds of the equity issues (Chart 2).

1/ Chart 1 shows that the utilities generally require approximately 3.5 times as many dollars in assets to generate each dollar of revenue as do manufacturing companies.

These facts have implications for the health of our economy as a whole, well beyond the confines of the utility sector. The utilities constitute a key element of the infrastructure on which our whole economy is built, for without continued investment in communications and electric facilities our economic progress would be seriously disrupted.

The Utilities' Need for Capital

The utility sector of the securities market is currently encountering difficulty in raising new capital to satisfy demands for service. Utilities already have a heavy debt burden and must procure equity capital. A recent analysis by Salomon Brothers shows that the common stocks of some ninety-five percent of one hundred seven listed electric and telephone utilities are trading below book value. This condition makes it extremely difficult for utilities to finance needed expansion soundly, since each new issue of common stock below book will threaten existing stockholders with dilution of their investment; this threat will have a further depressing effect on the market value of the stock; the further depression of market value will mean that subsequent stock issues will further dilute the stockholders' investment; and the utility will have entered a degenerative spiral leading ultimately to a complete inability to issue equity at all. It is a measure both of the problem faced by the utilities and of the

imperative demands for new capital to provide service that eighty-one percent of the public common stock offerings by utilities in the first ten-and-a-half months of 1979 were at prices below book value (Chart 3).

Discrimination in the Tax Code

The present tax code imposes an added and unnecessary disadvantage on equity financing by utilities. Traditionally investors in utility stocks have sought a high dividend yield. As a result the utilities have a significantly higher dividend payout ratio than non-utilities (Chart 4). Because a substantial proportion of shareholders currently invest in utilities for income rather than capital gains, the utilities do not have the same degree of flexibility to lower their dividend payout ratios as do industrial firms. The importance of dividend payout to utility investors can be illustrated best by the traumatic experiences of Consolidated Edison when it omitted a dividend payment in 1974 and of General Public Utilities when it unsuccessfully attempted to switch from cash to stock dividends.2/ Thus, while a non-utility may provide a return to investors through growth -- on which taxation of gain is deferred until sale and then taxed at capital gains rates, -- the utility as a practical matter must pay out a substantial part of earnings -- which are now taxed on a current basis as ordinary income.

2/ "A Case for Dropping Dividends," Fortune, June 15, 1968.

The discrimination is seen most clearly in the cases of stockholders of a high-growth company, who receive only stock dividends which are not subject to immediate taxation, and stockholders of a low-growth, high-dividend-payout company, who receive stock under an automatic dividend reinvestment plan after taxes. The example in Chart 5 shows that the discrimination can amount to thirty-one percent over a ten-year period. This discrimination against investors in high-dividend-paying stocks results in a higher cost of capital to the utilities -- a cost that is reflected in higher rates to utility consumers.

S. 1543 offers an equitable and administratively practical approach to removing this discrimination and to lessening the fundamental burden of double taxation by applying Section 305 of the Internal Revenue Code to reinvested dividends. Under S. 1543 stockholders of all businesses would be permitted to reinvest up to $1,500 per year of their dividends in newly issued stock of the dividend-paying corporations without being penalized by having to pay a tax on dividends that are never actually received.

If investors had the opportunity of reinvesting dividends under automatic dividend reinvestment plans without a tax penalty, the adverse effects of existing discrimination

would be significantly reduced. Investors in the capital-intensive industries such as the utility industry would be treated on a more equitable basis with investors in industrial companies. Furthermore, the ability of the utilities to obtain much needed equity capital from a far broader investor constituency would be enhanced.

The Importance of Dividend Reinvestment Plans

An immediately significant advantage of this proposal is that it would increase the flow of reinvested dividends into existing dividend reinvestment plans. Many companies, including most utilities, have already established these plans. The funds derived from the plans represent a significant and rapidly growing source of equity capital. As an illustration of the success of these programs, participation in the dividend reinvestment plans of General Telephone & Electronics Corporation (GTE) has increased from 11 percent of registered stockholders in 1972 to over 21 percent currently (Chart 6). The amount of money invested annually by participants in GTE's plan has increased over six times, from $5 million in 1972 to an estimated annual rate of $32 million in 1979 (Chart 7).

Equity funds supplied by participants in dividend reinvestment plans of course lower the effective payout ratio of the corporations paying the dividends. But, more signifi-

cantly in this era of below-book value stock prices, such funds may reduce the necessity for the corporation to bring a large equity financing to market, which often only further depresses the market price of the stock. Moreover, such reinvestment should be encouraged as counter-inflationary, since it reflects savings rather than consumption.

Dividend Reinvestment Benefits the Small Investor

The dividend reinvestment concept is particularly well-suited to the needs of the small investor, since dividend reinvestment plans provide an automatic, convenient, systematic, and inexpensive means of investing. Furthermore, in an increasing number of plans, participants pay no brokerage commissions or service charges, and many plans pass on the savings in issue costs to the participating shareholder in the form of a five percent discount on the price of the stock. The popularity among small investors is illustrated in the case of GTE's plan wherein nearly eighty percent of the participants own 100 shares or less 3/ (Chart 6). Conversely, participation among investors with large shareholdings is very modest. Of registered shareholders with over a thousand shares, less than five percent participate, and they comprise less than a half percent of the total plan participants (Ibid.).

3/ The success of these plans for the small investor is illustrated in Chart 8. The chart shows how a 100-share participant in the GTE plan in 1972 would have accumulated a total of 174 shares by 1979.

The proposal in no way gives a new tax benefit to the high-bracket taxpayer. He can currently minimize his taxes by investing in low dividend-payout companies or in tax-exempt securities.

Summary of the Benefits of S. 1543

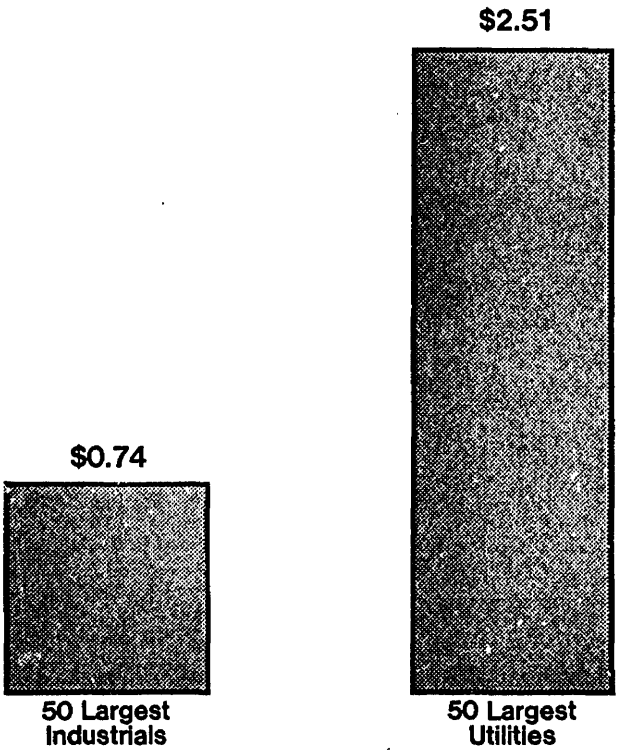
The adoption of the proposal to defer taxation on reinvested dividends would significantly increase participation in dividend reinvestment plans and thereby increase the rate of savings and investment in our nation. By promoting savings over consumption, the proposal would help dampen inflation, build a stronger fundamental economic base, and create conditions more favorable to further investment.

Allowing stock issued under automatic dividend reinvestment plans to be treated for tax purposes as a stock dividend under Section 305 would reduce the current discrimination against high dividend-paying stocks for prospective investors interested in capital appreciation, while retaining traditional investment appeal for shareholders seeking cash dividends. This proposal would also provide increased and reliable equity investment to help strengthen the capital structure of all businesses. It would also begin to eliminate both the tax bias favoring the issuance of debt rather than equity and the double taxation of dividends. Further, it

would reduce reliance on outside capital markets, improve cash flow, and provide funds required to increase capital expenditures, employment, and productivity.

Chart 1

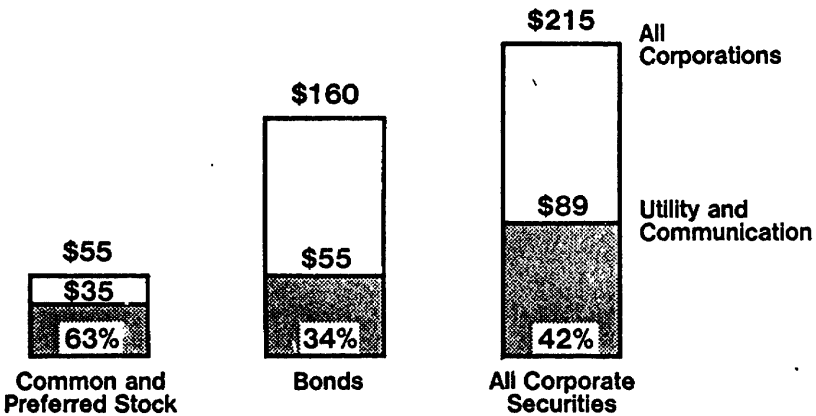
ASSETS PER DOLLAR OF REVENUE
Industrial Companies vs. Utility Companies
1978



Source: FORTUNE

Chart 2

CORPORATE SECURITY ISSUES
1975 - 1979 (Est.)
$ Billions



Source: SALOMON BROTHERS

Chart 3

ELECTRIC AND TELEPHONE COMPANIES
PUBLIC COMMON STOCK OFFERINGS BELOW BOOK VALUE
January 1, 1979 - November 12, 1979

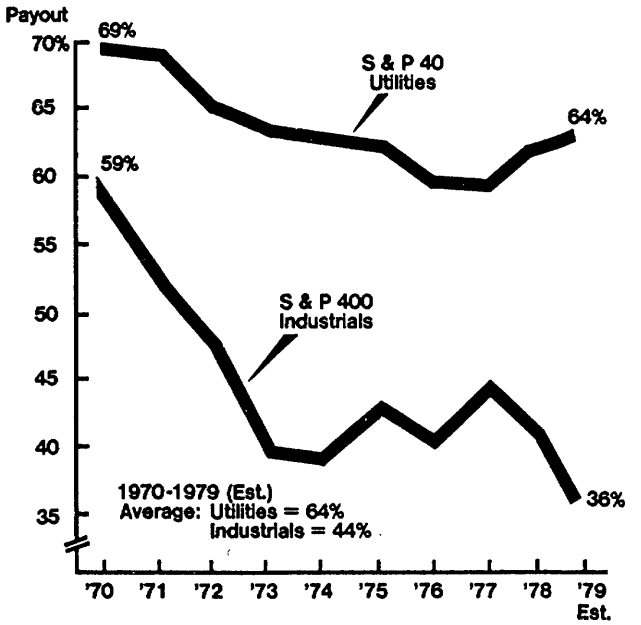
COMPANY	MARKET/BOOK RATIO
Long Island Lighting	67%
Northwest Energy Co.	71
Gulf States Utilities	72
Kansas Gas & Electric	72
Boston Edison	72
Pacific Gas & Electric	73
Niagara Mohawk Power	75
Public Service E. & G.	76
Kansas City Power & Lt.	76
Missouri Public Svc.	78
Northern Indiana Public Svc.	79
Kansas Power & Light	79
Detroit Edison	79
Delmarva Power & Lt.	79
Kentucky Utilities	80
Houston Industries	82
Allegheny Power System	83
Public Svc. N. Hampshire	84
Middle South Utilities Co.	84
Louisville Gas & Electric	84
San Diego Gas & Electric	85
Philadelphia Electric	85
Toledo Edison Co.	86
Public Svc. New Mexico	87
American Electric Power	87
Public Svc. Co. New Hampshire	89
Idaho Power	89
Houston Industries	89
Arizona Public Service	89
Minnesota Power & Light	90
Commonwealth Edison	91
Public Svc. Co. Colorado	91
South Carolina E. & G.	91
Otter Tail Power	92
Duke Power	92
Central & South West Corp.	92
Duquesne Light Co.	93
Atlantic City Electric	93
Cleveland Electric Illum.	95
Texas Utilities Co.	96
Iowa Public Service	96
Portland General Electric	98
Iowa Power & Light	99

	ISSUES	%
Issues under book	43	81%
Issues over book	10	19
Total common issues	53	100%

Source: SALOMON BROTHERS

Chart 4

DIVIDEND PAYOUT RATIOS
UTILITIES AND INDUSTRIALS
1970 - 1979 (Est.)



Source: STANDARD & POOR'S CORPORATION

Chart 5

TAX LAWS DISCRIMINATE AGAINST LOW GROWTH, HIGH DIVIDEND INVESTMENTS AND FAVOR HIGH GROWTH, LOW DIVIDEND INVESTMENTS

ASSUMING $100 INVESTMENT

Type of Company	Market Price Appreciation (1)	Dividend (2)	Pre-Tax Total Return (3) (1)+(2)	After-Tax Dividend* (4)	Total Return 1st Year (5) (1)+(4)	After-Tax Return Upon Sale After 10 Years** (6)
UTILITY						
Low Growth	$ 2.00	$10.00	$12.00	$7.00	$ 9.00	$133.10
High Dividend						
NON-UTILITY						
High Growth	$10.00	$ 2.00	$12.00	$1.40	$11.40	$173.88
Low Dividend						
		Net tax disadvantage to high dividend paying stocks			$ 2.40	$ 40.78

* Assumes a 30% tax bracket, and therefore a 12% capital gain tax.
** Assumes reinvestment of appreciation and after-tax dividends.

Chart 6

GTE DIVIDEND REINVESTMENT PLAN
SHAREHOLDER PARTICIPATION

SHAREHOLDERS		PLAN PARTICIPATION	
Shares Held	Registered Shareholders	Participants	Percent Participation
1-50	206,897	55,750	26.9%
51-100	112,751	24,372	21.6
101-200	76,402	13,351	17.5
201-500	58,020	6,035	10.4
501-1,000	16,870	1,593	9.4
1,001-over	8,789	359	4.1
TOTAL	479,729	101,460	21.1%

Participants Owning 100 Shares or Less 80,122
Total Participants 101,460 = 79.0%

As of November 1, 1979

Chart 7

GTE DIVIDEND REINVESTMENT PLAN
GROWTH OF ANNUAL INVESTMENT

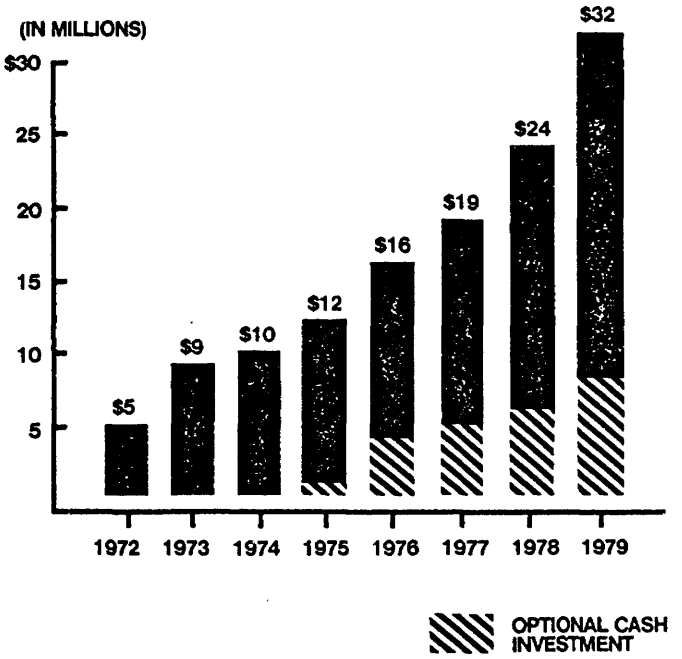


Chart 8

GTE DIVIDEND REINVESTMENT PLAN
Results of a 100 Share Original Investment
January 1, 1972 - October 1, 1979

YEAR	DIVIDENDS REINVESTED	SHARES FROM REINVESTMENT	CUMULATIVE SHARES FROM REINVESTMENT
1972	$ 156.77	5.117	5.117
1973	174.73	5.642	10.759
1974	197.72	8.497	19.256
1975	221.69	10.071	29.327
1976	245.76	9.189	38.516
1977	292.49	9.309	47.825
1978	349.81	11.684	59.509
1979	419.09	14.988	74.497
TOTAL	$2058.06	74.497	

TESTIMONY OF CRAIG L. MCNEESE
VICE PRESIDENT
HOUSTON LIGHTING & POWER COMPANY
ON S.1543
BEFORE THE
SUBCOMMITTEE ON TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

My name is Craig McNeese. I am Vice President of Houston Lighting & Power Company, an investor-owned electric utility that serves nearly one-fourth of the population of the State of Texas. Our service area is highly industrialized. Our customers refine 12% of the nation's petroleum products, produce 40% of the nation's petrochemicals, and serve the nation's market for steel and other highly diversified finished products. They also supply fuels to the Midwest and East, rubber to Akron and Detroit, plastics to New England, textiles to Georgia and the Carolinas, and agricultural chemicals to the Atlantic states. Large quantities of oil and natural gas are processed in the region and it is a center for worldwide oil and gas exploration and production activities.

Mr. Chairman, although we have traditionally relied almost exclusively on natural gas as a boiler fuel, since the early 1970's we have been following a corporate program of constructing all new generating capacity to use either coal or nuclear fuel. Two 660 MW coal units have been completed, a third will begin operating in 1980, and a fourth in 1983. The Company has initiated two nuclear projects, but both have experienced substantial delays.

The Powerplant and Industrial Fuel Use Act (FUA) which became effective on May 8, 1979, requires that we terminate our use of natural gas as of January 1, 1990, with certain limited exceptions. If this prohibition did not exist, the construction of new coal, lignite and nuclear capacity to cover normal retirements and system load growth would require capital expenditures of $19 billion in the period 1980 through 1995, an average of well over $1 billion per year. Certain exemptions provided in the Act extend limited use of gas to 1995. In that year, however, the Company will be forced to retire prematurely 4389 MW of servicable gas-fired generation. Construction of additional generation to replace that displaced by forced retirement will add $4.9 billion, resulting in a 16 year capital requirement of $23.9 billion.

We can accomplish the mandated reduction and ultimate termination of gas usage only by switching to oil in those gas units which have been converted to burn it. This use of oil, although in accord with the provisions of the FUA, will be prohibited under certain proposals now being considered by the Administration. An additional $4.4 billion will be required should that proposal be adopted.

Mr. Chairman, we need all the help we can get in raising these tremendous amounts of capital. In this regard,

we believe that S.1543, which you are presently considering, would be helpful. It would make changes in the Internal Revenue Code of 1954 that would help us to retain more of our earnings by encouraging our shareholders to take stock instead of cash dividends.

Many of our shareholders rely heavily on dividends as a source of personal income and in fact need to receive regular cash dividends in order to meet their monthly bills. Yet we also have many shareholders who would prefer to increase their investments by retaining within the corporation their full share of corporate earnings. The only way that we can accommodate both under existing law is to give them an election between cash or stock dividends. Unfortunately, however, the present law penalizes those shareholders who choose to take a stock dividend instead of cash. They are forced to pay a tax on a cash dividend that they never receive. This discourages shareholders from exercising their right to plow back into the corporation their full share of corporate earnings. As a result, our ability to retain sufficient earnings to meet our rapidly expanding need for capital is greatly hindered, and we are instead forced to resort more heavily to debt financing.

S.1543 would go a long way towards correcting this problem. Basically, the bill would allow a shareholder who elects a stock dividend instead of a cash dividend to exclude from income the first $1500 per year ($3000 in the

case of joint returns) of such stock dividend. This would mitigate at least partially the double tax burden imposed upon earnings retained through the optional stock dividend mechanism. Moreover, the bill would effectively tax as ordinary income all the proceeds from a sale within one year of the stock dividend or of a comparable amount of the shareholder's other common stock. This would prevent the abuse of the qualified dividend reinvestment plan as a tax scheme to convert stock dividends into cash without paying the full tax on them.

We believe that S. 1543 would encourage our shareholders to reinvest their dividends directly within their corporation and thus permit us to meet more of our capital needs through retained earnings instead of inflationary debt financing. Because the election of a stock dividend would result in no additional taxable income currently, our shareholders would be more willing and able to elect a stock dividend instead of cash. They would not be penalized for their election by being so taxed and, to the extent of the application of the bill's provisions, would not be discouraged from retaining their full share of corporate earnings within the corporation. In sum, we believe that the passage of this bill would help correct a distortion caused by the present tax law concerning optional stock dividends and would result in a net increase in our shareholders' investments.

56-074 O - 80 - 41

Wisconsin Electric POWER COMPANY
231 W. MICHIGAN, P.O. BOX 2046, MILWAUKEE, WI 53201

November 19, 1979

Mr. Michael Stern
Staff Director, Senate Finance Committee
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

Re: H.R.654; S.1543

I am writing to express my support for the above-captioned bills. Wisconsin Electric Power Company has had a new issue dividend reinvestment plan since November 22, 1974. Participation in the plan has steadily increased to its current level of participation by approximately 19.5% of outstanding Common Stock and 4.8% of outstanding Preferred Stock with an aggregate annual investment of approximately $11,000,000. We feel this response clearly demonstrates the increasing popularity of this type of plan.

As stated by Senator Nelson in the July 19, 1979 Congressional Record, utility companies, because of their capital intensive nature, are continually pressed to finance new construction through common stock offerings. Wisconsin Electric recently conducted a survey of its stockholders. The survey indicated that most of the stockholders are age 55 or older; over 50% have annual incomes of less than $20,000; and more than half own 100 shares or less of our stock. (A copy of the survey summary is enclosed.) These investors are primarily of modest means. They do not have the resources to invest large sums of money. However, we believe a deferral of current income taxes on dividends invested in new issue stock would assist them in investing small additional sums through dividend reinvestment plans such as Wisconsin Electric's.

We therefore believe that the subject bills would do much to encourage increased participation in such plans, particularly by small investors, and we would welcome the expansion of this opportunity to provide a convenient, low cost means of benefiting such investors and at the same time expanding this source of equity capital for companies such as ours which require a steady inflow of capital for new plant and equipment.

We have long felt that the double tax on corporate dividends is an unfair discrimination on this type of investment, particularly with respect to the individual investor, and we enthusiastically support these bills as a means of at least partially correcting this discrimination.

Very truly yours,

J. H. Goetsch/ca

Secretary

Our Stockholders...

Who they are...
What they expect from their investment

Wisconsin Electric Power Company
Stockholder Survey Results.

June 1979

To our stockholders:

I was very pleased with the response to the survey of Wisconsin Electric stockholders, conducted late last year. Almost 22,000 of you took the time to fill out the questionnaire and return it. And a large number took a little extra time to write in comments, questions and suggestions.

That response -- nearly 35 percent -- indicates a great deal of interest in Wisconsin Electric on the part of our stockholders. And your interest is important to the continuing success of the company, as we strive to provide reliable energy supply to our customers and a reasonable return on our stockholders' investment.

The survey is another part of our expanded effort to improve communications with our stockholders. In addition to the annual meeting, we have been conducting regional stockholder information meetings around Wisconsin for the past several years. These meetings have proven valuable to Wisconsin Electric management, because they have given us a better understanding of your concerns and the questions you have about the company and about energy matters in general.

This booklet outlines the results of the stockholder survey. It should be noted that the percentages listed are percentages of the nearly 22,000 who responded to the survey. We believe, however, that those who replied are fairly representative of all Wisconsin Electric stockholders, and our actions in response to this survey will be guided accordingly.

Again, my thanks for your cooperation in this survey. I believe you'll find the results interesting.

Sincerely,

Charles F. McGee

President

Highlights

The Wisconsin Electric Stockholder...

Over 77 percent of Wisconsin Electric stockholders responding to the survey are over age 55. Nearly a quarter of those responding are 75 or older. Other utilities have had similar findings in stockholder surveys.

At least 56 percent of those responding did not become stockholders of Wisconsin Electric until they were 40 or older, and over one-third first acquired their stock after age 55.

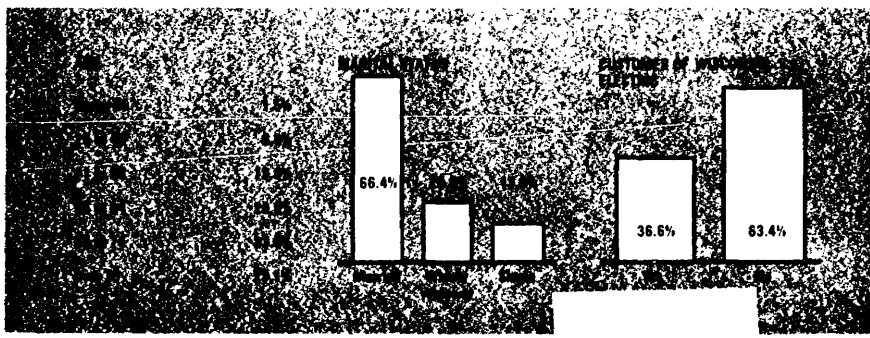
One reason may be that middle aged and older people, as a rule, have more funds available for investing. The demands of furnishing households and raising families leave younger people with less to invest.

Moreover, the survey suggests that older investors may be more interested in the relative stability of electric utility investments than their younger counterparts. Wisconsin Electric has a history of steady growth with dependable and regularly increasing dividends – making it attractive to older investors more interested in regular income from their investments.

It also is not surprising that 86 percent of responding stockholders are either married or widowed. Married persons, for the most part, would be expected to be more interested in income and security because of their family responsibilities.

Single people, on the other hand, may be in a position where they can assume the greater risk of speculative investments for the possibility of higher return.

We asked stockholders whether they are also customers of Wisconsin Electric. More than a third indicated they are. This response generally reflects the geographic distribution of the total number of Wisconsin Electric stockholders.



a Profile

As might be expected, considering the age profile of Wisconsin Electric stockholders, the retired and those nearing retirement account for more than 60 percent of respondents to the survey. Those who do not expect to retire soon comprise about one-fifth of those responding.

When asked about their present or pre-retirement occupation, the largest number of respondents categorized themselves as being engaged in "professional" occupations. The second most frequent response was "homemaker," followed by "managerial" and "other" in that order. Included in the "other" category are stockholders who are self employed and those who hold part time employment.

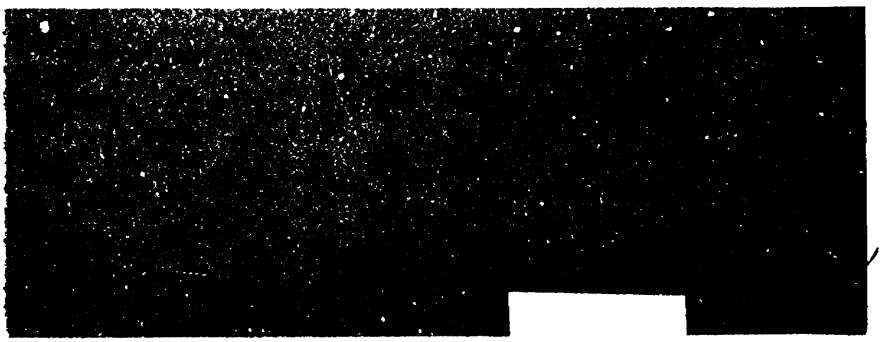
Occupation does not seem to affect an individual's investment objectives. The only difference of note was that homemakers more frequently cited current income as their reason for holding Wisconsin Electric stock.

Nor were there significant differences in investment objectives among retired, those nearing retirement and those with no immediate retirement plans. Retirees showed a greater interest in current income than those still actively employed, but "overall return" (the combination of current income and long-term gain) was the most frequently-cited investment objective, even among the retired.

"As senior citizens, we rely on our dividends for income."

"Yours is a remarkable record which shows annual increases in dividends over the years."

– Stockholder comments



"Small" Investor Important

Over half of all stockholders who responded to the survey have annual incomes of less than $20,000. This suggests that Wisconsin Electric is owned mostly by those of moderate means. It also suggests that the "small" investor is a very important part of the market for Wisconsin Electric securities.

While there are many common characteristics among stockholders of different income levels, there are also a number of differences. For example, the survey indicates that as income level increases, the relative importance of current income as a reason for holding Wisconsin Electric stock decreases. The importance of current income combined with long term gain ("overall return"), on the other hand, increases with income level.

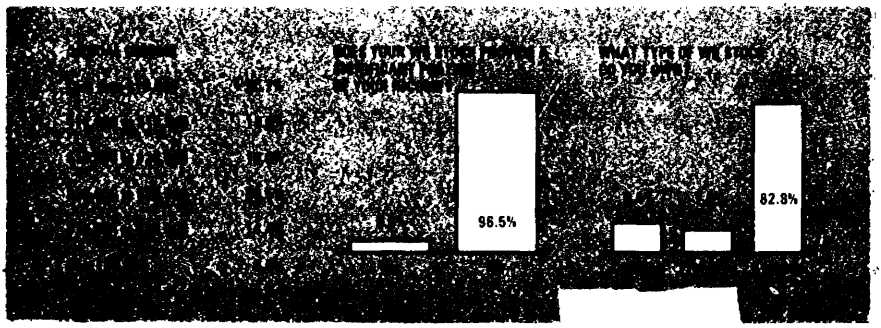
Also significant is the finding that Wisconsin Electric stock is a smaller part of total investments among persons in the higher income groups than among those in lower income groups. This is consistent with the finding that those in higher income groups do not tend to hold proportionally more shares than persons in the lower groups.

"We should all make every effort to protest the double taxation of dividends."

"We hope that net profits will justify an annual increase in dividends approximating the increase in the consumer index."

"Retirees could use a tax break on their income from dividends."

– Stockholder comments



More Than Half Own 100 Shares or Less

Among respondents to the survey, over 82 percent own Wisconsin Electric common stock, almost 8 percent own preferred stock and more than 9 percent own some of each type. The proportion of responses in each category essentially reflects the proportions of each type of stock outstanding.

There were relatively few differences between preferred and common stockholders. Those with preferred stock mentioned current income as their reason for holding Wisconsin Electric stock more frequently than holders of common stock.

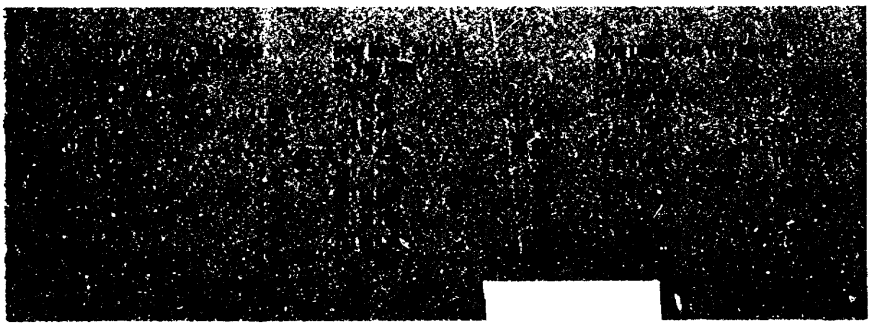
Slightly more than half of the respondents own 100 shares or less, and more than three-fourths hold 200 shares or less. Only a little more than 5 percent of stockholders own more than 500 shares.

The investment objectives of larger stock holders are essentially the same as those of stockholders owning a small number of shares The degree of satisfaction with their investment in the company does not appear to be affected by the size of holdings.

Almost 42 percent of responding stockholders indicated that they have held their Wisconsin Electric stock for 10 years or longer; about one in five had been a stockholder for over 20 years.

It is significant to note that more than 31 percent of respondents have been attracted to Wisconsin Electric stock within the past five years. The addition of new investors is important to electric utilities like Wisconsin Electric that, during periods when major facilities are being built, have capital requirements greater than can be met either from internal sources or by existing investors.

Most respondents indicated that their holdings of Wisconsin Electric stock represent less than 10 percent of their total securities investments. This appears to hold true regardless of the number of shares held.



"Overall Return" Main Objective

Nearly half of all respondents indicated that their main objective in holding Wisconsin Electric stock was "overall return."

The second most frequent response was "current income." "Long-term gain" was a distant third. Together, these three responses accounted for over 90 percent of all received.

"Overall return" was the most frequently cited reason among persons with incomes above $15,000, among every occupational group except homemakers, and among persons between the ages of 25 and 75.

"Current income" was the most important investment objective for homemakers, persons with incomes under $10,000 and persons over 75 years of age. Retired persons rated it equally with "overall return."

The youngest age group, those under 25, was the only group to rank "long-term gain" alone as the most important investment objective.

The very small number of respondents who indicated they are holding Wisconsin Electric stock for short-term gain purposes is consistent with the fact that Wisconsin Electric – indeed, most utility stocks – are not generally regarded as speculative investments.

"I consider it a good stock for current income and long term appreciation."

"We have had a modest gain and an adequate return. We hope you keep up the good work and that Wall Street doesn't decide to pick your bones."

"Annual increase in dividends is important and we hope you can keep it up. Although WEPCo. has not been a hedge against inflation, the dividend increase has helped."

"The price of my stock has depreciated about 10 percent but that's not the fault of the company."

– Stockholder comments

Investment Advisors a Motivating Force

The professional investment advisors – stockbrokers, security analysts, etc. – constitute the largest single source of interest in Wisconsin Electric stock. Brokers and analysts continue to be a potent motivating force in the investment decision-making process.

Friends and relatives also were cited by a large segment of respondents as the source of interest. While not specifically mentioned, it may be assumed that many persons whose parents bought the stock for them as children are included in this category, along with many, who willed the stock to their heirs.

The "other" category also accounted for a significant portion of the responses. Among those who specified further, personal analysis was the most frequently mentioned source of interest. A number of persons also chose this category to indicate that they had inherited their stock.

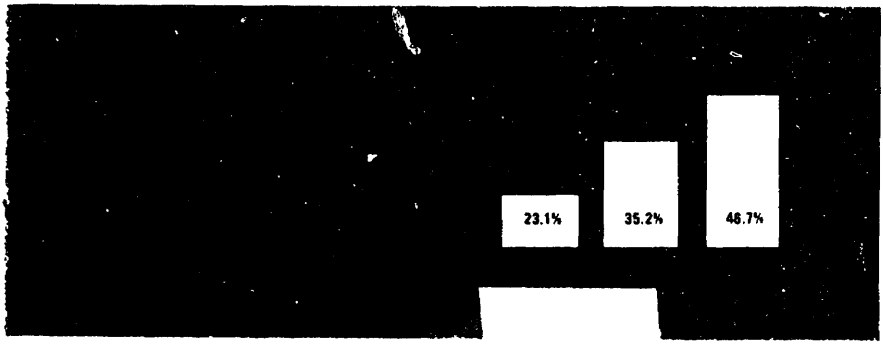
Wisconsin Electric employes accounted for a relatively small – but certainly not insignificant – portion of the investment influences. In fact, about 96 percent of our employes have an investment in their company.

News media – perhaps somewhat surprisingly – ranked lowest on the list of influences in the investment decision

"...my broker said that anyone who owns any stock shouldn't live another day without owning some Wisconsin Electric."

"Most of my Wisconsin Electric stock was part of an inheritance from my father. Since then I bought more and plan to pass it on to my children."

– Stockholder comments



Stockholders Indicate Satisfaction with Company Performance

The response to the question concerning stockholders' level of satisfaction with their investment in Wisconsin Electric is one of the most important to management. Along with survey comments, we have gained an insight into how well we are serving our stockholders and what we might do to serve them better.

Most of our stockholders indicate they are generally pleased with the company's efforts especially in dealing with the complex problems facing us today.

We believe that this high rating is due in large part to the fact that the policies and performance of Wisconsin Electric are consistent with the investment objectives of our stockholders. Overall return, income and long-term growth appear to be of greatest importance. The company has a history of continuous dividend payments and gradual but frequent increases in the amount of those dividends. The company is regarded as having one of the strongest financial positions in the utility industry.

Our obvious goals are to continue to maintain the confidence of our stockholders and improve their levels of satisfaction. Naturally, obstacles may slow our progress at times, such as regulatory delays and the performance of the stock market. But we will continue to pursue our goals through efficient operation of the company, conservative accounting practices, dependable dividends and the determination to seek rate increases when they are justified.

"Well pleased with dividend trend. Consider WEP as one of my best investments."

"I regard the company most highly and recommend potential investors to acquire an equity interest in this excellent and well-managed utility."

– Stockholder comments

Making Positions Known

We are living in an age when interests of all sorts are raising their voices, in the hope that their points of view will prevail in Washington, state capitols and city halls across the country.

Many of these special interests represent viewpoints at cross purposes with corporate stockholders, the owners of American businesses. In many ways, the stockholders constitute one of the most under-represented segments of our society.

There is a need for stockholders to protect and promote their own interests among legislators and regulators. By exercising their strength in numbers, they can and have successfully defended their right to a reasonable return on investment when it has been threatened.

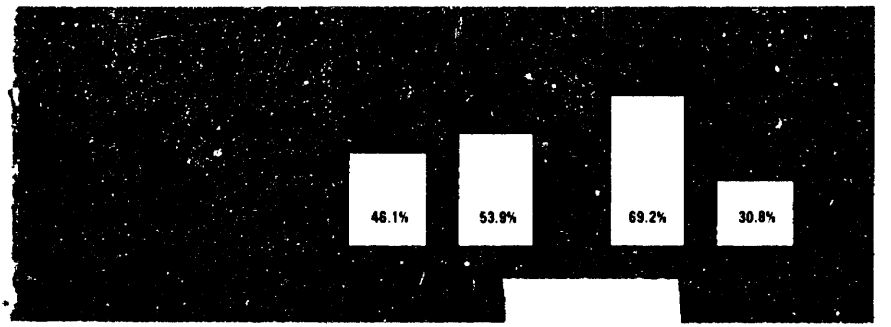
Shareholders would be well advised to become active letter-writers, making their positions on relevant issues known to their elected representatives. Shareholders in several states have even organized independently into formal associations for this purpose.

We asked Wisconsin Electric stockholders if they had ever called or written their elected representatives on important issues. Over 46 percent indicated that they had. While we have no figures to compare that number with the total population, we suspect that it would be considerably higher than the national average.

When we asked stockholders if they would sometime in the future contact their representatives on issues affecting Wisconsin Electric, the result was gratifying. More than two out of three said they would.

On occasion the company has written to stockholders asking that they protect their interests by contacting their representatives on specific issues affecting the company and the industry. A great number have responded, which often has had a favorable effect on the outcome.

Wisconsin Electric will contact you again when we feel your interests are threatened by pending legislative or regulatory action. We hope you will continue to respond by letting your representatives know how you feel on those issues.



Information Needs Being Met

Also of great importance in the survey was your evaluation of our efforts to keep stockholders informed. The more our investors know about Wisconsin Electric, the more likely they will be to make positive investment decisions concerning the company.

We were pleased that the overwhelming majority of stockholders responding to the survey – over 98 percent – feel that the company does keep them adequately informed.

Nearly 90 percent of all respondents indicated that the reports they receive from Wisconsin Electric are better than average. Less than 1 percent rated them "marginal," "poor" or "unsatisfactory."

Comments and Commentary

Almost one in four survey respondents took a little extra time to comment about stockholder reports or Wisconsin Electric in general.

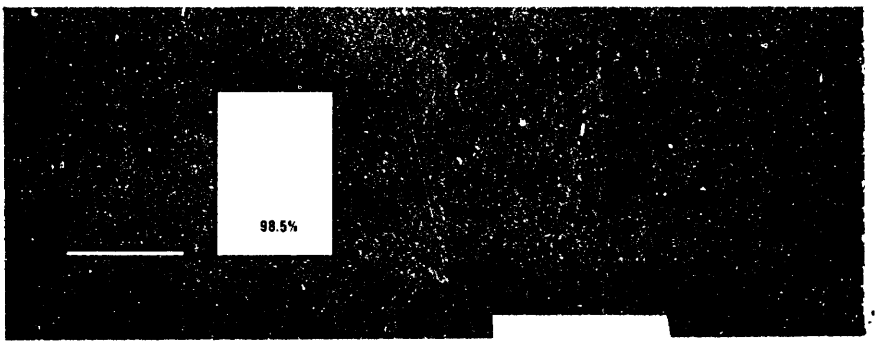
These 5,200 comments provide valuable insight into the concerns of stockholders.

Stockholder Matters

The largest single category of comments concerned stockholder matters. A number expressed concern about the level of dividends and frequency of dividend increases. Quite a few, on the other hand, complimented the company on its dividend program.

Our company has a long history of increases in the rate of dividends paid on its common stock. These increases are, at least in part, the result of the board's awareness of the needs of stockholders.

At the same time, however, the board must review the need to retain a portion of the company's earnings to help finance construction and other projects that are essential to insure that it will be able to generate earnings and dividends in the future.



The price appreciation of Wisconsin Electric stock is a subject of some disappointment among a number of stockholders, judging from the comments.

There are many factors affecting the price of the company's stock over which it has no control. Changes in interest rates, inflation, political unrest in various parts of the world and even the weather can influence not only the price of our stock but also the direction of the entire securities market.

In addition, the fact that Wisconsin Electric is a utility subject to federal and state regulation has an impact on the price of its stocks. The price of any stock is, to an extent, a reflection of investors' expectations of a company's earnings prospects. Since the major factors affecting earnings – prices charged to customers, the number of customers and the product sold – are all restricted by either government regulation or the nature of the business itself, there is less opportunity for Wisconsin Electric to make the relatively large gains in earnings needed to achieve rapid appreciation in the price of its stock.

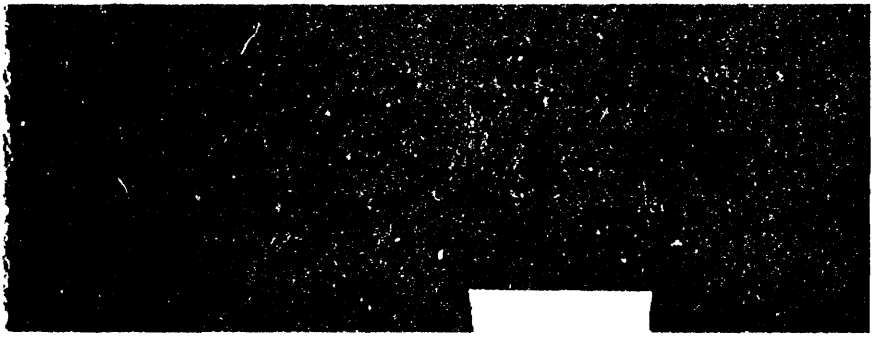
However, the same factors that tend to restrict growth in the price of the company's stocks also tend to restrict the large fluctuations in the price of the stock that often occur in other industries. Thus, while utilities generally do not offer the same potential for growth, they do tend to offer greater stability of price. Some investors feel that the nature of the services provided by utilities also reduces their financial risks.

There were many comments expressing a desire for the addition of a 5 percent discount feature to the Automatic Dividend Reinvestment and Stock Purchase Plan.

As most stockholders know, the company now offers a discount feature as part of its Automatic Dividend Reinvestment and Stock Purchase Plan. This feature was, in fact, in the process of being added at the time the survey was mailed last October. However, because all the necessary approvals had not been received, it was necessary to delay announcement of the addition of the discount and several other new features until February 1979. The company is pleased to be able to provide stockholders with a specific service which they have requested.

Communications

The second largest category of comments concerned the company's communications. A



number questioned whether or not a savings could be realized by making the reports "less fancy." Others suggested making the reports shorter and writing in simpler language. Others congratulated the company on the physical appearance and clarity of the reports.

Some stockholders felt the company should be more assertive in its public communications, that accusations by environmental and consumer oriented groups could be countered more effectively.

In our stockholder communications program, we continue to strive for easy readability through meaningful, concise articles in attractively designed reports. Cost-consciousness has always played an important role in our planning of these items. We also have stepped up our efforts in news media contact, to emphasize the company position relating to significant events as well as to answer critics of our company and industry.

Seasonal Rates and Bills

More than a third of responding Wisconsin Electric stockholders are also customers of the company. Many of them indicated displeasure with the seasonal rate structures ordered by the Public Service Commission of Wisconsin (PSCW) last year. Others felt that rates in general are too high.

Another group expressed opposition to the PSCW's winter ban on cutoff of utility services for non-payment of bills. They encouraged the company to fight this practice more aggressively.

Our seasonal rates were designed by the PSCW and had a more severe impact on our customers than we had proposed. We would have preferred a lesser summer-winter differential and believe adjustments are needed. The company's electric rates continue to compare favorably, however, with rates in other large metropolitan areas. A recent survey of the nation's 20 largest metropolitan areas found only three with a lower average kilowatt-hour cost in 1978 than Milwaukee's.

Regarding the ban on winter disconnections, we have repeatedly voiced our opinion that the ban discriminates against the customers who regularly pay their bills. We also have proposed to the PSCW an alternative to a complete ban which would avoid threats to life but which would attempt to reduce the amount of uncollectible accounts during the ban.

Governmental Matters

There were considerable comments on government, regulatory, political and economic matters. These included criticism of government and bureaucracy, complaints on taxes and inflation with special emphasis on double taxation of dividends, comments on the environment and environmental activities and matters of a general political nature.

It is interesting to note that most of the comments in this area suggested the company become more assertive by responding to environmental groups, making the costs of governmental regulation known and generally speaking out more on political matters.

The growing amount of government legislation and regulation that affect business concerns us. Reflecting the company's official position, we speak out to various groups and to those making laws and public policy in the hope that we can provide a meaningful and practical input into government affairs. Another important voice is that of the individual stockholder. Lawmakers often tend to be more interested in and responsive to opinions of individuals whose interests are likely to be affected by laws and regulations than to corporate opinions.

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Nuclear Energy

A total of 187 comments on nuclear energy were received. Of these, 122 were in favor of further development of nuclear energy and 65 were opposed. Among the negative comments, some expressed concern because of conflicting information, rather than outright opposition.

The Three Mile Island accident has focused national attention on nuclear energy. Government and the industry are taking an intensive look at nuclear power to be certain it is as safe as possible.

The nation's energy situation is such that it must continue to develop both coal and nuclear resources. So it is vital that the subject be weighed rationally and objectively.

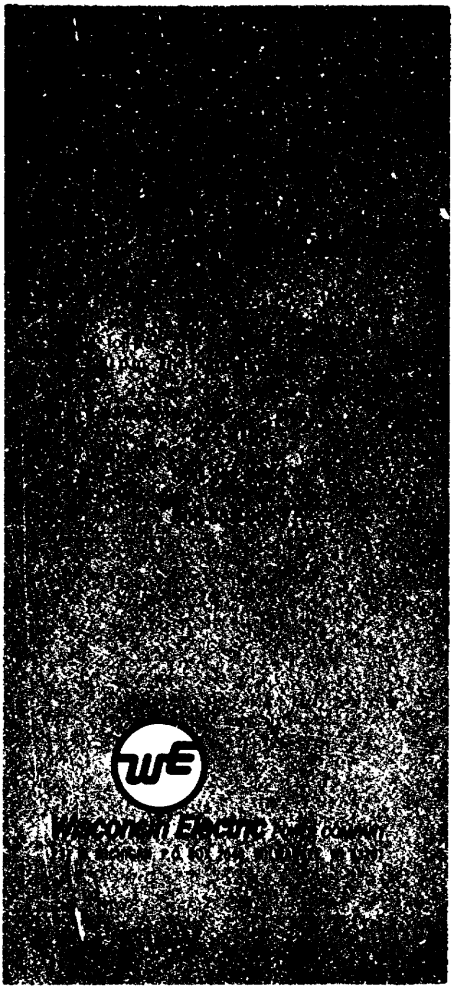
At Wisconsin Electric we are in a good position to keep our fuel options open. We have enough coal-fired plant capacity under construction or active planning to meet our obligations until the late 1980s. We will continue to explore all fuel alternatives and make our decisions based on the best interests of stockholders and customers. Nuclear safety will certainly be a significant factor in our deliberations over future energy sources.

Other Subjects

Other comments from stockholders centered on the subjects of management compensation, board of directors, various operating matters and the survey itself.

All the survey comments have been categorized and distributed to various company officers for their detailed review.

Many stockholders asked specific questions and requested replies. Those who gave their names and addresses have already received replies from the company.



Wisconsin Electric POWER COMPANY
231 West Michigan Street P.O. Box 2046
Milwaukee, Wisconsin 53201
(414) 277-2345

68M-6/79

STATEMENT OF WILLIAM D. WEBB, ASSISTANT VICE PRESIDENT
FEDERAL AFFAIRS, KANSAS CITY POWER & LIGHT COMPANY
IN SUPPORT OF S. 1543
BEFORE THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
OCTOBER 31, 1979

My name is William D. Webb. I am Assistant Vice President-Federal Affairs of Kansas City Power & Light Company. The Company provides electricity to some 334,000 customers who reside in 94 communities in 23 Western Missouri and Eastern Kansas counties. I would like to present my views, and the views of the Company, on S. 1543, sponsored by Senators Nelson and Bentsen.

Let me start by saying that Kansas City Power & Light Company strongly supports the approach outlined in this bill which would defer current Federal tax on dividends reinvested in original issue stock of a company having a qualified dividend reinvestment plan.

As I understand the proposal, a single taxpayer would be allowed to reinvest a maximum of $1,500 in dividends annually while a married taxpayer filing a joint return would be allowed to reinvest a maximum of $3,000. The proposal would encourage capital formation and would provide a stimulus to the construction of essential capital facilities, thus creating employment opportunities which would lead to a strong economy.

Kansas City Power & Light Company is a fairly typical electric utility. It is a medium-size company. Its stockholders reside in all 50 states. Like other companies, it is going about its business of furnishing electric service to its customers at reasonable rates consistant with reliable service, and raising its capital in the most economical ways possible.

About a year ago, the Company adopted an original issue dividend reinvestment plan in an effort to raise needed equity capital. At present, there are some 3,200 common stockholders and 200 preferred stockholders enrolled in this plan.

The common stockholders participating are, generally speaking, small stockholders with stockholdings having a current market value of about $6,700. The amount currently being reinvested by common and preferred stockholders, in the aggregate, is $2,500,000 annually.

We are pleased with these results. True, this amount of money is not large, but it does provide needed funds for part of the Company's construction program. Adoption of S. 1543 would encourage additional stockholders of the Company to reinvest in the Company's common stock, thereby providing Kansas City Power & Light Company with much needed funds at an economical cost, which savings will ultimately benefit its customers.

Statement of the American Council for Capital Formation on the Bill to Defer Taxes on Dividends Reinvested in Original Issue Stock (S. 1543)

The American Council for Capital Formation is grateful for this opportunity to present to the Finance Subcommittee on Taxation and Debt Management the views of the American Council on the bill to defer taxes on dividends reinvested in original issue stock (S. 1543).

Established in the early 1970's, the American Council for Capital Formation is dedicated to promoting the productive saving and investment required to encourage stable economic growth, limit inflation, and create jobs for our expanding labor force. The Council's membership includes both large and small businesses, associations, and individuals who are united in their support of legislation to eliminate the bias in our tax system that favors consumption over saving and investment. Among those legislative measures have been the reduction in the corporate tax rate, liberalization of the investment tax credit, and last year's sharp cut in the capital gains tax rate.

The bill to defer taxes on dividends reinvested in original issue stock (S. 1543), introduced in this Congress by Senator Gaylord Nelson and Senator Lloyd Bentsen, would encourage productive saving and investment by allowing individual shareholders to defer Federal income tax on dividends reinvested in original issue stock of a company with a qualified dividend reinvestment plan. Under this bill, single taxpayers would be allowed a maximum reinvestment of $1,500 annually in dividends

while married taxpayers filing a joint return would be allowed a maximum contribution of $3,000. The proposal also provides that the reinvested dividends would be taxed when the shares purchased under the plan were sold so that, if the shares were held for more than one year, the proceeds would be taxed as capital gains. Under current law, dividends are now taxed as ordinary income in the year paid, after the dividend exclusion.

The American Council supports this legislation.

Capital Formation Problems in the 1970's

S. 1543 is an outstanding example of the innovative legislation needed to continue to move tax policy toward the goal of encouraging, rather than discouraging, capital formation. This goal has become increasingly clear as Congressional tax leaders, in this Committee especially, have sought to shape economic policy in general and tax policy in particular, toward the supply-side considerations that concern the incentives to work, save, and invest. The highly constructive Revenue Act of 1978, which derived much of its impetus from this Committee, marked the major turning point in tax policy as attention was shifted, both in Congress and in the country, away from the question of how income should be distributed to how best it could be produced.

However, the consensus on the need for incentives to encourage work effort and to stimulate saving and productive investment is only beginning to emerge. As recently as the mid-1970's, many in Congress and outside argued that there was no capital formation problem, that demand stimulation was all that was

needed to bring forth a supply response. All too often, tax changes to promote capital formation were rebuffed as "handouts to the rich" which would have a large and negative impact on the Federal budget. The debate over the Tax Reform Act of 1976 gave voice to many arguments concerning the need to close so-called "loopholes" in the tax laws but, since the passage of that Act, capital formation needs have become increasingly apparent.

Capital formation is recognized by most economists as the means through which society enlarges its capacity to produce goods and services, expands job opportunities, dampens inflation, and encourages economic growth. It is through the expansion of this capacity that our standard of living is increased and improved. But capital formation requires investment in excess of replacement investment which, in turn, demands that society release some of its resources to investment. This release of aggregate resources for investment purposes is the saving of a society; thus, society's aggregate savings increase the possibility for future consumption.

Following the Keynesian logic in force since the mid-1930's, however, saving, far from being encouraged, has been discouraged through tax policy. We have acted to encourage current consumption in the belief that government stimulus to consumption would be sufficient to maintain long-run growth. More and more tax policymakers are now becoming concerned that this runs counter to the best interests of our economy and, unless reversed, will cripple our ability to move to a stable, high-investment, high-growth path.

The situation today shows this concern is not misplaced. The rate of personal saving in the U.S., as a percent of disposable income, has averaged between 6 and 6½ percent over the past three decades. On a downward slide over the past three years, the savings rate fell to a low of 4.7 percent in the final quarter of 1978 when commercial banks experienced the largest quarterly outflow of savings deposits since the Federal Reserve began keeping these statistics in 1965. The personal savings rate has hovered around 5 percent in the first two quarters of 1979 and preliminary figures indicate an even lower rate for the third quarter of the year.

Savings rates in the U.S. are lower than those of other industrialized nations and the rate in the U.S. has been falling over the past decade while savings rates in other countries have been on the rise. In Japan, for example, the rate of savings has increased from 18.5 percent in 1967 to 21.5 percent in 1977. Savings rates in Canada, Great Britain, France, and Germany have risen over the same time period, too.

Not surprisingly, the rate of real nonresidential fixed investment as a percent of real gross domestic product in the U.S. posted a record worse than that of other major industrialized countries, according to the 1979 Economic Report of the President. From 1966 to 1976, the U.S. devoted only a 13.5 percent share of real GDP to investment while Japan averaged almost twice as much, with 26.4 percent for the period. Canada averaged 17.2 percent; France, 16.7 percent; West Germany, 17.4 percent; and Great Britain, 14.9 percent.

The special problems of this decade--stubborn rates of inflation, declining productivity growth, lagging capital investment and intractable budget deficits--all indicate the need for new approaches to economic and tax policy. As a result, consideration of measures to promote the long neglected goals of increased saving and investment have moved to the forefront.

Legislation to Encourage Saving

It is to these problems that S. 1543 speaks. This legislation would encourage both saving and investment on the part of the individual stockholder, giving him a greater opportunity at a lower cost to participate in equity ownership. Firms with the requisite qualified dividend reinvestment plan would be able to attract new equity capital to meet their investment needs more easily and inexpensively. The bill would also help reduce the double taxation of dividends for those individuals participating because it would eliminate the tax imposed at the stockholder level when dividends are reinvested in new issue stock.

While S. 1543 is a strong, positive step, we believe that the severity of today's problems require an even more dramatic approach, one which is suited to the needs of a broad range of individuals and available for a comprehensive range of savings mechanisms.

The so-called "rollover" for reinvested interest, dividends, and capital gains is such a comprehensive approach, and it is

also an approach well worth exploring. Under the tax-free rollover account, an individual would be allowed to establish a special trust account with a bank or similar federally insured institution, to which he could contribute cash for investment by a trustee and to which he could contribute any stock or securities of a domestic corporation. The amount of cash contributed to the rollover account plus all the income realized in the account would be invested and reinvested in stocks, bonds, or interest bearing deposits. At the election of the individual, either the trustee could be given investment discretion, or the individual could retain the right to direct the trustee in the investment and reinvestment of funds in the rollover account.

The individual would not be allowed a tax deduction for contributions to the account. However, all capital gains, dividends, and interest realized in the account would be non-taxable until withdrawn from the rollover account. When withdrawn, all previously accumulated capital gains, interest, and dividends would be taxed to the individual in the same manner as if he had realized that income directly in the year of withdrawal.

The tax-free rollover account shares many of the positive aspects of S. 1543 for the individual while offering a comprehensive plan which would be tax-neutral with respect to a broad range of savings mechanisms. Adoption of the rollover would encourage saving and investment because it would increase the after-tax yield from these activities. Our economy would benefit from the larger pool of savings created through the tax-free rollover account as higher levels of saving will make possible

a higher level of investment. With higher levels of investment, worker productivity can increase, leading to lower rates of inflation, higher real income, greater economic growth, increased job creation, and increased tax revenues.

Conclusion

A strong case can be made for the need to enact bold and innovative legislation to encourage individual saving and investment. The crucial nature of the capital formation problem, which has become increasingly evident in the 1970's, indicates the need to shape the tax system so as to encourage saving and productive investment.

S. 1543 is a step in the right direction, and we urge the Committee to act favorably on it. In addition, we urge the Committee to consider an even broader "rollover" approach which would help assure that the 1980's will be a decade of strong, non-inflationary economic growth.

10/31/79

STATEMENT OF EDISON ELECTRIC INSTITUTE
CONCERNING S. 1543
BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT,
SENATE FINANCE COMMITTEE

This statement is submitted by the Edison Electric Institute (EEI). EEI is the principal association of investor-owned electric power companies in the United States. Its members comprise 99 percent of the investor-owned segment of the industry and serve 77 percent of all electricity users in the country.

EEI and its member companies have consistently advocated tax legislation which would encourage and facilitate capital formation, including the proposals in S. 1543 for capital formation through tax-deferred dividend reinvestment.

S.1543 is of considerable importance to the industry. Our needs for new common equity financing are expected to be $25-$30 billion during the next five years. The tax-deferred dividend reinvestment proposal would assist significantly in encouraging investment in utility common stock and aiding in the formation of capital for utility investment. The substantial financing needs of the industry dictate that some encouragement of investment in utility common stocks is essential at a time many utility stocks are trading below book value.

S. 1543 would provide a treatment comparable to that now provided conventional stock dividends. Many utility stockholders purchase their stock for the cash yield and it is therefore not practical for utilities to change their dividend policy to provide for lower cash dividends to be supplemented by stock dividends. It should be pointed out that the public service obligation of utilities distinguishes our financing requirements from those of other industries. Our industry must raise capital on a continuing basis because we must construct required plant to meet customer demand. Common stock is the foundation of our capital structure and, to continue construction, equity must often be obtained from external sources even at times of unfavorable market conditions. The tax-deferred dividend reinvestment proposal offers an important and needed way to make equity investment more attractive.

Additionally, tax-deferred dividend reinvestment would contribute to the alleviation of the burden of double taxation of corporate earnings, an essential element of long-term capital formation.

In conclusion, encouragement of capital formation through tax-deferred dividend reinvestment, as proposed by S. 1543, will be an important step in improving the overall financial condition of American industry. The investment

stimulus is needed and justifiable for business generally and specifically for the electric industry. The tax benefits clearly would be meaningful to the electric utility industry and its customers.

The Dayton Power and Light Company
Courthouse Plaza, S.W., Box 1247, Dayton, Ohio 45401

Robert E. Frazer
President

November 21, 1979

Honorable Michael Stern, Staff Director
Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Supporting Statement of The Dayton Power and Light Company on S.1543 before Senate Finance Subcommittee on Taxation and Debt Management.

Dear Chairman Byrd and Members of the Committee:

This statement is being made in support of and to endorse the proposal included in S.1543 (and H.R.654). Both Senate and House Bills provide for deferral of current Federal Tax on dividends reinvested in an original issue stock of any company having a qualified dividend reinvestment plan. Adoption of the dividend reinvestment proposal would:

1. Encourage capital formation.
2. Eliminate or reduce the double tax on dividends reinvested.
3. Encourage individual savings to provide supplemental income for retirement.
4. Treat stock acquired by reinvestment of dividends as conventional stock dividends.
5. Assist in financing essential energy facilities and in dealing with the energy problem.
6. Help reduce consumer demand and counter inflation.

The Dayton Power and Light Company has an Automatic Dividend Reinvestment and Stock Purchase Plan and actively supports the work of the Committee for Capital Formation through Dividend Reinvestment. We are vitally concerned about our ability to raise the necessary capital to continue our construction program essential for our customers' future needs. The Company's construction program for the 1979-1983 period, including $224 million for 1979 and an estimated $275 million for 1980, will total more than $1 billion.

We feel the adoption of S.1543 (and H.R.654) would stimulate greater participation in dividend reinvestment programs such as ours and make a significant contribution to capital formation in the utility industry where capital is so urgently needed. We strongly urge your favorable consideration of S.1543.

Respectfully,

R. E. Frazer

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